CHAPTER 7—Coverage and nondiscrimination with emphasis on determinations processing

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

CAUTION-REPRINTED MATERIAL

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

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SECTION I-COVERAGE-INTRODUCTION AND OVERVIEW

This course book (the Guide) provides a comprehensive guide for the coverage and nondiscrimination regulations and relates these requirements to the Revenue Procedure 93-39 determination letter requirements. The Guide, first available in 1996, was based on the Continuing Professional Education (CPE) texts of 1993, 1994 and 1996, the alert guidelines (worksheet 5), and Revenue Procedure 93-39. For the 1997 CPE, the Guide was substantially revised to provide:

- An-depth analysis of the safe harbor requirements for defined benefit plans
- An additional section for examining DB plans, including a discussion on Rev. Proc. 93-42 and reliance on a determination letter,
- This guide can be used for reviewing determination letter requests as well as examining a plan for coverage and nondiscrimination. Any questions should be referred to Al Reich at (202) 622-7581, Bob Masnik at (202) 622-7525 or Jerry Livingston at (410) 962-2330.

The coursebook begins by comparing the old coverage and nondiscrimination requirements with the new coverage and nondiscrimination requirements. Next, the coverage rules are reviewed in detail, with a flow chart and a comprehensive example. The nondiscrimination rules are then covered in detail including the "amounts testing" safe harbor and general test requirements. The steps in running the general test determining accrual rates (with the optional rules), forming rate groups and applying coverage to rate groups are then explained with examples.

After the technical portion, the coursebook then shifts to an analysis of Rev. Proc. 93-39. Although Rev. Proc. 93-39 has been superseded by Rev. Proc. 97-6, the text will continue to refer to Rev. Proc. 93-39. The purpose and the sections of Revenue Procedure 93-39 are explained. Appendix A and demonstrations 5 and 6 are then summarized. Demonstrations 5 and 6 are interrelated with the coverage and nondiscrimination rules that were covered in the technical portion. Finally, the information required when a rate group fails the ratio percentage test is summarized, along with a comparison of the average benefits test for coverage and the modified average benefits test for nondiscrimination.

UNDERLYING CONCEPTS OF COVERAGE AND NONDISCRIMINATION-COMPARISON OF OLD RULES

With the Tax Reform Act of 1986, regulations were issued under coverage and nondiscrimination substantially changing those requirements. However, upon close analysis, the underlying theory of coverage and discrimination remained the same. The changes consisted of a shift away from facts and circumstances analysis to objective numerical testing. This section describes those changes.

COVERAGE

OLD COVERAGE RULES

There were three tests under the old coverage rules, the 70% and 70-80% test and the "b" test. The coverage requirements looked at the entire plan population. (The new coverage requirements now look at a relative comparison of the HCEs and NHCEs who benefit under the plan).

The (b) test was a facts and circumstances analysis determining whether the plan covered reasonable classification of HCEs and NHCEs, that is, whether a sufficient portion of the lower paid employees participated in the plan.

CURRENT COVERAGE

With respect to current coverage, the ratio percentage test compares the proportion of NHCEs and HCEs benefitting under the plan, i.e percentage of NHCEs divided by the percentage of HCEs benefitting.

> The definition of benefitting became more refined, requiring an actual allocation or benefit be accrued for the participant in order to be considered as covered under the plan.

The reasonable classification test or (b) tests retained the facts and circumstances test, but added another numerical test, the nondiscriminatory classification test, which establishes a minimum required ratio percentage that the plan must satisfy.

The average benefit percentage test was added which is also numerically based. This test shifts the testing to a comparison of the rate at which the plan provides benefits for HCEs and NHCEs.

NONDISCRIMINATION-OLD RULES

OVERALL FACTS AND CIRCUMSTANCES TEST

The old discrimination requirement was a facts and circumstances test that determined whether benefits were provided to a fair cross section of employees or whether the benefits discriminated in favor of the "prohibited group", that is officers, shareholders or highly compensated employees. Whether benefits discriminated in favor of the prohibited group was a facts and circumstances test.

Thus, a company could have a lot of little plans and each plan could have provided a different benefit. If each plan passed coverage (facts and circumstances), all plans were qualified.

TESTED ULTIMATE BENEFITS

Another important distinction with the old rules is that in a defined benefit plan, the ultimate benefits of the employees were compared. A plan was nondiscriminatory if equivalent ultimate benefits were provided to the participants. A plan was not discriminatory if each participant would receive the same benefit at normal retirement age.

These rules were based on the assumption that a DB plan would remain in existence indefinitely.

Defined contribution plans compared the contributions made for each employee each year.

NONDISCRIMINATION-NEW RULES

NONDISCRIMINATION LOOKS AT RATE GROUPS INSTEAD OF FAIR CROSS SECTION OF EMPLOYEES

Nondiscrimination is now determined by applying objective numerical coverage rules (instead of facts and circumstances analysis) to objectively determined rate groups (instead of a facts and circumstances fair cross section analysis). However, the concepts are the same, coverage is applied to each rate group as the fair cross section analysis was applied for each separate little plans.

NEW RULES ARE EVOLUTIONARY, NOT REVOLUTIONARY

Think of these new rules as evolutionary, not revolutionary, since these are the same concepts as the old rules, but they have been refined and made more numerical. In addition, the definitions have become more refined.

SHIFTED FOCUS FROM LOOKING AT TOTAL BENEFIT

In addition, in determining discrimination, the regulations shifted the focus from looking at the benefit provided under the plan to looking at the rate of accrual for each employee for each plan year.

With the issuance of the latest regulations under IRC section 401(a)(4), the assumption was made that a corporation's DB plan might not remain in existence indefinitely. Because of this assumption, the discrimination rules focus on the rate of accrual for a participant for each year. However, a plan can also satisfy the nondiscrimination requirements if the plan is considered a "safe harbor" plan. With such a plan, the nondiscrimination requirements are satisfied by looking to the plan document.

EXAMPLE 1 Comparing old and new discrimination rules.

Taylor Tool Inc. has a defined benefit plan which accrues benefits under the fractional accrual rule. The benefit provided is 30% x highest 3 years average compensation. Ben, age 60 is highly compensated and Jerry, age 25, not highly compensated, started working on January 1, 1993. Normal retirement age is 65.

Under the old non-discrimination rules, since both Ben and Jerry will receive the same ultimate benefit (30% x highest 3 years average compensation), the plan is nondiscriminatory.

Under the general test, the rate of Ben's benefit accrual would be compared with the rate of Jerry's benefit accrual. Since Ben's rate of accrual (6% per year or 30%/5) is much higher than Jerry's rate of accrual (.75% per year or 30%/40), the plan may fail the general test, depending on the rates of accrual of the other participants.

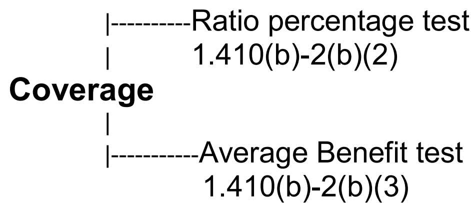
Under the general test, the rate of accrual for each participant has to be determined each year using the participant's years of service, compensation, etc.. Whether a plan meets the general test depends on an analysis of the employee population as well as benefits provided for in the plan document. Under the prior rules, analysis of the plan document alone was sufficient..

COVERAGE, INCLUDING THE AVERAGE BENEFITS TEST.

IMPORTANCE OF COVERAGE

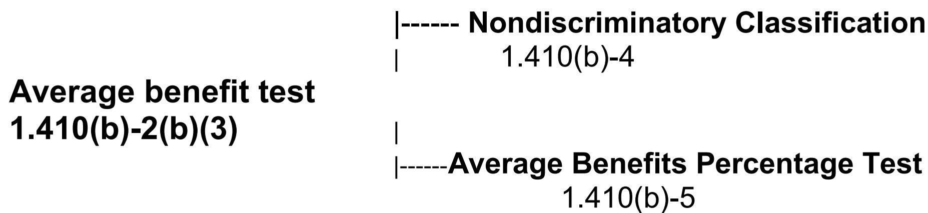
Keep in mind that the coverage rules are the foundation of the nondiscrimination requirements under the regulations. The general test under the amounts requirement is an application of the coverage requirements (with a few modifications) to rate groups. Current availability under benefits, rights and features also applies the coverage rules. The "gateway test" for applying the separate lines of business rules is an application of coverage without the average benefits percentage test. Thus, understanding coverage is essential for understanding the other nondiscrimination areas, especially the general test, because these areas all use slightly different versions of the same underlying coverage principles

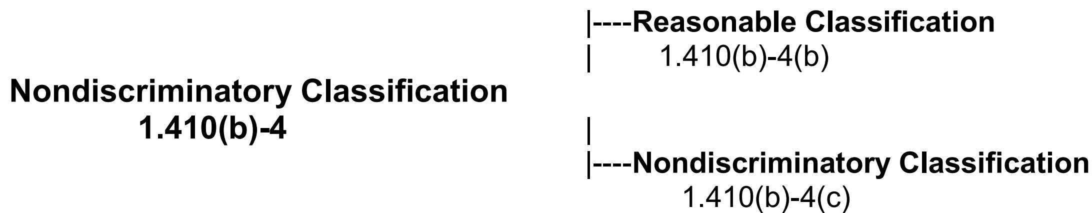
FLOW CHART-COVERAGE TESTS

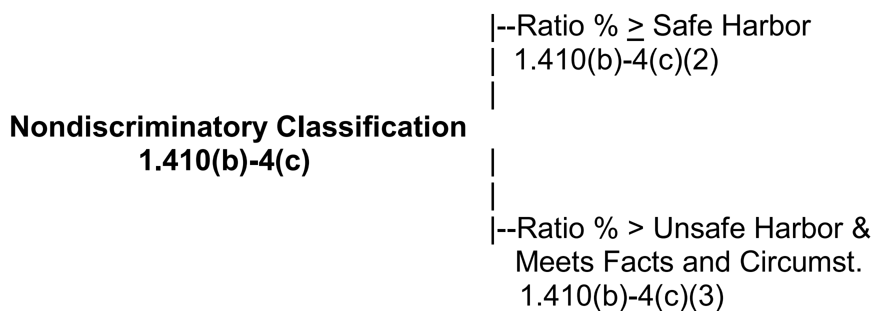


Ratio percentage---<u>% NHCEs who benefit under the plan</u>
1.410(b)-2(b)(2) % HCEs who benefit under the plan

$\geq$ 70% 1.410(b)-2(b)(2)







Average Benefit Percentage-

NHCE benefiting percentage must be at least 70% of HCE benefiting percentage Use allocation or accrual rates under 1.401(a)(4)

The above flow chart is helpful to gain a quick understanding of how the various coverage tests fit together.

COVERAGE TESTS-INTRODUCTION

There are two basic tests for satisfying coverage,

1. ratio percentage and
2. average benefits test.

First, try to satisfy the ratio percentage test. Otherwise, the plan must satisfy the average benefits test.

THE RATIO PERCENTAGE TEST

The ratio percentage test is satisfied if the plan's "ratio percentage" is greater than or equal to 70%.

Defining benefiting percentage

To determine the ratio percentage, first determine the benefiting percentages.

The % NHCEs benefiting is a ratio:

$$\frac{\text{NHCEs benefiting under the plan}}{\text{Total nonexcludable NHCEs}}$$

The % HCEs benefiting is the same ratio, but with HCEs:

$$\frac{\text{HCEs benefiting under the plan}}{\text{Total nonexcludable HCEs}}$$

Defining ratio percentage

The ratio percentage is a ratio:

$$\frac{\text{NHCE benefiting percentage}}{\text{HCE benefiting percentage}}$$

The ratio percentage is determined by dividing the NHCE benefiting percentage by the HCE benefiting percentage. If this ratio percentage falls below 70%, apply the average benefits test.

Defining Nonexcludable and Excludable Employees

The concept of nonexcludable and excludable employee is important for determining who is counted for coverage and nondiscrimination. If an employee is considered excludable, that employee generally does not exist and is not counted for coverage and nondiscrimination purposes. The list of excludable employees can be found in section 1.410(b)-6.

The excludable employees are as follows:

Ees who have not met the minimum age and service,

Nonresident aliens,

Collectively bargained Ees,

Employees of Qslobs,

Certain terminating employees

AVERAGE BENEFITS TEST

If the plan does not satisfy the ratio percentage test, the average benefits test must be applied. The average benefits test has 2 parts:

- Nondiscriminatory classification test and
- average benefits percentage test.

Nondiscriminatory classification

Nondiscriminatory classification is comprised of two tests:

The reasonable classification test:

This is a facts and circumstances analysis, whether the classification satisfies "reasonable business criteria".

The nondiscriminatory classification test:

This is a numerical test which requires a couple of steps.

1. First, determine the NHCE concentration percentage:

   Total nonexcludable NHCEs
   Total nonexcludable employees

2. With this concentration percentage, refer to the chart in the regulations (1.410(b)-4(c)(4)(iv) to determine the safe harbor and unsafe harbor percentages.

3. Compare the plan's ratio percentage with the safe harbor and unsafe harbor percentages. The nondiscriminatory classification test compares the safe and unsafe harbor percentages with the plan's ratio percentage test.

   - If the plan's ratio percentage is equal or above the safe harbor %, then the plan satisfies this part of the test.

   - If the plan's ratio percentage is below the safe harbor %, but above the unsafe harbor %, then the nondiscrimination classification test is satisfied based on the facts and circumstances, including the factors described in section 1.410(b)-4(c)(3). The employer can come in (with a determination letter application) with facts and circumstances, including these factors.

   - If the plan's ratio percentage is equal or below unsafe harbor %, then it fails coverage.

The average benefits percentage test

This is the second part of the average benefits test. With this test, the plan's average benefit percentage has to be equal or greater than 70%. The average benefit percentage is calculated:

$$\frac{\text{Actual benefit \% of NHCEs}}{\text{Actual benefit \% of HCEs}}$$

The actual benefit percentage of the NHCEs is the average of all the employer's (including controlled groups) NHCE's benefit percentage. The same calculation is true for the HCE actual benefit percentage.

Defining employee benefit percentages

The benefit percentage is defined as the normal accrual rate or allocation rate determined under the 401(a)(4) regulations, expressed as either a percent of annual average compensation or a dollar amount. For defined contribution plans, plan year compensation can be used.

The employee benefit percentage is calculated in the same manner as the accrual rates for nondiscrimination. Thus, the employer can utilize the same optional rules such as cross testing (under -8), imputing permitted disparity, restructuring (under -9) etc. that are used to determine the accrual rates under the general test of section 1.401(a)(4)-2 or -3. However, the employer does not have to utilize the same optional rules for average benefits percentage as those used for nondiscrimination.

Note that the same limitations that apply when using these optional rules also apply when determining the employee benefit percentage for the average benefit percentage test. For example, for ESOPs, cross testing cannot be used to determine the employee benefit percentages since ESOPs cannot be cross tested in determining the accrual rates for the general test.

THE EMPLOYEES AND PLANS THAT ARE COUNTED FOR THE AVERAGE BENEFITS PERCENTAGE TEST

Remember, all non-excludable employees of the employer (or controlled group) are counted. Thus, if a non-excludable NHCE does not benefit under the plan, the NHCE benefit percentage is 0% and is part of the calculation, even if that employee is part of another company of the controlled group.

In addition, all the benefit percentages of all the other plans of the controlled group are included in this test, even 401(k)s and ESOPs.

The average benefit percentage test does not apply the mandatory disagregation rules for ESOPS and 401ks. Thus, deferrals to a 401(k) plan are counted as employer contributions for the Average Benefits Test, see section 1.410(b)-5(d) and 1.410(b)-7(e).

Employee contributions are not taken into account to determine employee benefit percentages

When determining employee benefit percentages, only employer-provided contributions and benefits are taken into account. Thus, employee contributions (both allocated to separate accounts and not allocated to separate accounts) and benefits derived from such contributions are not taken into account for determining employee benefit percentages.

PLANS WITH CERTAIN EARLY RETIREMENT BENEFITS MUST USE MOST VALUABLE ACCRUAL RATE FOR EMPLOYEE BENEFIT PERCENTAGE

Under section 1.410(b)-5(d)(7), if:

any DB plan in the testing group provides for early retirement benefits to any highly compensated employees, and

the average actuarial reduction for any one of these benefits commencing in the five years prior to the plan's normal retirement age is less than four percent per year,

then the aggregate or equivalent most valuable allocation or accrual rate must be substituted for the normal rates in determining the employee benefit percentages.

However, this rule does not apply if these early retirement benefits are currently available to NHCEs that are at least 70 percent of the HCEs to whom these benefits are currently available.

EXAMPLE (2) Illustrating section 1.410(b)-5(d)(7)

Moose Antler Lodge is a subsidiary of the Tree Frog Wildlife Preserve. Moose sponsors a DB plan and is required to satisfy the average benefits test for coverage. If a participant elects to receive his/her benefit prior to NRA (age 65), the plan provides an early retirement benefit equal to 100% of the participant's accrued benefit as of his early retirement date. However, if the participant elects to receive his/her accrued benefit earlier than age 62, his/her accrued benefit is reduced if by 5/12% for each full month by which the date the pension payments actually precedes age 62.

Moose's early retirement benefit is currently available to a ratio percentage of 65% of NHCEs.

Based on the above, early retirement reductions are as follows:

Age	65	64	63	62	61	60
Early Retirement benefit	**100%**	**100%**	**100%**	**100%**	**95%** **100%-(5/12% x 12**	**90%** **100%-(5/12% x 24**

Since the average annual reduction is less than 4%, for any one of the first 3 years (65-62), the plan must use the most valuable accrual for determining the average benefits percentage.

EXAMPLE (3)

Refer to Moose Head. Assume instead that the early retirement benefit is currently available to 73% of the NHCEs. In this case, the plan can use the normal accrual rate because the ratio percentage is above 70%.

EXAMPLE (4)

Refer to Moose Head. Assume instead that the early retirement benefit is the actuarial equivalent of the accrued benefit at age 65. In this case, the plan's actuary would have to provide a table of the reduction factors to determine whether the reduction is less than 4% per year in any of the five years prior to NRA.

Age	***65***	***64***	***63***	***62***	***61***	***60***
Early Retirement benefit	100%	97.38%	93.7%	89.83%	85.75%	81.48%

The reduction for each age is as follows:

Age	***Reduction***	***Calculation***
Age 64	3.62%	(100%-97.38%)
Age 63	3.68%	(97.38%-93.7%)
Age 62	3.87%	(93.7%-89.83%)
Age 61	4.08%	(89.83%-85.75%)
Age 60	4.27%	(85.75%-81.48%)

Note, that if the employer is using an actuarial equivalent calculation to determine the reduction to the accrued benefit and the employer uses a pre-retirement rate of 4% or more, then generally the reduction will be 4% or greater because of discounting using such rate.

ADDITIONAL OPTIONAL RULE UNDER 1.401(B)-5(E)-EMPLOYEE BENEFIT PERCENTAGES CAN BE DETERMINED AS SUM OF SEPARATE EMPLOYEE BENEFIT PERCENTAGES.

Section 1.410(b)-5(e)(2) provides that the employee benefit percentages may be determined as the sum of separately determined employee benefit percentages for each of the plans in the testing group that are aggregated, provided that these employee benefit percentages are determined on a consistent basis under section 1.410(b)-5(d)(5)(iii) of this section. Thus, any optional or alternative rule that is used for one plan must be used on a consistent basis for all employees and for all plans.

Note that section 1.410(b)-5(e)(2)(iii) provides that plans can be inconsistent with respect to certain items, including different 414(s) definitions of compensation, different definitions of average annual compensation etc. and can still apply this optional rule.

ADDITIONAL OPTIONAL RULE-DETERMINATION OF EMPLOYEE BENEFIT PERCENTAGES WITHOUT REGARD TO PLANS OF ANOTHER TYPE-SECTION 1.410(B)-5(E)(3)

Section 1.410(b)-5(e)(3) provides that employee benefit percentages may be determined under plans of one type (DB or DC) by treating all plans of the other type as if they were not part of the testing group. Thus, the plans of the other type can be disregarded when determining the employee benefit percentages.

If this optional rule is used for DC plans (and DB plans are not considered part of the testing group):

- all DC plans in the testing group must be determined on a contributions basis, and
- benefits under any DB plans may not be included in the employee benefit percentage.

If this optional rule is used for DB plans (and DC plans are not considered part of the testing group):

- all DB plans in the testing group must be determined on a benefits basis and
- allocations under any DC plans may not be included in the employee benefit percentage.

A plan (DB or DC) does not satisfy the average benefits percentage test using this method unless each of the plans of the other type (DC or DB) satisfy either:

- The average benefits test using this method or
- the ratio percentage test under section 1.410(b)-2(b)(2).

SPECIAL RULE FOR COLLECTIVELY BARGAINED PLANS UNDER SECTION 1.410(B)-5(F)

A plan (as determined without regard to the mandatory disaggregation rule of section 1.410(b)-7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefits percentage test of this section if:

The provisions of the plan applicable to each employee are identical to every other employee in the plan, including the plan benefit formula, optional forms of benefit, etc. and

The plan would satisfy the ratio percentage test of section 1.410(b)-2(b)(2) if the excludable employee (-6(d)) and mandatory disaggregation rules (-7(c)) for collectively bargained and non-collectively bargained rules did not apply.

EXAMPLE 5 ILLUSTRATING COVERAGE

Health Bar Co. has a total of 305 employees.

100 employees are covered under a collective bargaining agreement.

Division A has 60 NHCEs and 72 HCEs.

Division B has 65 NHCEs and 8 HCEs.

Division C has 100 NHCEs who are covered under the collective bargaining agreement.

Health Bar Co. maintains a profit sharing plan covering only Division A and provides a three percent allocation each year for Division A employees.

Does the plan satisfy coverage?

SOLUTION

First, determine the total number of non-excludable NHCEs and HCEs. Since Division C employees are covered under a collective bargaining agreement, these employees are excludable and not considered when testing coverage. Thus, there are 205 total non-excludable employees, 125 NHCEs and 80 HCEs.

Ratio percentage test

Remember, the ratio percentage is a fraction:

% NHCEs benefiting under the plan
% HCEs benefiting under the plan

The benefiting percentage for NHCEs (or HCEs) is:

NHCEs (or HCEs) benefiting under the plan
Total NHCEs (or HCEs) of the employer

Applying the above facts, the NHCE benefiting percentage is:

60 NHCEs benefiting (Division A NHCEs)
125 total Nonexcludable NHCEs

or 48%.

The HCE benefiting percentage under the plan is:

72 NHCEs benefiting (Division A HCEs)
80 total Nonexcludable HCEs

or 90%.

Remember, once the benefiting percentages are determined, can now calculate the ratio percentage:

48% (NHCE benefiting percentage)
90% (HCE benefiting percentage)

or 53%.

Since the plan's ratio percentage test is below 70%, it fails the ratio percentage test. Thus, the average benefits test must be applied.

Average benefits test

Remember, there are two parts, the nondiscriminatory classification test and the average benefits percentage test.

Nondiscriminatory classification test-this test is comprised of two parts:

1. Reasonable classification test

   Applying the above facts, the employees who benefit under the plan are classified by division (only Division A employees participate). Classification by division would be considered a reasonable classification.

2. Nondiscriminatory classification test

   First, determine the NHCE concentration percentage. Using the concentration percentage, determine the safe and unsafe harbor percentages by referring to the table in the regulations. The concentration percentage is 125/205 or 60.9%.

In this case, the 60.9% is not rounded to 61%, but is considered 60%. The regulations require that the safe and unsafe harbor percentage starts at 50% and 40% respectively and is reduced .75% for each whole percentage point by which the NHCE concentration percentage exceeds 60%. Since 60.9% does not exceed 60% by a whole percentage point, the safe and unsafe harbor percentages are determined using 60%. Thus, the plan's safe and unsafe harbor percentage is 50% and 40% respectively.

The plan's ratio percentage is compared with the safe and unsafe harbor percentages. Since the plan's ratio percentage of 53% is above the safe harbor percentage, the nondiscriminatory classification test is satisfied.

Average benefits percentage test-second part of average benefits test

First, determine the average benefit percentage for both the NHCEs and the HCEs. Remember, the average benefit percentage is calculated:

$$\frac{\text{Average benefit \% of NHCEs}}{\text{Average benefit \% of HCEs}}$$

The average benefit percentage of the NHCEs is the average of all the employer's nonexcludable NHCE's employee benefit percentage. This percentage is defined as the normal accrual rate or allocation rate determined under the 401(a)(4) regulations. If a nonexcludable employee does not benefit under the plan, the percentage is 0%.

Assume the allocation rate under the plan is 3% and no optional rules were applied. The NHCE average benefit percentage is:

60 NHCEs @ 3% (180%) (Division A ees)
65 NHCEs @ 0% (0%) (Division B ees)

The average benefit percentage is averaged over the total number of nonexcludable employees or 125 ees. Thus, the average benefit percentage for NHCEs is 180%/125 employees or 1.44%.

The average benefit percentage for the HCEs is:

72 HCEs @ 3% (216%) (Division A ees)
8 HCEs @ 0% (0%) (Division B ees)

Thus, the average benefit percentage for HCEs are 216%/80 or 2.7%.

The average benefit percentage of the plan is:

1.44% (NHCE average benefit percentage)
2.7% (HCE average benefit percentage)

or 53%. Thus, this plan fails the average benefits percentage test. Note that 53% was the ratio percentage test of the plan. However, this is just a coincidence.

SECTION II, SAFE HARBOR UNIFORMITY REQUIREMENTS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

The new comparability regulations

New determination procedures

Repeal of 415(e),

401(k) safe harbor provisions and

HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

NONDISCRIMINATION REQUIREMENTS

OVERALL NONDISCRIMINATION REQUIREMENTS UNDER TREAS. REG. SECTION 1.401(A)(4)

The regulations under IRC section 401(a)(4) provide for three overall requirements. Treas. Reg. section 1.401(a)(4)-1:

1. The benefits or contributions under a plan must be nondiscriminatory in amount. Treas. Reg. section 1.401(a)(4)-2 & -3 CPE 93, Chapters 1-3
2. The benefits rights and features provided under a plan must be made available to all employees in the plan in a nondiscriminatory manner. Treas. Reg. section 1.401(a)(4)-4 CPE 93, Chapter 8

3. The timing of plan amendments and plan terminations must not have the effect of discriminating in favor of the highly compensated employees (HCEs). Treas. Reg. section 1.401(a)(4)-5 CPE 93, Chapter 8

These requirements comprise the basic structure of the (a)(4) regulations and the other discrimination requirements stem from these three requirements. For example, whether the plan satisfies the safe harbor or the general test stems from the nondiscriminatory amount requirement.

NONDISCRIMINATORY AMOUNT REQUIREMENT

With respect to the nondiscrimination in amounts requirement, plans can either meet one of the safe-harbors or the general test. If a plan does not satisfy one of the safe harbors, the plan must satisfy the general test.

Comparison of safe harbor and general test requirements

Safe-harbors are based on uniformity requirements and require an analysis of the plan's provisions. A plan can be either a Design Based Safe Harbor (satisfying the safe harbor requirements solely by plan language) or non-design based safe harbor (satisfying the safe harbor requirements by plan language and limited numerical testing). CPE 93, chapter 1

The general test is based on whether "rate groups" pass coverage under IRC section 410(b). Coverage is determined by considering the rate groups as a separate plan. This test requires extensive numerical analysis outside of the plan document. CPE 93, chapters 2-3

Advantages to safe harbor

For the design based safe harbors, the plan, as written, would satisfy the amounts requirement of 1.401(a)(4)-2 or -3. The employer would not have to maintain additional records or perform numerical testing as would be required under the general test.

Advantages to general test

Although the general test is much more complicated to administer, the employer does not have to satisfy the uniformity rules as required for safe harbor plans. Thus, the employer can provide for broader types of allocation or benefit formulas.

SAFE HARBOR FOR DC PLANS 1.401(A)(4)-2(B)

INTRODUCTION

A DC plan must provide for either type of allocation formula to be a safe harbor plan:

- Uniform allocation formula (design based safe harbor) or
- Uniform points allocation formula (non-design based safe harbor).

A uniform allocation formula is a formula that allocates to each employee:

- The same percentage of plan year compensation,
- the same dollar amount, or
- the same dollar amount for each uniform unit of service (not to exceed one week).

This formula allows allocations to be based on compensation, years of service and age. An employer would have to perform additional numerical tests to determine whether the plan passes amounts testing under this formula.

Points are assigned for compensation, years of service or age (or in any combination). Points have to be assigned for either age or service. The points are totalled for each employee and an allocation is made based on the ratio:

$$\frac{\text{Employee points}}{\text{Total points of all employees}}$$

Requirements for Uniform Points Allocation

Each employee must receive the same points for each year of age, for each year of service and for each unit of compensation.

A numerical test must be satisfied. Once allocations are determined, the average allocation rate for highly compensated employees (HCEs) cannot exceed the average allocation rate for non-highly compensated employees (NHCEs).

PROVISIONS PERMITTED IN DC SAFE HARBOR PLANS—1.401(A)(4)-2(B)(4)

A DC safe harbor plan can provide for the following (and still be considered a safe harbor plan):

1. different entry dates (as permitted in IRC section 410(a)(4),
2. conditions on allocations, such as employed on the last day of the year or complete 1000 hours of service,
3. limits on allocations, such as a maximum dollar amount etc.,
4. provide lower allocations to HCEs,
5. provide for two or more formulas if certain requirements are met,
6. provide for permitted disparity.

SECTION 401(K) AND (M) PLANS

Section 401(k) and (m) plans that satisfy the requirements of the ADP or ACP tests do not have to satisfy the amounts requirements under section 1.401(a)(4)-2.

However, these plans still have to meet the other two requirements under 1.401(a)(4)-4 and -5, (availability of benefits rights and features and special circumstances).

Exceptions-when 401(k) and (m) plans have to meet amounts testing

Non-qualified cash or deferred arrangement (see CPE 1996,chapter 6, for a more detailed discussion of nonqualified 401(k) plans)

A non-qualified cash or deferred arrangement has to satisfy the amounts requirement under 1.401(a)(4)-2.

QUALIFIED CASH OR DEFERRED ARRANGEMENT

Elective contributions not meeting certain conditions

If elective contributions under a qualified cash or deferred arrangement do not meet the allocation or contribution requirements under 1.401(k)-1(b)(4)(i), then these contributions must satisfy the amounts requirement.

Qualified non-elective contributions (QNECs)

If there are any QNECs, these contributions would also be tested under the amounts requirement. However a plan with no other formula satisfies the nondiscriminatory amount requirement because only NHCEs are benefitting. A plan with a profit sharing formula and a QNEC would still meet the uniformity requirement under the special rule for multiple formulas, section 1.401(a)(4)-2(b)(4)(vi).

SAFE HARBOR FOR DEFINED BENEFIT PLANS-1.401(A)(4)-3(B)

INTRODUCTION

The following section provides an in-depth review of the requirements that a defined benefit plan must satisfy in order to be considered a safe harbor plan. This section can be used in the determination letter or examination context. Please note that if a plan is determined not to be a safe harbor plan in either context, in addition to the reliance issues, the plan may still satisfy the nondiscrimination requirements by satisfying the general test.

For example, if upon applying for a determination letter, the plan is determined not to be a safe harbor, the plan does not automatically fail the nondiscrimination requirements. However, if a favorable determination letter on the nondiscrimination requirements is requested, the employer may either amend the plan to satisfy the safe harbor requirements or submit additional demonstrations satisfying the general test.

OVERALL SCHEME OF SAFE HARBOR REQUIREMENTS

INTRODUCTION

In order for a DB plan to be considered a safe harbor plan, the formula has to satisfy two requirements:

1. the uniformity requirements under 1.401(a)(4)-3(b)(2) (this chapter)and

2. one of the accrual requirements (following chapter) under

   - 1.401(a)(4)-3(b)(3) for unit credit plans,
   - 1.401(a)(4)-3(b)(4) for fractional accrual rule plans, or
   - 1.401(a)(4)-3(b)(5) for fully insured plans described under section 412(i).

UNIFORMITY REQUIREMENTS-FIVE REQUIREMENTS

In order for a DB formula to be considered uniform, the formula must satisfy each of the following five requirements:

Uniform normal retirement benefit,

Uniform post normal retirement benefit,

Uniform subsidies,

No contributory DB plans allowed, and

The period of accrual requirement

UNIFORM NORMAL RETIREMENT BENEFIT-SECTION 1.401(A)(4)-3(B)(2)(I)-FIRST REQUIREMENT TO SATISFY THE UNIFORMITY REQUIREMENTS

The plan has to provide to all employees the same benefit formula providing the same percentage of average annual compensation or the same dollar amount for employees who will have the same number of years of service at normal retirement age. In addition, the benefit must be payable in the same form (life annuity, etc.) to all employees. Please note that there are exceptions to the uniformity requirements under sections 1.401(a)(4)-3(b)(6) and 1.401(a)(4)-3(f).

EXCEPTIONS TO UNIFORMITY REQUIREMENT

A plan's normal retirement benefit (benefit formula) may be considered uniform even though two participants with the same years of service with the employer have different accrued benefits. Two situations in which this can happen are:

1. if the plan has had a fresh start or
2. if the plan grants past, pre-participation or imputed service.

FIRST EXCEPTION TO UNIFORMITY REQUIREMENT-FRESH START, SECTION 1.401(A)(4)-13

If the plan has a fresh start date, the plan formula has been amended and the accrued benefit before that date is disregarded in determining whether the amended benefit formula meets the uniformity requirements. In order to satisfy the fresh start requirements under 1.401(a)(4)-13(c), the accrued benefits of employees in the fresh start group must be frozen as of the fresh start date and the accrued benefits must be determined under one of the fresh start formulas.

A fresh start group is defined as all employees who have accrued benefits as of the fresh start date and one hour of service after the fresh start date. A fresh start group may consist of only certain employees, such as members of an acquired group of employees.

A fresh start date is usually the last day of the plan year. The day after the fresh start date is when the amended plan formula is effective.

For further information regarding fresh start, please see the fresh start section after the end of the general test section.

SECOND EXCEPTION TO UNIFORMITY REQUIREMENT-PAST, PRE-PARTICIPATION OR IMPUTED SERVICE-SECTION 1.401(A)(4)-11(D)(3)

Generally, service for periods in which an employee does not perform service as an employee or for periods in which the employee did not participate in the plan may not be taken into account in determining whether the plan satisfies amounts testing (safe harbor or general test) or provides nondiscriminatory benefits, rights and features. A plan that grants service for periods in which an employee does not perform service as an employee of the employer maintaining the plan or for periods in which the employee did not participate in the plan would not satisfy the uniformity requirements.

EXAMPLE 6 Illustrating pre-participation

The Dolen Comedy Club Co. has a defined benefit plan with a benefit formula: 2% x years of service x average annual compensation. In 1994, the Club acquires Kemper Album and Tape Co. and amends the plan to credit service with Kemp prior to the acquisition. In 1998, Adam has 4 years of service with Dole Co. and 10 years of service with Kemper Album prior to the acquisition. Roz started with Dole Co. in 1994 and has 4 years of service.

Without any special exceptions, the benefit formula would not be considered uniform because two employees (Adam and Roz) who have the same number of years of service with Dole Co. do not have the same accrued benefit (Adam has 28% of average annual compensation and Roz has 8% of average annual compensation).

Section 1.401(a)(4)-11(d)(3) permits past, pre-participation or imputed service to be taken into account in determining whether the plan satisfies amounts testing (safe harbor or general test) or benefits, rights and features. For a safe harbor plan, if the plan formula grants past, pre-participation or imputed service and satisfies the requirements under section 1.401(a)(4)-11(d)(3), such service can be taken into account and the benefit formula would still be considered uniform and satisfy the period of accrual requirement (see below).

Definition of past service

Under section 1.401(a)(4)-11(d)(3)(i)(B), past service refers to service prior to the plan's inception or prior to a plan amendment. Note that such service may be counted for purposes of amounts testing and availability (section 1.401(a)(4)-1(b)(2) and (b)(3)) because service for such periods generally would have been credited for the employee but for the timing of the plan establishment or amendment.

However, the grant of past service must satisfy the requirements of section 1.401(a)(4)-5, which provide that the timing of such establishment or amendment may not discriminate significantly in favor of the highly compensated employees.

Definition of Pre-participation service

Section 1.401(a)(4)-11(d)(3)(ii) defines pre-participation service refers as service prior to the employee's participation in the plan. Such service can be with the employer or with a prior employer.

EXAMPLE 7 If service taken into account satisfies -11(d)(3)

Same facts as previous example. If the plan satisfies the requirements of section 1.401(a)(4)-11(d)(3), Adam's service with Kemper may be taken into account. To determine uniformity, Adam's accrued benefit would be compared with another employee who has 14 years of credited service under the plan (even if all of this employee's service is with Dole).

Definition of Imputed Service

Imputed service refers to counting service after an employee has started participating in the plan while the employee is not performing services for the employer. For example, the plan can count service for the period that the employee performs service for another employer in a joint venture.

Requirements for pre-participation and imputed service credit

Section 1.401(a)(4)-11(d)(3)(i)(C) of the regulations provides that **if all three requirements** under section 1.401(a)(4)-11(d)(3)(iii) are satisfied, pre-participation service may be taken into account for purposes of determining whether a plan satisfies the nondiscrimination in amount or benefit requirement under section 1.401(a)(4)-1(b)(2) and the nondiscriminatory benefit, rights and features requirement under section 1.401(a)(4)-1(b)(3).

For imputed service, in addition to these three requirements, the requirements under 1.401(a)(4)-11(d)(3)(iv) must be satisfied.

The three requirements are as follows:

1. The provision granting pre-participation service must apply to all similarly situated employees (section 1.401(a)(4)-11(d)(3)(iii)(A)).
2. There must be a legitimate business reason, based on all the relevant facts and circumstances (section 1.401(a)(4)-11(d)(3)(iii)(B)).
3. Based on all the relevant facts and circumstances, a plan provision crediting pre-participation service must not by design or in operation discriminate significantly in favor of HCEs (section 1.401(a)(4)-11(d)(3)(iii)(C)).

First requirement for satisfying pre-participation or imputed service-Similarly situated requirement under section 1.401(a)(4)-11(d)(3)(iii)(A

A plan crediting pre-participation service to any HCE must apply on the same terms to all similarly situated NHCEs. The determination as to whether two employees are similarly situated is based on reasonable business criteria.

Employees who enter the plan as a result of a particular merger and who participated in the same plan of a prior employer are generally similarly situated. However, employees who are transferred to different joint ventures or different spun-off divisions are generally not similarly situated.

In example (2) of the regulations, Employer X acquires two trades or businesses from different employers. All employees became Division M employees and are covered by the same plan, Plan B. Plan B grants pre-participation credit for employees of one of the acquired companies, but not the other. Plan B still satisfied the similarly situated requirement because it is reasonable to treat employees of one acquired trade or business as not similarly situated to employees of another acquired trade or business.

Second requirement for satisfying pre-participation or imputed service-Legitimate business reason requirement under 1.401(a)(4)-11(d)(3)(iii)(B)

There must be a legitimate business reason, based on the facts and circumstances, for a plan to credit pre-participation service for service with another employer. Note that under 1.401(a)(4)-11(d)(3)(iv), a legitimate business reason does not exist for a plan to **impute service** after an individual has ceased to perform services as an employee for the employer maintaining the plan and is not expected to resume performing services with that employer.

The regulations list relevant factors such as:

1. Whether one employer has a significant ownership, control or other similar interest in, or relationship with, the other employer.
2. Whether the employees are an acquired group of employees, or the employees became employed by another employer in a transaction between the two employers that was a stock or asset acquisition, merger etc. involving a change in the employer of the employees of a trade or business.
3. Whether the two employers share interrelated business operations.
4. Whether the employers maintain the same multiple employer plan.
5. Whether the employers share similar attributes, such as operation in the same industry or same geographic area.
6. A legitimate business reason is deemed to exist for a plan to credit military service as service with the employer.

Third requirement for satisfying pre-participation or imputed service-Significantly discriminatory requirement under section 1.401(a)(4)-11(d)(3)(iii)(C)

Based on all of the relevant facts and circumstances, the pre-participation provision must not by design or in operation discriminate significantly in favor of HCEs. Section 1.401(a)(4)-11(d)(3)(iii)(C)(2) of the regulations lists examples of relevant facts and circumstances that can be used in determining whether the provision is discriminatory:

1. The degree of excess coverage under section 410(b) of NHCEs for the plan crediting the service, taking into account employees who are credited with the service.
2. The circumstances underlying the employee's transfer into the group of employees covered by the plan.
3. The relative number of employees other than five percent owners or the most highly-paid HCEs of the employer who are being credited with pre-participation service. This number takes into account all employees who have been over time, or are reasonable expected to be in the future, credited with such service.
4. Whether the service credit does not duplicate benefits, but merely makes an employee whole (prevents the employee from being disadvantaged with respect to benefits by a change in job

or employer or provides the employee with benefits comparable to those of other employees).

5. The degree of business ties between the current employer and the prior employer, such as the degree of ownership interest or other affiliation.
6. Whether the other employer maintains a qualified plan for its employees.
7. Whether the other employer maintains a qualified plan for its employees.
8. The existence of reciprocal service credit under other plans of the employer or the prior employer.
9. The type of service being credited.

EXPLANATION OF DEMONSTRATION 7

Demonstration 7, one of the demonstrations that may be required as part of the determination letter application, describes the nature of the past service, pre-participation or imputed service granted by the plan and references the applicable plan provision. In determining whether the requirements under section 1.401(a)(4)-11(d)(3) are satisfied when reviewing the determination letter application, the agent should review Demo 7 for anything that may violate one of these requirements. If so, the agent should ask the employer for further information to determine whether such requirements were violated.

AVERAGE ANNUAL COMPENSATION

To satisfy uniformity, the benefit formula must produce a benefit of the same percentage of average annual compensation or the same dollar amount for each employee with the same service. Thus, for a benefit formula that bases a benefit on compensation to be considered a safe harbor formula, compensation that is used must satisfy the definition of average annual compensation. In addition, average annual compensation must also be used in conjunction with the general test if accrual rates are determined as a percentage of compensation.

Section 1.401(a)(4)-3(e) provides the requirements for determining average annual compensation. One requirement is that the plan must use a definition of compensation that satisfies section 414(s). Such definition can be either a specific definition under section 1.414(s)-1(c) or an alternative definition that is determined to be nondiscriminatory under section 1.414(s)-1(d). If a plan with a safe harbor benefit formula is using an alternative definition of compensation, demo 9 is required to be submitted with the determination letter application.

With respect to an alternative definition of compensation, section 414(s)(3) prohibits a definition of compensation that discriminates in favor of highly compensated employees. Section 1.414(s)-1(d) provides that any definition of compensation satisfies section 414(s) if:

1. the definition of compensation does not by design favor highly compensated employees,
2. the definition is reasonable within the meaning of section 1.414(s)-1(d)(2) and
3. the definition satisfies the nondiscrimination requirement of section 1.414(s)-1(d)(3).

Thus, unless all three requirements under section 1.414(s)-1(d) are satisfied, the plan does not have a definition of compensation that satisfies section 414(s).

With respect to the determination letter application, Demo 9 is used to show that these requirements are satisfied for plans that have a design based safe harbor formula.

For general test plans or average benefit test plans, element H of Demonstration 6 is used to show that the definition of compensation is nondiscriminatory if the accrual rates are determined as a percentage of compensation.

Compensation definition used to based benefits under the plan does not have to be nondiscriminatory under section 414(s)

Note that a definition of compensation used to base benefits under the plan does not have to satisfy the requirements of section 414(s). A plan can use any definition of compensation under the plan for determining a participant's accrued benefit.

If this definition is discriminatory under section 414(s), the plan must satisfy the general test in order to satisfy the nondiscrimination requirements because the formula is not a safe harbor formula. With respect to the general test, although the plan base its benefits on any definition of compensation in determining the accrued benefit, a nondiscriminatory definition of compensation must be used to state the accrual rates as a percentage of compensation.

In addition to using one of the above definitions of compensation, the plan must satisfy the "averaging period" requirements. The average annual compensation is the highest average annual compensation determined over the averaging period in the employee's compensation history. The averaging period must consist of 3 or more consecutive 12 month periods, but need not be longer than the employee's period of employment. The averaging period may be modified to exclude certain periods of employment. An employee's compensation must be continuous, be no shorter than the averaging period and end in the current plan year. For further details, please see section 1.401(a)(4)-3(e)(2).

EXAMPLE 8 Illustrating average annual compensation

The Nelson Aerospace Plan is a defined benefit plan. The Plan determines benefits on the basis of each employee's annual compensation for the five consecutive plan years (or the employee's period of employment, if shorter) during the compensation history in which the average is highest. The compensation history used for this purpose is the last 10 plan years, plus the current plan year. In determining compensation for each plan year in the compensation history, the Plan defines compensation using a single definition that satisfies section 414(s) as a safe-harbor definition under Treas. Reg. section 1.414(s)-1(c) (total compensation). Plan A determines benefits on the basis of average annual compensation.

UNIFORM POST-NORMAL RETIREMENT BENEFIT-SECOND UNIFORMITY REQUIREMENT

The annual benefit provided to the employee after normal retirement age has to be the same percentage of average annual compensation as provided to an employee with the same years of service prior to normal retirement age.

> There is an exception for crediting interest to the normal retirement benefit that is held by the plan after normal retirement age. If a participant works beyond normal retirement age, there can be an actuarial increase to the normal retirement benefit for each year the plan retains this benefit. (See special rules section below.)

UNIFORM SUBSIDIES-THIRD UNIFORMITY REQUIREMENT

Each subsidized optional form of benefit must be currently available to substantially all employees. However, if the optional form is not currently available to substantially all employees and the optional form is eliminated prospectively, the plan is a safe harbor plan (see "Provisions permitted in DB safe harbor plans, section 1.401(a)(4)-3(b)(6)" section below).

"Substantially all" is a facts and circumstances test, which can include the employer showing that the employees to whom the benefit is not currently available are HCEs. Otherwise, this requirement is not satisfied and the plan would be considered a general test plan.

EXAMPLE 9 Defining subsidized optional form of benefit

Nik's Taxicab's defined benefit plan provides an early retirement benefit equal to 100% of the participant's accrued benefit as of his early retirement date reduced, if he elects to receive his benefit before attaining age 62, by 5/12 percent for each full month by which the date at which pension payments actually begin precedes his attainment of age 62.

The early retirement benefit from age 62 to 65 (NRA) is a subsidized optional form of benefit since there is no actuarial reduction in the accrued benefit between those ages. In addition, Regs. section 1.401(a)(4)-4(e)(1)(i) defines optional form of benefit to be an early retirement benefit. Thus, the benefit offered by Nik's must satisfy the uniform subsidy requirement in order for the plan to be considered a safe harbor plan.

EXAMPLE 10 Illustrating the uniform subsidy requirement

Refer to Example 9 above. To satisfy the uniform subsidy requirement, the benefit must be currently available to substantially all employees. Regs. Section 1.401(a)(4)-4(b)(2)(ii)(A) indicates a specified age condition is disregarded in determining current availability with regard to an employee.

In this situation, age is the only condition for determining whether the unreduced subsidy is available. Consequently, the early retirement subsidy is available to everyone on the same basis.

EXAMPLE 11 Illustrating a separate optional form of benefit

Refer to Example 9 above. The early retirement benefit prior to age 62 would constitute a separate optional form of benefit because this benefit is not payable on substantially the same terms as another distribution alternative. Regs. Section 1.401(a)(4)-4(e)(1)(i) provides a list of relevant terms including terms affecting the value such as actuarial assumptions. In this case, the reductions are different prior to age 62 than subsequent to age 62.

EXAMPLE 12 Determining whether a benefit is subsidized

Refer to Example 9 above. Whether the early retirement benefit prior to age 62 is subsidized is determined using reasonable actuarial assumptions. The actuarial reduction in this example is 5% per year. If the agent suspects that this actuarial reduction includes a subsidy, the agent should require the employer to demonstrate that this reduction does not include a subsidy. If the employer demonstrates that there is no subsidy, this reduction does not have to be evaluated.

The following approach can be used to determine if there is a subsidy. If standard assumptions (Regs. Section 1.401(a)(4)-12) are used (such as UP84 mortality with 7.5% pre and post retirement interest), then the plan reduction can be compared against these assumptions to help determine if a subsidy exists. An optional form **may** be subsidized if the plan reduction is less than the reduction calculated using standard assumptions.

For example, the annuity purchase rates for age 62 and 61 respectively are $9.072 and $9.27. The reduction using the above standard assumptions is (1 - [9.072/9.27 /1.075]) or 8.96%. This may indicate the early retirement benefit prior to age 62 is subsidized since the plan reduction is less than the reduction using standard assumptions. Note standard assumptions are not the only assumptions allowable, but are used to illustrate the method of evaluation.

EXAMPLE 13 Each subsidized benefit must be evaluated separately

Refer to Example 9 above. Since there are two subsidized early retirement benefits in this plan, each must be evaluated separately to determine whether they are currently available to substantially all employees.

As stated above, the age condition is disregarded when evaluating current availability. The early retirement benefit for participants who retire prior to age 62 is currently available to everyone when the age condition is disregarded.

NO CONTRIBUTORY DB PLANS-FOURTH UNIFORMITY REQUIREMENT

A DB safe harbor plan cannot be a contributory DB plan, i.e. is one in which the benefit is funded partially by employee contributions. However, there are exceptions for plans utilizing one of the methods specifically permitted in section 1.401(a)(4)-6. Please see the "Provisions permitted in DB safe harbor plans, section 1.401(a)(4)-3(b)(6)" section below.

PERIOD OF ACCRUAL REQUIREMENT-FIFTH UNIFORMITY REQUIREMENT

The years of service over which the benefits are accrued has to be the same as the years of service over which the benefit is calculated. Section 1.401(a)(4)-11(d)(3) (service crediting requirements) determine the years over which the benefits are accrued when applying the nondiscrimination in amount requirements (safe harbor or general test). The plan determines the years of service over which the benefits are calculated. Thus, a plan can include any years of service to determine the accrued benefit. However, when satisfying the nondiscrimination requirements, the years over which the benefit can be accrued are limited to those years that satisfy the requirements of section 1.401(a)(4)-11(d)(3).

As stated above, section 1.401(a)(4)-11(d)(3)(A) provides the general rule that the following periods of service may not be taken into account in determining whether the plan satisfies the amounts requirement under section 1.401(a)(4)-1(b)(2) and (b)(3):

- periods of service for which an employee does not perform services for the employer or
- periods of service for which the employee did not participate in the plan

However, section 1.401(a)(4)-11(d)(3) provides exceptions (see above) permitting certain types of service (past service, pre-participation service etc.) to be taken into account for the amounts requirement if certain additional requirements are satisfied.

Impact of years of service not being recognized under section 1.401(a)(4)-11(d)(3) on the period of accrual requirement

Even though the plan provides for a benefit for years of service, such as past service, imputed service etc., such service may not be recognized for the amounts requirement if the requirements under section 1.401(a)(4)-11(d)(3) are not satisfied. If years of service are not recognized, the nondiscrimination in amounts requirement is applied as if the service does not exist. Thus, the period over which the benefit is accrued does not include the service that does not satisfy the requirements of section 1.401(a)(4)-11(d)(3).

The period of accrual requirement provides that the period over which the benefit is calculated must be the same period as the benefit is accrued. Thus, unless years of service are recognized under section 1.401(a)(4)-11(d)(3), these years are not counted for accrual purposes and the period of accrual will be different from the period over which the benefits are calculated, causing a plan to be considered a general test plan instead of a safe harbor plan.

EXAMPLE 14 Illustrating when service does not satisfy -11(d)(3)

The Fancy Clothes Company provides a DB plan with a benefit formula of 50% of average annual compensation with a minimum 30 years of service. Fancy Clothes Company acquired L.R.R. Sports Inc in 1995 and granted pre-participation service for L.R.R. employees. Mr. Supowitz, age 45, started with L.R.R. in 1985 and was granted 10 years of pre-participation service.

Assume that the granting of pre-participation service does not satisfy section 1.401(a)(4)-11(d)(3). The plan is not a safe harbor plan because the period of accrual requirement is not satisfied. The years of service over which the benefit is calculated (1985-2005) is not the same over which the benefit is accrued (1995-2005). Since the pre-participation service is not permitted to be taken into account under section 1.401(a)(4)-11(d)(3) for purposes of amounts testing, the 10 years pre-participation service credit is considered to be accrued in the year the plan is established, 1995.

EXAMPLE 15 Illustrating when service satisfies -11(d)(3)

Same facts as above, except that the pre-participation service credit satisfies section 1.401(a)(4)-11(d)(3). The pre-participation service credit is counted for purposes of amounts testing and the employee is deemed to have accrued a benefit from 1985. The plan satisfies the safe harbor requirement because the years of service over which the benefit is calculated (1985-2005) is the same period as the benefit is accrued (1985-2005).

Compensation must be determined over the same period as the benefit accrual

Compensation used in calculating the benefit must be determined over the same period that the participant receives an accrual. For example, if a participant performs service for a member of a controlled group, the plan may provide that such service is not taken into account for an accrual. However, if the plan's definition of average annual compensation (the high 3 average etc.) can take into account such service when determining a participant's benefit, the period of accrual requirement is not satisfied.

EXAMPLE 16

Smart Inc. sponsors a DB plan for the NALA Corporation which provides the benefit of 2% x years of service x high 3 year average compensation. The plan limits years of service to the NALA Corporation. However, the plan's definition of average annual compensation does not limit the high 3 year average period to service with the NALA Corporation.

The plan does not satisfy the period of accrual requirement because high 3 year average compensation can include service with other members of the Smart Control Group. Such service is not included when determining the accrued benefit of the DB plan.

SECTION III-ACCRUAL REQUIREMENTS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

ACCRUAL REQUIREMENTS-SECOND SAFE HARBOR REQUIREMENT

INTRODUCTION

As stated above, in order for a defined benefit plan to be considered a safe harbor plan, the plan has to satisfy the **uniformity requirements** (1.401(a)(4)-3(b)(2) and **one** of the accrual requirements described below.

Thus, a DB plan with a safe harbor formula has to satisfy the requirements of one of the following categories:

1. 1.401(a)(4)-3(b)(3) (unit credit plans),
2. 1.401(a)(4)-3(b)(4) (fractional accrual rule plans) or
3. 1.401(a)(4)-3(b)(5) (insured plans described under section 412(i))

UNIT CREDIT PLAN REQUIREMENTS-SECTION 1.401(A)(4)-3(B)(3)

The plan has to provide a unit credit formula-applying the plan's benefit formula to the employee's years of service and, if applicable, average annual compensation.

The plan's formula has to satisfy the 133 1/3 rule described in section 411(b)(1)(B).

The benefit formula cannot provide a benefit which is greater than 133 1/3% larger than any other prior year.

FRACTIONAL ACCRUAL RULE REQUIREMENTS-1.401(A)(4)-3(B)(4)

INTRODUCTION

There are three requirements in order to satisfy the fractional accrual rule requirements:

- The plan must satisfy the fractional accrual rule under section 411(b)(1)(C) (section 1.401(a)(4)-3(b)(4)(i)(A)),
- The plan must satisfy a modified fractional accrual rule (section 1.401(a)(4)-3(b)(4)(i)(B), and
- The plan must satisfy one of the three accrual requirements (section 1.401(a)(4)-3(b)(4)(i)(C).

FIRST FRACTIONAL ACCRUAL RULE REQUIREMENT-FRACTIONAL ACCRUAL RULE UNDER SECTION 411(B)(1)(C, SECTION 1.401(A)(4)-3(B)(4)(A)

The plan has to satisfy the fractional accrual rule described in section 411(b)(1)(C). Section 1.411(b)-1(b)(3)(i) provides that a plan satisfies the fractional accrual rule if a participant's accrued benefit under the plan is

not less than the "fractional rule benefit" under 1.411(b)-1(b)(3)(ii)(A) multiplied by a fraction:

$$\frac{\text{Total yrs. of participation (Secs. 2530.204-1, 411(b)(4)(A))}}{\text{total projected yrs. of participation if separated at NRA}}$$

Note that the fractional rule is a minimum accrual that the plan must satisfy for each plan year. A plan can provide for a greater benefit than the fractional rule.

Definition of fractional rule benefit

The fractional rule benefit is defined as the annual benefit commencing at NRA under the plan's formula (applying the plan's definition of compensation taking into account the current plan year's compensation).

Although the fractional accrual rule was really meant for either flat or fixed benefit plans, a plan can utilize the fractional accrual rule even though it provides for a unit credit formula. If the plan has a unit credit formula, the unit credit formula should be "converted" to a fixed benefit formula before applying the fractional accrual rule plan. A unit credit formula is converted to a fixed benefit formula by applying the unit credit formula to the employee's projected service to normal retirement age. This total benefit (the fractional rule benefit as defined in section 1.411(b)-1(b)(3)(ii)(A) is then used to determine the accrued benefit using the fraction years of participation over total years of projected participation.

EXAMPLE 1 Illustrating fractional accrual rule

McDermott Recording Studios provides a normal retirement benefit of 1.6% percent of average annual compensation times each year of service up to 25. Normal retirement age is 65. The accrued benefit is equal to the employee's fractional rule benefit multiplied by a fraction:

$$\frac{\text{years of participation}}{\text{total projected years of participation}}$$

Mr. Clark, age 55, started with the company in 1992 at age 50. In 1997, he has 5 years of service and his average annual compensation is $50,000. Mr. Clark's benefit can be converted or treated as a flat benefit plan by multiplying 1.6% times his projected years of service to normal retirement age. Thus, his flat benefit under the plan would be 1.6% times 15 years or 24% times average annual compensation. In 1997, his fractional rule benefit as defined in section 1.411(b)-1(b)(3)(ii)(A) is 24% x $50,000.

Mr. Clark's accrued benefit is the fractional rule benefit multiplied by fraction above or:

24% x $50,000 x 5 (current yrs)/15 (total yrs)
or $4,000.

SECOND FRACTIONAL ACCRUAL RULE REQUIREMENT-"MODIFIED" FRACTIONAL ACCRUAL RULE UNDER SECTION 1.401(A)(4)-3(B)(4)(I)(B)

Each employee's accrued benefit as of any plan year before the employee reaches normal retirement age must be determined by multiplying the fractional rule benefit by a fraction:

ee's yrs of service at the end of the plan year
ee's years of service projected to NRA.

The modified fractional accrual rule requires the **same ratable accrual** that takes into account all years of service over which the benefit is calculated under the plan. The ratable accrual is calculated by using the fractional rule fraction, but includes all years of service taken into account by the plan which qualifies as testing service under section 1.401(a)(4)-11(d)(3).

As stated above, the fractional rule benefit is the annual benefit currently accrued commencing at NRA applying the plan's definition of compensation taking into account the current plan year's compensation. Also, note that years of service is defined in section 1.401(a)(4)-12. In order to satisfy the modified fractional rule, the definition of the fractional rule benefit must be specifically applied in the plan. Thus, if the plan's definition of compensation takes into account more years of service prior to the immediately preceding 10 years, the modified fractional rule is not satisfied.

EXAMPLE 2 Illustrating modified fractional accrual rule

Furillo Advertising Agency sponsors a DB plan which provides a normal retirement benefit of 50% of the highest three year average compensation of the last 10 years of service, including current year compensation, reduced by 2% points for each year of service below 25 years of service the employee has at normal retirement age. In addition, the plan provides that an employee's accrued benefit is equal to the employee's annual benefit under the plan multiplied by a fraction:

ee's yrs of service at the end of the plan year
ee's years of service projected to NRA.

In 1998, Leah, age 60, has 5 years of service and is projected to have 10 years of service at NRA. As of the 1998 plan year, Leah’s highest three year average is $50,000.

The plan's formula satisfies the modified fractional accrual rule. Leah's accrued benefit is based on all years of service. Her accrued benefit is also based on her "fractional rule benefit", the annual benefit at NRA or 20% of average annual compensation (including current year compensation). Note that the fractional rule benefit was "converted" to a fixed benefit by applying the formula to Leah's projected years of service to NRA. Thus, 50% is reduced by 2% for every year under 25 years. Since Leah is projected to have 10 years of service to NRA, her benefit of 50% is reduced by 2% x 15 or 30%. Thus, her fractional rule benefit to apply the fraction is 20%. Leah's accrued benefit in 1998 is 10% (20% x 5/10) x $50,000 or $5,000.

Note that in this instance, the accrued benefit determined under the fractional rule and the modified fractional rule are the same benefit.

DIFFERENCES BETWEEN THE FRACTIONAL ACCRUAL RULE AND THE MODIFIED FRACTIONAL ACCRUAL RULE

As stated above, the benefit required to be accrued under the fractional rule is a minimum accrual that must be provided by the plan. If past service credit is provided by the plan, the fractional accrual rule requires a minimum ratable accrual for all years of service for benefit purposes.

The modified fractional accrual rule under the section 401(a)(4) regulations requires the same ratable accrual for all years of testing service taken into account under section 1.401(a)(4)-11(d)(3). Note that if there are any differences between the testing service and service taken into account for benefit purposes, the period of accrual requirement will not be satisfied.

Compensation must follow the fractional rule benefit definition

As stated above, the definition of compensation must specifically follow the definition of fractional rule benefit, including the requirement that the definition of compensation cannot take into account more than the preceding 10 years of service. This requirement differs from the fractional accrual rule because the accrual under the fractional rule is a minimum accrual. Under the fractional rule, the plan may take into account more than the prior 10 years of service if the plan provides the minimum accrual determined under the fractional rule. However, for purposes of the modified fractional rule, the plan must specifically apply the fractional rule benefit and cannot take into account such years, even if it produces a larger benefit.

EXAMPLE 3 Applying pre-participation service to fractional rules

The Newton Auto Service Clinic and Car Museum Corporation's DB plan provides a benefit of 50% of compensation for 25 or more years of service. The accrued benefit is determined using the fractional accrual rule.

On January 1, 1997, the Clinic purchased Gray's Body Shop. The DB plan credited Gray employees with a benefit of 2.5% of service for all years of service prior to the acquisition. The benefit attributable to Gray's service accrues under the plan in the first year of service with Newton's. The years of service with Gray satisfies the testing service requirements under section 1.401(a)(4)-11(d)(3).

Jim, age 30, started with Gray in 1987 and was credited under Newton's DB plan with 12 years of service in 1998. For the 1998 plan year, Jim's accrued benefit is 25% of compensation (for service attributable with Gray) and 2/25 x 50% x compensation for two years of service with Newton's. For the plan to be considered a safe harbor plan, the plan must satisfy both the fractional rule under section 1.401(a)(4)-3(b)(4)(i)(A) and the modified fractional rule under section 1.401(a)(4)-3(b)(4)(i)(B).

The plan satisfies the fractional rule under section 411(b)(1)(C)

The plan satisfies the fractional accrual rule plan if Jim's accrued benefit is at least equal to the benefit calculated under the fractional accrual rule.

Jim's accrued benefit under the fractional rule is as follows:

> Jim's projected benefit is 25% (2.5% x 10 yrs. of svc) for the pre-participation service plus 50% of compensation under the benefit formula.
>
> For the 1998 plan year, Jim's accrued benefit is 75% x 12/35 (current yrs of participation divided by projected yrs of participation) or 25.71%.

Jim's accrued benefit under the plan is as follows:

> 2.5% x 10 years of service (pre-participation service) plus
>
> 50% x 2/25 (years of participation/total yrs for the years under the regular benefit formula)
>
> or 29%. Since Jim's accrued benefit under the plan is greater than the fractional accrual rule benefit, the plan satisfies the fraction accrual rule.

The plan does not satisfy the modified fractional rule

Remember, the modified fractional rule requires the same ratable accrual for all years of service that are taken into account. The plan does not

satisfy the modified fractional rule because its formula does not provide the same ratable accrual for all years of service that are taken into account. In this case, the formula provides for 2.5% per year for the pre-participation years of service with Gray and 2% per year for the years of service with Newton (50% reduced by 2% for each year less than 25). The following calculation illustrates this conclusion.

Jim's accrued benefit under the modified fractional accrual rule is as follows:

> Jim's projected benefit is 25% (2.5% x 10 yrs. of svc) for the pre-participation service plus 50% of compensation under the benefit formula.
>
> For the 1998 plan year, Jim's accrued benefit is 75% x 12/35 (current yrs of testing service under section 1.401(a)(4)-11(d)(3) divided by projected yrs of testing service under -11(d)(3)) or 25.71%.

Jim's accrued benefit under the plan (as stated above) is

> 2.5% x 10 years of service (pre-participation service) plus
>
> 50% x 2/25 (years of participation/total yrs for the years under the regular benefit formula)
>
> or 29%.

Note that the modified fractional accrual rule is calculated in the same manner (and uses the same years of service) as the fractional accrual rule. However, unlike the fractional accrual rule, which is a minimum accrual requirement, the regulations require a participant's accrual to be equivalent to the accrual calculated under the modified fractional rule. Since Jim's accrued benefit under the plan is not equivalent to the modified fractional accrual rule benefit, the plan does not satisfy the modified fractional accrual rule and is not a safe harbor plan.

EXAMPLE 4 Applying permitted disparity to fractional rules

Wilson Fence Company sponsors a DB plan with the formula of 2% of average annual compensation plus .65% of average annual compensation above covered compensation, for each year of service up to 25. In addition, the employee's accrued benefit is the sum of:

> 2% of average annual compensation for each year of service up to 25 multiplied by the fraction years of service/total years of projected service plus

.65% of employee's average annual compensation above covered compensation multiplied by the employee's years of service (up to 25) as of the current plan year.

In 1998, Jill, age 50, has 20 years of service. Normal retirement age under the plan is 65. Her average annual compensation is $75,000 and her covered compensation is $50,000. Her accrued benefit is determined as follows:

(2% x 25 x $75,000) x 20/35 **plus**

.65% x $25,000 x 20 or

$21,429 plus $3,250 or $24,679.

Although the plan satisfies the fractional accrual rule under section 411(b)(1)(C), the plan does not satisfy the modified fractional accrual rule. By looking at the plan formula, the excess (.65%) does not accrue over projected years of service. Thus, the formula does not provide the same ratable accrual for all years of service that is taken into account.

To confirm this conclusion by a calculation, under the modified fractional accrual rule, the fractional rule benefit and fraction includes both the 2% and the .65% permitted disparity factor. Thus, the benefit under the modified fractional rule would be:

(2% x 25 x $75,000) x 20/35 **plus**

(.65% x 25 x $25,000) x 20/35 or

$21,429 plus $2,321.42 or $23,750.42.

Since the benefit under the plan ($24,679) is different than the modified fractional accrual rule benefit, the plan is not a safe harbor plan. Note that the plan does not satisfy the modified fractional accrual rule because the permitted disparity factor is not reduced by fraction "years of service/total years of service".

Note that without an exception, this benefit formula would violate the period of accrual requirement because the period over which the benefits are determined (25 years) differ from the period over which the benefit is accrued (35). However, as noted below, section 1.401(a)(4)-3(b)(6)(v) provides that a plan can still be considered a safe harbor plan even though the benefit formula limits the years of service.

THIRD FRACTIONAL ACCRUAL RULE REQUIREMENT-

THREE ACCRUAL ALTERNATIVES THAT PLAN MUST SATISFY, SECTION 1.401(A)(4)-3(B)(4)(C)

INTRODUCTION

To recap, the fractional accrual rule requirement under section 1.401(a)(4)-3(b)(4) has three requirements:

the plan must satisfy the fractional accrual rule under section 411(b)(1)(C),

The plan must satisfy the modified fractional accrual rule of section 1.401(a)(4)-3(b)(4)(1)(B), and

the plan must satisfy one of three accrual requirements under section 1.401(a)(4)-3(b)(4)(i)(C).

With respect to satisfying one of the three accrual requirements, the regulations shifted the focus from looking at the total benefit under the plan to looking at the rate of accrual for each employee for each plan year (see section comparing old and new nondiscrimination requirements). In order for a plan to be considered a safe harbor plan, a participant's rate of accrual for each plan year cannot be significantly different from other participants. The three options explained below ensure that such rates do not vary significantly.

- The first accrual requirement is based on the plan's formula being stated as a unit credit formula.
- The second accrual requirement requires a pro-rata reduction for a participant with less than 25 years of service.
- The third accrual requirement is an exception to the 25 year requirement, but the plan has to satisfy an additional demographic requirement. Plans using this option would be considered a nondesign based safe harbor.

FIRST ACCRUAL ALTERNATIVE-1/3 LARGER FOR A FORMULA STATED AS A UNIT CREDIT FORMULA-SECTION 1.401(A)(4)-3(B)(4)(I)(C)(1)

If the formula is stated as a unit credit formula, the plan cannot provide an accrual rate for any employee that is more than 1/3 larger than any other employee in any other plan year. Employees with more than 33 years of service are treated as having 33 years of service for purposes of determining the accrual rate. If a plan uses permitted disparity, an employee is treated as accruing benefits at a rate equal to the excess

benefit percentage in the case of a defined benefit excess plan or at a rate equal to the gross benefit percentage in the case of an offset plan.

EXAMPLE 5 Illustrating 1/3 rule

Kramer Investment Services sponsors a DB plan with a normal retirement benefit equal to 2% of average annual compensation x years of service up to 25. In addition, an employee's accrued benefit is determined under the fractional accrual rule and equals the annual benefit multiplied by the following fraction:

Employee's years of service
employees projected years of service up to NRA

The highest accrual rate and the lowest accrual rate that an employee can accrue is first determined. The highest accrual rate is 2% for those employees with 25 or less years of service. The lowest accrual rate would be for a participant who is projected to have 33 years of service. (Note that employees with more than 33 years of service are treated as having 33 years of service). Such participant's accrual rate for any plan year would be 50%/33 or 1.52%.

The next step is to determine whether the highest accrual rate is more than 1/3 of the lowest accrual rate. One way to determine this step is to multiply the lowest accrual rate by 1.33 (1/3 larger). In the above example, 1.52% x 1.33 is 2.02%. Since 2% is less than 2.02%, 2% is not 1/3 larger than 1.52% and the above formula satisfies option 1 (the 1/3 larger option).

EXAMPLE 6 Illustrating 1/3 rule

Same facts as the previous example, except that the benefit formula is 2% for each year of service up to 20. The highest accrual rate is 2% for those employees with 20 or less years of service. The lowest accrual rate would be 40%/33 or 1.21%. 1/3 larger than the lowest accrual is 1.21% x 1.33 or 1.61%. Since 2% is larger than 1.61%, the formula fails the 1/3 larger accrual requirement.

EXAMPLE 7 Illustrating permitted disparity and 1/3 rule

The Constance Baseball Cap Co. sponsors a DB plan with a normal retirement benefit equal to 1% of average annual compensation up to the integration level and 1.6% of average annual compensation x YOS up to 35. The plan satisfies the permitted disparity requirements of section 401(l). In addition, an employee's accrued benefit is determined under the fractional accrual rule and equals the annual benefit multiplied by the following fraction:

Employee's years of service

employees projected years of service up to NRA

For purposes of satisfying the 1/3 larger accrual requirement option, all employees with less than 35 years of service are assumed to accrue benefits at 1.6% since the plan satisfies permitted disparity. The formula satisfies this option since all employees with 33 or fewer years of projected service accrue a benefit of 1.6% of average annual compensation.

SECOND ACCRUAL ALTERNATIVE-FLAT BENEFIT WITH A MINIMUM REQUIREMENT OF 25 YEARS OF SERVICE, SECTION 1.401(A)(4)-3(B)(4)(I)(C)(2)

If the formula is stated as a flat benefit formula, the plan must require 25 years of service for an employee to receive the unreduced flat benefit (determined without regard to section 415) with a pro-rata reduction for years of service less than 25 years. A flat benefit is a benefit that is the same percentage of average annual compensation or the same dollar amount for all employees who have the minimum number of years of service at normal retirement age. An employee is permitted to accrue up to the maximum 415 benefit over a period of less than 25 years as long as the flat benefit under the plan, determined without regard to section 415, accrues over the minimum 25 years.

EXAMPLE 8 Illustrating flat benefit requirement

The Sherry Wine Company provides a normal retirement benefit of 125% of average annual compensation, reduced by five percentage points for each year of service below 25 that the employee has at normal retirement age. In addition, an employee's accrued benefit is equal to the annual benefit at NRA (fractional rule benefit) multiplied by the fraction "years of service/total years of projected service at NRA".

Bob, age 61, has 21 years of service and is projected to have 25 years of service at NRA. Although under the plan, Bob's accrued benefit is 105% of average annual compensation, Bob's benefit is limited by section 415 to 100%. This plan satisfies the second option because the flat benefit under the plan, determined without regard to section 415, accrues over a minimum of 25 years. Thus, the employee may accrue the maximum benefit allowed under section 415 (100% of compensation) in less than 25 years.

THIRD ACCRUAL ALTERNATIVE-FRACTIONAL ACCRUAL OVER LESS THAN 25 YEARS, NON-DESIGN BASED SAFE HARBOR, SECTION 1.401(A)(4)-3(B)(4)(I)(C)(3)

If the formula is stated as a flat benefit formula, the plan has to meet the requirements of the second option (except the 25 year requirement). In addition, the average normal accrual rate for NHCEs has to be 70% of the average normal accrual rate for HCEs (nondesign based safe harbor). The normal accrual rates are determined in the same manner as the general test.

EXAMPLE 9 Applying the three alternative accrual requirements

The Bounce Tire Company sponsors a DB plan with a flat benefit of 75% of average annual compensation for all employees with at least 20 years of service, reduced 3.75% per year for each year a person reaches normal retirement age with less than 20 years of service. In addition, an employee's accrued benefit is equal to the annual benefit at NRA (fractional rule benefit) multiplied by the fraction "years of service/total years of projected service to NRA".

The formula satisfies the fractional accrual rule and the modified fractional accrual rule. Next, the plan must satisfy one of the three accrual alternatives under section 1.401(a)(4)-3(b)(4)(i)(C).

The 1/3 larger rule under -3(b)(4)(i)(C)(1)

The plan formula does not satisfy the first accrual alternative (the 1/3 rule). As the formula provides, participants are entitled to 75% of average annual compensation with a minimum of 20 years of service. The maximum accrual per year is 75%/20 or 3.75%. Section 1.401(a)(4)-3(b)(4)(i)(c)(1) requires that up to 33 years of service be taken into account when applying this alternative. Thus, the lowest yearly accrual under this formula is 75%/33 or 2.27%.

The 1/3 rule is satisfied if the highest yearly accrual does not exceed the lowest yearly accrual by more than 1/3. Since 3.75% exceeds more than 1/3 of 2.27% (2.27% x 1.333 or 3.03%), the formula does not satisfy the 1/3 rule.

The 25 year minimum period of accrual under -3(b)(4)(i)(C)(2)

The second accrual alternative is not satisfied since the formula requires less than the minimum of 25 years of service required for the flat benefit under this accrual alternative.

The nondesign based safe harbor under -3(b)(4)(i)(C)(3)

Since the first two accrual alternatives are not satisfied, the plan formula must satisfy this alternative in order to be considered a safe harbor plan. Under this alternative, the plan must show that the

average normal accrual rates for all non-excludable NHCEs is 70% of the average normal accrual rates for all non-excludable HCEs in order to be considered a non-design based safe harbor. Otherwise, the plan is not a safe harbor plan and must satisfy the nondiscrimination requirements under the general test.

SAFE HARBOR FOR INSURANCE CONTRACT PLANS UNDER SECTION 412(I), 1.401(A)(4)-3(B)(5

The DB plan has to meet the requirements of IRC section 412(i) and meet the fractional accrual rule of IRC section 411(b)(1)(F).

SECTION IV, PROVISIONS PERMITTED IN A SAFE HARBOR PLAN

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

PROVISIONS PERMITTED IN DB SAFE HARBOR PLANS, SECTION 1.401(A)(4)-3(B)(6)

INTRODUCTION

A DB safe harbor plan can provide for the following features and still be considered a safe harbor plan. These features are exceptions to the uniformity requirement because they can result in participants with the same years of service having different accrued benefits under the plan. However, such features do not result in the plan failing the uniformity requirements. These features must apply to all employees:

1. Permitted disparity
2. different entry dates
3. conditions on accruals
4. Limits on accrual
5. dollar accrual per uniform unit of service
6. prior benefits accrued under different formula
7. employee contributions
8. certain subsidized optional forms
9. lower benefits for HCEs
10. multiple formulas

PERMITTED DISPARITY 1.401(*a)(4)-3(b)(*6)(II)

The plan can provide for permitted disparity if the plan satisfies section 401(l) in form. Thus, differences in employees' benefits as a result of such disparities do not cause the plan to fail uniformity.

DIFFERENT ENTRY DATES 1.401*(a)(4)-3(b)(6)(*III)

The plan can provide one or more entry dates during the plan year as permitted by section 410(a)(4) without failing the uniformity requirements.

CERTAIN CONDITIONS ON ACCRUALS 1.401(a)(4)-3(b)(6)(iv)

The plan can provide that an employee's accrual is less than a full accrual (including a zero accrual) because of a plan provision permitted by the year of participation rules under section 411(b)(4) (and section 2530.204-1 of the Department of Labor Regulations permitting service to be disregarded for purposes of benefit accrual). This includes ratable reduction in the accrual of benefits if participant works less than customary

full-time in the trade or industry (usually 2,000 hours). In addition, the plan can require the employee to work 1,000 hours before any benefit is accrued.

CERTAIN LIMITS ON ACCRUALS 1.401(a)(4)-3(b)(6)(v)

A plan can limit the benefit by providing a limit on the years of service taken into account or a limit on the percentage of compensation. In addition, the plan can apply the section 415 limits and apply the limit on the amount of compensation taken into account in determining benefits. None of these limits will result in the plan failing the uniformity requirements.

FRESH START 1.401(a)(4)-3(b)(6)(vii)

A plan can provide for a non-uniform benefit formula as long this formula is amended to be a safe harbor formula as of a fresh start date and complies with the requirements under 1.401(a)(4)-13 (see fresh start section). The accrued benefit under the old formula is not taken into account in determining whether the plan satisfies the uniformity requirements.

EXAMPLE 1 Illustrating fresh start

Plan Q a defined benefit plan is amended for TRA 86 effective 1-1-89. Prior to the amendment, the plan provided a benefit formula of 60% of three year average annual compensation. The benefit was being fractionally accrued. When the formula was amended to meet TRA 86, the formula was changed to a unit credit formula of 3% of five year average annual compensation for a maximum of 30 years of service. In order for plan Q to meet uniformity, it must fresh start the benefit effective 1-1-89.

EMPLOYEE CONTRIBUTIONS 1.401(a)(4)-3(b)(6)(viii)

A contributory DB plan is a plan that provides a benefit that is funded in part on employee contributions. In this plan, employee contributions are used to fund the benefit promised to the participant.

Section 1.401(a)(4)-6 provides the rules as to how a contributory DB plan satisfies the nondiscrimination in amount requirement under section 1.401(a)(4)-1(b)(2) (one of the three overall requirements of the regulations). 1.401(a)(4)-6 tests the "employer-provided" benefit and the "employee-provided" benefit separately. 1.401(a)(4)-6(b) provides for safe harbor methods in determining the employer provided benefit: composition of workforce method, minimum benefit method, and a grandfather rule for

plans in existence on May 14, 1990. There is another method for governmental plans and a method for plans that have ceased to allow employee contributions. Section 1.401(a)(4)-6(c) provides the tests for the employee-provided benefits.

A plan is considered to be a safe harbor plan if the plan's benefit formula provided benefits at employer provided benefit rates determined under 1.401(a)(4)-6(b). A minimum benefit that is added solely to satisfy the minimum benefit method under section 1.401(a)(4)-6(b)(3) is not taken into account in determining whether the plan satisfies this employee contribution exception.

Special rules for fractional accrual and insurance contract safe harbor plans

A plan would not be considered to be a fractional accrual rule or insurance contract safe harbor plan unless the plan applies the grandfather rule method (for plans in existence on May 14, 1990), the government-plan method or the cessation of employee contributions method (the methods under section 1.401(a)(4)-6(b)(4)-(b)(6). Thus, a fractional accrual rule or insurance contract safe harbor plan cannot use either the composition of workforce method or the minimum benefit method under section 1.401(a)(4)-6(b)(2)-(b)(3).

SUBSIDIZED OPTIONAL FORMS AVAILABLE TO FEWER THAN SUBSTANTIALLY ALL EMPLOYEES 1.401(a)(4)-3(b)(6)(ix)

Subsidized optional benefits that are available to fewer than substantially all employees because the optional form of benefit has been eliminated prospectively under 1.401(a)(4)-4(b)(3) will not cause the plan to fail uniformity.

LOWER BENEFITS PROVIDED FOR HCES, 1.401(a)(4)-3(b)(6)(x)

The plan will not fail uniformity merely because the plan provides benefits to highly compensated employees that are inherently less valuable than the benefits provided to non-highly compensated employees.

MULTIPLE FORMULAS PROVIDED UNDER THE PLAN (1.401(a)(4)-3(b)(6)(xi)

The plan can provide that an employee's benefit under the plan is the greater of the benefits determined under two or more formulas, or is the sum of the benefits determined under two or more formulas. However, in order for the plan to satisfy uniformity, certain requirements must be satisfied:

1. The formulas must be the only formulas under the plan,
2. Each of the formulas must satisfy the uniformity requirements and the accrual requirements (described above),
3. All of the formulas must be available on the same terms to all employees.

A formula does not fail to be available on the same terms to all employees merely because the formula is not available to any HCEs, but is available to some or all NHCEs on the same terms as all of the other formulas in the plan.

Note that plans that provide the greater of the benefits under two or more formulas, one of which is a top-heavy formula, are deemed to satisfy this availability requirement (see 1.401(a)(4)-3(b)(6)(xi)(D)(3).

ADVANCED TOPICS, SPECIAL RULES-SECTION 1.401(A)(4)-3(F)

INTRODUCTION

The following special rules, if provided for in the plan, must be applied in order for a plan to be considered a safe harbor plan. In addition, these rules must apply uniformly to all employees. These rules apply to either (or both) the safe harbor and general test DB plans and generally determine whether various items are "included" for purposes of the amounts requirement under 1.401(a)(4)-3.

In a safe harbor context, the regulations describe whether the uniformity of a safe harbor formula of a plan using the special rule is affected. **If the plan satisfies the requirements when utilizing the optional rules, the plan would still be a safe harbor plan.** For example, for a qualified disability benefit, the benefit may not affect uniformity if certain requirements are met.

In the general test context, the regulations describe how the calculation of the accrual rates is affected. For a qualified disability benefits, the benefit may be treated as part of the accrued benefit if certain requirements are met.

The special rules concern the following:

1. Qualified disability benefits
2. Accruals after normal retirement age

3. early retirement window benefits
4. Unpredictable contingent event benefits
5. adjustments for certain plan distributions
6. adjustments for certain QPSA charges
7. disregard for certain offsets

QUALIFIED DISABILITY BENEFITS

Qualified disability benefits described in section 411(a)(9) are not taken into account for purposes of the amounts requirement. However, a qualified disability benefit that credits compensation or service for a period of disability in the same manner as actual compensation or service is credited under the benefit formula can be taken into account as an accrued benefit upon the employee's return to service with the employer following the period of disability and would not affect the plan's safe harbor status. The qualified disability benefit must then be treated in the same manner as an accrued benefit for all purposes under the plan. Note that if the qualified disability benefit credits service under the formula, the benefit must also satisfy the imputed service requirements under section 1.401(a)(4)-11(d)(3) to be taken into account as testing service under the regulations.

EXAMPLE 2 Illustrating qualified disability benefit

Jim began employment in 1986 with The Pie Shop Inc. and is a participant in their unit benefit DB plan. The plan provides a qualified disability benefit (Jim's accrued benefit at disability). Assume that the qualified disability benefit also satisfies the imputed service requirement of section 1.401(a)(4)-11(d)(3).

The plan credits years of service for a period of disability due to surfing injuries towards the plan's retirement benefit. In 1994, Jim got injured and was out for 2 years and returned in 1996. The disability benefit credits two years of service to be used in computing Jim's benefit under the plan's benefit formula. Scott also started in 1986 after being laid off as an auto mechanic. He worked continuously from 1986 through 1996.

Jim (with 8 years of actual service prior to his disability) and Scott (with 10 years of service) have the same accrued benefit under the plan. The plan still satisfies uniformity even though Jim was credited with years of service for which he did not perform services. Since the disability benefit satisfies section 1.401(a)(4)-3(f)(2) and the service satisfies section 1.401(a)(4)-11(d)(3), the accrued benefit is calculated as if Jim actually performed service during the years of his disability. Thus, Jim and Scott are treated

as having the same number of years of service when determining whether the benefits under the plan are uniform.

If a plan uses the general test to satisfy the amounts requirement, a disability benefit that satisfies section 1.401(a)(4)-3(f)(2) is included as part of the accrued benefit for determining the accrual rates and testing service.

EXAMPLE 3 Illustrating when disability benefits are included

Same facts as above, but The Pie Shop's defined benefit plan utilizes the general test. In determining the accrual rates for Jim, the 2 years of service that is credited under the disability benefit is included in the accrued benefit and the testing service. Thus, Jim is considered as having 10 years of service when running the general test. For more information as to how to calculate the accrual rates, please see the general test section below.

ACCRUALS BEYOND NORMAL RETIREMENT AGE

The post-normal retirement benefit for a participant after normal retirement age must be the same as the normal retirement benefit for a participant at normal retirement age with the same number of years of service. However, if a participant works beyond normal retirement age, actuarial increases to the normal retirement benefit for each year the plan retains this benefit can be disregarded for determining uniformity and running the general test if certain requirements are met:

The same uniform normal retirement age applies to all employees,

The actuarial percentage factor used to increase the accrued benefit is no greater than the largest factor that could be applied to increase actuarially the employee's accrued benefit using any standard mortality table and any standard interest rate.

EARLY RETIREMENT WINDOW BENEFITS, SECTION 1.401(a)(4)-3(f)(4)- INTRODUCTION AND DEFINITION

An early retirement window benefit is:

1. an early retirement benefit, retirement-type subsidy, QSUPP
2. other optional form of benefit under a plan that is available
3. or a change in the plan's benefit formula

that is applicable only to employees who terminate employment within a limited period of time specified by the plan (not to exceed one year) under circumstances specified by the plan.

A QSUPP or qualified social security supplement is a social security supplement defined under section 1.411(a)-7(c)(4)(ii) that satisfies each of the requirements under section 1.401(a)(4)-12.

Certain employees may receive the benefit even though they terminate employment within a reasonable time after the election period. The plan must specifically provide for this feature.

An amendment that extends the time to elect the benefit is not treated as a separate early retirement window benefit provided that the extended period does not exceed one year. However, any other change or amendment to the early retirement window benefit creates a separate early retirement window benefit.

Early retirement window benefits are taken into account under section 1.401(a)(4)-3(f)(4)(ii)(A) when currently available

All types of early retirement benefits are taken into account regardless of whether they are permanent features of the plan or are offered only to employees whose employment terminates within a limited period of time.

Early retirement window benefits under section 1.401(a)(4)-3(f)(4)(iii) (benefits offered within a limited period of time) are taken into account in determining whether a plan satisfies the amounts requirements for DB plans in the first plan year in which the early retirement window benefit is currently available within the meaning of section 1.401(a)(4)-4(b)(2). An early retirement window benefit is disregarded in determining whether a plan satisfies these requirements for DB plans for all other plan years.

General rule in defining currently available for early retirement benefits under section 1.401(a)(4)-4(b)(2)

Under section 1.401(a)(4)-4(b)(2)(i), whether a benefit, right or feature that is subject to specified eligibility conditions is currently available to an employee is generally determined based on the current facts and circumstances with respect to an employee. However, under -4(b)(2)(ii), any specified age or service condition with respect to an optional form of benefit or the social security supplement is disregarded in determining whether such benefit or supplement is available to an employee. Thus, an optional form of benefit that is available to an employee upon attaining age 55 with 10 years of service is treated as currently available to an employee whether or not the employee has or can satisfy the age or service conditions in the plan year.

Age and service conditions not disregarded under section 1.401(a)(4)-4(b)(2)(i)(A)(2)

Under section 1.401(a)(4)-4(b)(2)(ii)(A)(2), an age or service condition is not disregarded in determining the current availability of an optional form of benefit or a social security supplement if the condition must be satisfied within a certain period of time. For example, an early retirement window benefit that is available for less than one year is currently available to an employee only if that employee is eligible for that benefit by satisfying the age and or service conditions specified in the window benefit.

To determine whether an employee is eligible for the window benefit (to determine current availability), the age and service of employees may be projected to the last date by which the age or service condition must be satisfied in order to be eligible for the optional form of benefit. Thus, the window benefit is currently available to all employees who are projected to be eligible for the benefit on the last day that the benefit is available.

If an early retirement window benefit is offered between two plan years, the benefit is considered currently available for all employees in the first plan year who are projected to be eligible for that benefit through the last day the window benefit in the second plan year.

EXAMPLE 4 Illustrating definition of currently available

The Mice Pest Control Corporation sponsors a DB plan with a 2% unit credit formula. On December 1, 1997, the Company offers to all employees who are age 55 with 20 years of service an additional 5 years of service to their accrued benefit if they retire by January 31, 1998.

The first plan year in which the benefit is currently available is the 1997 plan year. Thus, all employees who are projected to attain age 55 with 20 years of service on January 31, 1998 are considered currently available for that benefit in the 1997 plan year for purposes of amounts testing

under section 1.401(a)(4)-3 and benefits, rights and features under section 1.401(a)(4)-4.

EARLY RETIREMENT WINDOW BENEFITS-EFFECT ON AMOUNTS TESTING-INTRODUCTION

An early retirement window benefit that modifies the plan's benefit formula, can affect the following requirements under amounts testing:

1. Safe harbor-uniformity requirements
2. General test-most valuable accrual rates
3. average benefits percentage test for rate groups that provide for an early retirement window benefit

Effect on safe harbor requirements

A plan that provides for an early retirement window benefit that temporarily changes the plan's benefit formula is not a safe harbor formula because the formula does not satisfy the uniformity requirements, specifically the requirement that each participant with the same years of service receive the same accrued benefit.

EXAMPLE 5 Illustrating effects on safe harbor

The A-1 costume factory defined benefit plan has a 2% unit credit formula. The plan credits five years of service for all employees age 55 with 10 years of service who retire between July 1, 1997 and August 30, 1997. Greg, age 55 with 12 years of service, decides to retire and study the habits of bats at the local university. Greg retires with an accrued benefit based on 17 years of service. Mary, also age 55, had just received a promotion in the Ghoul Division and decides not to retire.

Assume that the additional years of service for the window benefit does not satisfy the service crediting requirements of section 1.401(a)(4)-11(d)(3) (past service, pre-participation service etc.) and thus may not be taken into account as years of service for the nondiscrimination in amounts requirement under section 1.401(a)(4)-1(b)(2).

For 1997, the formula with the window benefit does not satisfy the uniformity requirements under section 1.401(a)(4)-3(b)(2)(i) because Greg is entitled to a larger benefit (34% of average annual compensation) than Mary (24% of average annual compensation) with the same 12 years of service.

Plan with an early retirement window may satisfy the safe harbor requirements by restructuring

A plan with such an early retirement window benefit could still satisfy the safe harbor requirements if the plan satisfies the safe harbor requirements both reflecting the temporary change in the benefit formula and disregarding the change in the benefit formula. This requirement may be satisfied if the plan is restructured into two components, one component consisting of all employees who are not eligible for the window benefit and the other component consisting of all employees who are eligible for such a benefit. The analysis is as follows:

Disregarding the temporary change in the benefit formula, Component 1 and 2 would still satisfy the uniformity requirements since there is no change in Component 1 and the change in Component 2 is disregarded.

Reflecting the temporary change, Component 2 would be considered a safe harbor formula since this component still provides a uniform benefit to all employees with the same years of service (although the benefit is higher than under the regular benefit provided under Component 1).

EXAMPLE 6 Illustrating restructuring

Same facts as previous example. The plan is restructured under section 1.401(a)(4)-9(c) into two component plans:

- Component A consisting of all employees who are not eligible for the early retirement window benefit and all of their accruals and benefits rights and features under the plan, and

- Component B consisting of all employees who are eligible for the early retirement benefit and all of their accruals and benefits, rights and features under the plan.

Disregarding the temporary change

Component A satisfies the safe harbor requirements since there has been no change in the plan's formula for those employees in this component plan.

Component B satisfies the safe harbor requirements since by disregarding the change in the benefit formula, the formula is the same as in Component A.

Reflecting the temporary change

Component B satisfies the safe harbor requirements reflecting the change since all participants receive the same benefit for the same number of years of service which may be taken into account (including the additional 5 years of service). Even though the benefit under Component B is higher than Component A, the benefit is the same for all employees within Component B.

Each restructured component must satisfy coverage

Remember, with restructuring, each component plan must satisfy the coverage requirements under section 410(b). However, the component plan is deemed to satisfy the average benefit percentage test if the plan as a whole satisfies this test. For further information, please see section 1.401(a)(4)-9(c)(4) and (c)(5).

A plan with an early retirement window may be a safe harbor plan if the additional years of service provided satisfies the requirements of 1.401(a)(4)-11(d)

A benefit formula may be considered to be uniform if it provides an early retirement window benefit that adds years of service to the benefit formula and such years of service are considered to be past service, pre-participation or imputed service within the meaning of section 1.401(a)(4)-11(d). Thus, if the requirements are met with respect to 1.401(a)(4)-11(d), the additional years of service provided by the early retirement window benefit would be included in determining uniformity and would be treated as if the employee had actually performed service for those additional years (see definition of service above).

Effect of early retirement window benefit on general test

An early retirement window benefit that temporarily changes the benefit formula is disregarded for purposes of determining an employee's normal accrual rate. Such a benefit that is currently available is taken into account when determining the most valuable accrual rate as of the earliest of:

- the employee's date of termination,
- the close of the early retirement window or
- the last day of the plan year in which the window was first currently available.

See general test section below for a discussion of the calculation of most valuable accrual rate.

EXAMPLE 7 Illustrating when a window benefit is taken into account

The James and Roger Petting Zoo Inc. Defined Benefit plan is a general test plan. On December 1, 1996, the plan provided for an early retirement window benefit which added 3 years of service to employees who are 55 with 10 years of service. The window benefit was offered until January 15, 1997.

Mr. Roger, age 57 with 15 years of service on December 1, 1996, decided to take the benefit and terminated on December 15, 1996. Ms. Abbot had 10 years of service on December 1, 1996 and turned 55 on January 14, 1997. Ms. Abbot decided to take the benefit and terminated on January 31, 1997. Mr. Dune, age 56 with 15 years of service on December 15, decided not to take the benefit.

Mr. Roger's, Ms. Abbot's and Mr. Dune's normal accrual rate is not affected.

Mr. Roger's most valuable accrual rate is taken into account on December 15, which is earlier than the date the window closes or the last day of the plan year in which the benefit is first currently available.

Ms. Abbot’s most valuable accrual rate is determined as of December 31, 1996, which is the earlier than the date of termination or the date the window closed. For purposes of determining current availability, the year that the benefit is first currently available is 1996 for all employees who are eligible to receive the benefit through the last day of the window, or January 15, 1997.

Mr. Dune's most valuable accrual rate is affected even though he did not terminate with the company.

Effect of early retirement window benefit on the average benefit percentage test-special rule under section 1.401(a)(4)-3(f)(4)(ii)(D)

This special rule can apply when a window benefit is offered and all the rate groups of a general test plan satisfy coverage under the ratio percentage test (a ratio percentage of 70% or greater) if the window benefit is disregarded. Once the window benefit is taken into account under -3(f)(4)(ii)(C), the resulting increases in the most valuable accrual rates for the HCEs might cause one or more rate groups ratio percentages to fall below 70%, thus requiring such rate groups to satisfy the modified average benefits test.

As explained below in the general test section, if a rate group does not satisfy the ratio percentage test, the rate group must satisfy a modified average benefits test under section 1.401(a)(4)-2(c)(3), including the

average benefits percentage test. A rate group satisfies the average benefits percentage test if the plan, as a whole, satisfies the average benefits percentage test.

With respect to the special rule, a rate group that provides an early retirement window benefit is deemed to satisfy the average benefits percentage test if:

- all rate groups would satisfy the ratio percentage test if the early retirement window benefit was disregarded, and
- the group of employees to whom the early retirement window benefit is currently available satisfies coverage without regard to the average benefits percentage test.

As a result of this special rule, in order for a rate group to satisfy coverage, the rate group has to satisfy only the nondiscriminatory classification test (the midpoint test). The rate group is deemed to satisfy the average benefits percentage test.

EXAMPLE 8 Illustrating special rule

The Big Chain Motel sponsors a DB plan that satisfies the nondiscrimination requirements using the general test. Big Chain also sponsors a 401(k) plan. The plan satisfied coverage by the ratio percentage test and did not apply the average benefits percentage test. In 1997, the DB plan offers an early retirement window benefit. For 1997, all rate groups satisfy the ratio percentage test. However, after taking into account the window benefit, several rate group's ratio percentages fall below 70%.

Assume that the early retirement window benefit satisfies current availability. These rate groups' ratio percentages must satisfy the nondiscriminatory classification test under section 1.401(a)(4)-2(c). However, the rate group is deemed to satisfy the average benefits percentage test. As a result, the plan, as a whole, does not have to satisfy the average benefits percentage test.

UNPREDICTABLE CONTINGENT EVENT BENEFITS-INTRODUCTION AND DEFINITION

An unpredictable contingent event benefit is defined under section 412(l)(7)(B)(ii) as any benefit contingent on an event other than:

- Age, service, compensation, death or disability, or
- an event which is reasonably and reliably predictable (as determined by the Secretary).

An unpredictable contingent event benefit is not taken into account until the occurrence of the contingent event. Specifically, an unpredictable contingent event benefit is ignored for determining whether a plan satisfies the safe harbor requirements until the contingent event occurs.

If the unpredictable contingent event is expected to result in the termination of employees within a period of time consistent with the early retirement window benefit, the unpredictable contingent event benefit is allowed to be treated as an early retirement window benefit for those employees eligible for the benefit.

EXAMPLE 9 Illustrating unpredictable contingent event

Spot International manufactures gourmet cat food and has a number of plants across the country. Spot also sponsors a defined benefit plan with an early retirement benefit for employees who retire after age 55 (but before normal retirement age) and has at least 10 years of service. The plan provides that such a benefit will be equal to the normal retirement benefit reduced by 4% each year prior to normal retirement age.

The plan also provides for a plant closing benefit for employees eligible for the early retirement benefit. The plant closing benefit provides for an unreduced normal retirement benefit for those employees who work at the plant where operations have ceased.

For the 1997 plan year, there were no plant closings. In January 1998, the plant in Furry, South Dakota was closed since the plant had outdated equipment for manufacturing the new caviar line of foods. There were 50 employees at the plant, 15 of whom were eligible for the early retirement benefit. The employees were expected to terminate employment by March, 1998.

For 1997, the unpredictable contingent benefit is not taken into account when determining the safe harbor requirements or the accrual rates.

Because of the plant closing in 1998, the 15 employees are expected to terminate employment within one plan year and will satisfy the conditions for the plant closing benefit. Thus, the availability of this benefit must be taken into account when determining whether the plan satisfies the safe harbor requirements or in determining the accrual rates under the general test.

Since the employees are expected to terminate employment within a 12 month period (consistent with the requirement for the early retirement window benefit), the benefit may be treated as an early retirement window benefit for these employees. Thus, the plant closing benefit may be

disregarded when determining the normal accrual rates. In addition, the availability of the benefit is only considered in the 1998 plan year, and all other years are disregarded.

ADJUSTMENTS FOR CERTAIN PLAN DISTRIBUTIONS, SECTION 1.401(a)(4)-3(f)(7)-INTRODUCTION

This rule refers to situations in which a participant receives a distribution from the plan. Subsequent to the distribution, the years of service that relate to those distributions are used in determining the participant's current accrued benefit. The plan would count those years of service, but reduce the accrued benefit by the actuarial equivalent of the prior distribution.

EXAMPLE 10 Illustrating adjustments for distributions

In 1989, Thomas has 15 years of service when he terminates employment with the Leah Cosmetic Co. He receives a lump sum distribution of $50,000 under their DB plan. Thomas is rehired in 1998. The plan has a unit benefit formula and credits Thomas with 15 years of service in 1998. In addition, the plan reduces this accrued benefit by the actuarial equivalent of the lump sum distribution paid in 1989.

Adjustment for prior distributions-nondiscrimination requirements

For purposes of the "amounts testing" requirement under section 1.401(a)(4)-3 (both safe harbor and general test), an employee's accrued benefit includes the actuarial equivalent of prior distributions to the employee if the years of service in determining the accrued benefits that were distributed are used in determining the employee's current accrued benefit. As stated above, the plan would reduce the participant's accrued benefit by the actuarial equivalent of the prior distribution. However, for nondiscrimination, the prior distribution is considered to be part of the accrued benefit if the requirements of section 1.401(a)(4)-3(f)(7) are satisfied.

One of these requirements is that "actuarial equivalence" must be determined in a uniform manner for all employees using reasonable actuarial assumptions. A standard interest rate and a standard mortality table are considered reasonable assumptions. If the plan does not use reasonable actuarial assumptions in determining actuarial equivalence, the prior distributions would not be included as part of the accrued benefit. As a result, a safe harbor benefit formula would no longer be considered a safe harbor formula because the uniformity requirements would not be satisfied.

For purposes of the general test, if the requirements under section 1.401(a)(4)-3(f)(7) are satisfied (and depending on the measurement period used), the cashed out amount would be converted to its actuarial equivalent using reasonable rates and included as part of the participant's accrued benefit in calculating the accrual rate for a year subsequent to his reemployment.

Illustrating prior plan distributions-401(a)(9)

Plan distributions that are taken into account can occur when the employee has commenced receipt of benefits as required by section 401(a)(9) of the Code (prior to the changes made in 1996). In such a situation, in calculating the current accrued benefit, the plan reduces the accrued benefit for the distributions, but takes into account those years of service.

For purposes of the "amounts testing" requirement under section 1.401(a)(4)-3, the current accrued benefit is restored as if the distributions had not occurred. If the requirements of section 1.401(a)(4)-3(f)(7) are not satisfied, the actuarial equivalent of the prior distribution is not restored, and the accrued benefit for testing purposes is the accrued benefit provided under the plan.

EXAMPLE 11 Illustrating adjustments for prior distributions

Morgan Easy Chair Industries maintains a defined benefit plan that provides "if an individual is reemployed by the Employer after his prior employment has been terminated, all periods of his continuous employment with all Employers, both before and after the period he was not an Employee, shall be considered as continuous service". In addition the plan also provides that benefits payable under this plan to any reemployed member, with respect to whom assets of this plan representing his/her accrued normal retirement benefit hereunder as of any date were previously transferred to another qualified retirement plan in which such member is fully vested or cashed out, shall be reduced by an amount equal to the amount of his/her accrued normal retirement benefit determined as of such date.

The Plan provides benefits of 2% of Final Average Earnings x Years of continuous service not in excess of 25 years. The plan is considered to be a safe harbor plan.

Judy P. had a $7,000 annual accrued benefit and received a distribution of $25,000 when she terminated employment 20 years prior to retirement. She was subsequently reemployed and re-participated in the Plan. She retired at normal retirement age with a pension reduced for the previous distribution which she did not repay. If using reasonable actuarial

assumptions, the actuarial equivalent of the previous distribution is $7,000, the distribution is included as part of Judy's accrued benefit for testing purposes and the plan meets the uniform normal retirement benefit requirement under section 1.401(a)(4)-3(b)(2)(i). If not, the plan is not a safe harbor since Judy's accrued benefit is not the same benefit as another participant with the same number of years of service.

Note: This rule will apply if the plan provides for suspension of benefits upon reemployment. See DOL Regs 2530.203-3, Suspension of pension benefits upon reemployment of retirees.

EXAMPLE 12

Same facts as above, except that the plan is a general test plan. If the actuarial equivalent, using reasonable actuarial assumptions of the previous distribution, is $7,000, then Judy's normal and most valuable accrual rate includes such actuarial equivalent of this prior distribution.

ADJUSTMENTS FOR CERTAIN QPSA CHARGES, SECTION 1.401(a)(4)-3(f)(8)

Although the plan may reduce the accrued benefit by the cost of a qualified pre-retirement survivor annuity (QPSA), an employee's accrued benefit for purposes of the safe harbor requirements or the general test includes the cost of a qualified pre-retirement survivor annuity. If the QPSA charge applies uniformly to all employees, the employee's accrued benefit is determined as if the cost of the QPSA had not been charged against the accrued benefit. Thus, the QPSA charge to the accrued benefit is ignored for determining whether the safe harbor requirements are satisfied.

EXAMPLE 13 Illustrating when QPSA is disregarded

The Thyme Clock Co.'s defined benefit plan provides that if a pre-retirement survivor annuity was elected with respect to a participant, the pension otherwise payable shall be reduced in consideration of the coverage to the extent of 1/3 of 1% for each full year of coverage.

Since the charge is uniform for all employees, the accrued benefit for testing under either the safe harbor rules or for purposes of the general test does not reflect the charge.

EXAMPLE 14

The Sage Brush Co.'s defined benefit plan provides if a pre-retirement survivor annuity was payable with respect to a participant, but the

participant survives until his Annuity Starting Date, the pension otherwise payable shall be reduced in consideration of the coverage to the extent of 1/4 of 1% for each full year of coverage.

The charge is not uniform for all employees who elect coverage because the charge is applicable only to participants who survive until their Annuity Starting Date. For participants who did not survive until the annuity starting date, the benefit paid to the survivor would not be reduced by the QPSA charge. Consequently, when evaluating the plan for purposes of the safe harbor requirements or the general test, the charge must be taken into account in calculating the accrued benefit.

EXAMPLE 15

Rosemary's Child Care Center's defined benefit plan provides if pre-retirement survivor annuity coverage was elected by a participant, the pension otherwise payable shall be reduced by 1/4 of 1% for each full year of coverage from age 55 through 62 and 1/2 of 1% for each full year of coverage from age 62.

The charge is uniform for all employees who elect coverage because the charge reasonably reflects the actual cost of providing the benefit. Note that the costs of the QPSA would increase as the participant gets older. In this case, the charge increases as the age of the participant increases. A participant who terminates and receives his benefit prior to age 55 will not be charged at all, while a participant who terminates after age 55 will be charged .25% for each full year of coverage from age 55. However, this charge increases to .5% for each full year of coverage from age 62.

The following examples illustrate the situation in which the QPSA charges are not disregarded.

EXAMPLE 15 Impact on uniformity requirement if the QPSA charge is not disregarded

Refer to the Sage Brush Co example above. Since the pre-retirement survivor annuity charge is required to reduce the accrued benefit of participants who elect coverage, the plan would fail the Uniform Normal Retirement Benefit requirement for safe harbor plans. This occurs because the same percentage of average annual compensation or same dollar amount will not be paid to participants who have the same number of years of service for participants who were charged for QPSA coverage.

EXAMPLE 16 Impact on uniformity requirement if the QPSA charge is not disregarded

Refer to the Rosemary's Child Care Center example above and **assume** the QPSA charges do not reasonably reflect the actual cost of the QPSA (for purposes of this example, the same QPSA charges from Example 40 are used.) Since the QPSA charge cannot be disregarded under the regulations, the charge is required to reduce the accrued benefit of participants who elect coverage. As a result, the plan may fail the Uniform Normal Retirement Benefit requirement if participants have different reductions, depending on age, for plans whose NRA is dependent upon a years of service or participation requirement.

Rosemary's defined benefit plan provides a benefit of 70% of three year average annual compensation fractionally accrued. The following four employees participate.

	NRA	QPSA	Coverage	Years of Participation
Leah	65	$45,000	Not elected	25
Al	65	$45,000	Elected	25
Jerry	66	$37,000	Elected	5
Bob	65	$37,000	Elected	5

Leah's normal retirement benefit would be (70% x $45,000) or $31,500.

Al's normal retirement benefit would be (70% x 45,000) reduced by [(.0025 x 7) + .005 x 3)=1,023)] or $30,477.

Jerry's normal retirement benefit would be (70% x $37,000 reduced by [(.0025 X 2) + (.005 X 3) = $518)] or $25,382.

Bob's normal retirement benefit would be (70% x $37,000 reduced by [(.0025 x 1) + (.005 X 4) = $582)] or $25,318.

Note that this plan fails the uniformity normal retirement benefit requirement because participants with the same number of years of service at normal retirement age have different accrued benefits. As stated above, this difference is due to the varying QPSA charges. Since this plan is now a general test plan, the accrual rates are adjusted to reflect the QPSA charge.

DISREGARD OF CERTAIN OFFSETS, SECTION 1.401(a)(4)-3(f)(9)- INTRODUCTION

A plan may provide an offset when the same years of service are credited under two different plans. For example, Jones Fashion Institute acquires the Chelsea Dress Company. Both Jones and Chelsea has a DB plan. Jones credits employees with years of service with Chelsea and reduces this benefit by the accrued benefit under the Chelsea plan. Such a reduction by the Jones plan is the "offset".

Adjustment for offsets-nondiscrimination requirements

For purposes of the "amounts testing" requirement under section 1.401(a)(4)-3 (both safe harbor and general test), an employee's accrued benefit includes the offset benefit if certain requirements are satisfied. Thus, if the plan is a safe harbor plan and these requirements are met, the offset (or reduction) provided by the plan being tested is "included" for nondiscrimination purposes, thus preserving the safe harbor status of the benefit formula. Otherwise, the offset actually reduces the accrued benefit for testing, and the benefit formula no longer satisfies the uniformity requirements. The requirements to disregard these offsets are the following:

- The accrued benefit is included for testing purposes to the extent the service that is credited satisfies section 1.401(a)(4)-11(d)(3) for pre-participation or past service. Note that all similarly situated employees must be treated the same.
- The benefit under the plan being tested is reduced or offset by a qualified defined benefit or defined contribution plan (whether or not terminated).

Thus, the plan providing the offsetting benefit does not have to remain in existence in order for the benefit from that plan to reduce the benefit the under the plan being tested.

The assets of the plan whose benefit is used as the offset cannot be transferred in a merger, etc. through a 414(l) transaction to another the plan providing the current benefit.

The benefit under the plan being tested is reduced or offset by benefits under a foreign plan that are reasonably expected to be paid.

Finally, if any portion of the accrued benefit that is reduced or offset is vested, the offsetting benefit in the other plan must also be vested.

EXAMPLE 17 Illustrating offsets

Division X was acquired from Silk Co. in 1992. Division X became participants in Hill Co's defined benefit plan as a result of the acquisition. Hill Co's defined benefit plan credits service under its plan for Division X employees for the period they worked for Silk. In addition, Hill Co's plan offsets benefits accrued from Silk against the benefits accrued in Hill's plan.

Silk Co's benefit formula is 45% of five year average annual compensation (a 414(s) definition) accrued over years of service from date of hire up to a maximum of thirty years.

Hill Co's benefit formula is 2% of three year average annual compensation (also a 414(s) definition) times years of service from date of participation up to twenty five. For Division X employees, service with Silk Co is counted as years of participation and the benefit accrued under Silk's plan offsets (reduces) the benefit's accrued under Hill's plan.

Employee Mr. Bee is employed by Division X both prior and subsequent to the acquisition by Hill Co. Mr. Bee's accrued benefit in Silk's plan at the date of acquisition (1992) is $6,300. This is calculated using $42,000 average annual compensation with 10 years of service using the maximum denominator of 30.

Mr. Bee's accrued benefit in 1996 with Hill Co. is $14,840. This is calculated using $53,000 average annual compensation times 2% times 14 years of service. The benefit under Hill's plan is then offset by the $6,300 accrued under Silks plan. Hill's plan then provides the net benefit of $14,840 - 6,300 = $8,540.

Note: There is a difference between an offset and a provision that only includes crediting service earned with a prior employer. In this situation, have to determine whether the service can be used for testing for nondiscrimination under Regs section 1.401(a)(4)-11(d)(3) and whether the offset satisfies the requirements of section 1.401(a)(4)-3(f)(9) described above. In determining whether the plan is a safe harbor or general test plan, the offset is disregarded if these requirements are satisfied. In addition, if the plan is a general test plan, the $14,840 is used as the accrued benefit.

EXAMPLE 18

Same facts as previous example, except that the plan does not satisfy either 1.401(a)(4)-11(d)(3) or the requirements of section 1.401(a)(4)-3(f)(9). As a result, the offset cannot be disregarded and the plan does not satisfy the safe harbor uniformity requirements. For purposes of the general test, the accrued benefit is reduced by the offset of $6,300 to

$8,540. In this situation, the offset is frozen at the point Mr. Bee became an employee of Hill Co.

> Under the fresh start rules discussed above, compensation increases after the date Mr. Bee transferred can be used to calculate the offset.

To illustrate that Mr. Bee's accrued benefit of $8,540 does not satisfy the safe harbor requirements, divide the $8,540 by the years of service (which is 4, from 1992-1996) divided by average annual compensation of $53,000. The result gives an accrual rate of 4%. Since this rate exceeds the 2% accrual rate for the other participants, the plan fails the uniform normal retirement benefit requirement. A similar normal accrual rate is determined for purposes of the general test using the current and prior year measurement period ignoring imputed permitted disparity.

SECTION V, ADVANCED SAFE HARBOR TOPIC—CONTRIBUTORY DEFINED BENEFIT PLANS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

ADVANCED TOPICS-CONTRIBUTORY DEFINED BENEFIT PLANS UNDER SECTION 1.401(A)(4)-6

INTRODUCTION

This section explains the rules for determining whether a contributory defined benefit plan satisfies the nondiscriminatory amount requirement under section 1.401(a)(4)-1(b)(2) (either safe harbor or general test). A contributory defined benefit plan is a defined benefit plan that includes employer contributions that are not allocated to separate accounts, but are used to fund part of the accrued benefit that is provided to the participant. Both the employer-provided benefit (the accrued benefit that is funded by employer contributions) and the employee-provided benefit (the accrued benefit that is funded by employee contributions) are tested separately to determine whether the plan satisfies the nondiscriminatory amount requirement. The employer provided benefit is tested under section 1.401(a)(4)-6(b) and the employee provided benefit is tested under section 1.401(a)(4)-6(c).

In certain situations, the employer provided benefit has to be calculated before the formula can be determined to be a safe harbor or general test plan.

UNIFORMITY REQUIREMENTS-APPLICATION OF A CONTRIBUTORY DB PLAN

As stated above, a safe harbor plan under section 1.401(a)(4)-3(b) must satisfy the uniformity requirements under section 1.401(a)(4)-3(b)(2). Section 1.401(a)(4)-3(b)(2)(iv) provides that in order to satisfy the uniformity requirements, the plan must not be a contributory DB plan. However, an exception under section 1.401(a)(4)-3(b)(6)(viii) provides that a plan can be considered a safe harbor plan even though the plan is a contributory DB plan. To do so, the plan's benefit formula must provide benefits at employer provided benefit rates determined under section 1.401(a)(4)-6(b). Note that a minimum benefit added to the plan solely to satisfy the minimum benefit method of section 1.401(a)(4)-6(b)(3) (and thus providing benefits at employer provided rates under -6(b)) is **not** taken into account in determining whether this exception under -3(b)(6)(viii) is satisfied.

Section 1.401(a)(4)-6(b) provides the rules for determining the amount of benefits derived from employer contributions (employer provided benefits) for purposes of determining whether the plan is a safe harbor plan under section 1.401(a)(4)-1(b)(2). An employer provided benefit under a contributory DB plan equals the difference between the employee's total benefit and the employee provided benefit under the plan. The rules of section 411(c) generally must be used to determine the employer provided benefit. However, section 1.401(a)(4)-6(b)(2)-(b)(6) provide the following alternative methods for determining an employee's employer provided benefit:

- Composition of workforce method (-6(b)(2)),
- Minimum benefit method (-6(b)(3)),
- Grandfather rule for plans in existence on May 14, 1990 (-6(b)(4)),
- Government plan method (-6(b)(5)), and
- Cessation of employee contributions (-6(b)(6)).

Note that the last three rules are special rules for certain situations. This section will explain the composition of workforce method and the minimum benefit method.

COMPOSITION OF WORKFORCE METHOD

A contributory DB plan that satisfies the two eligibility requirements under section 1.401(a)(4)-6(b)(2)(ii)(A) and (B) may determine the employer-provided benefit rates under 1.401(a)(4)-6(b)(2)(iii). The two eligibility requirements are:

- Uniform rate of employee contributions -6(b)(2)(ii)(A), and
- Demographic requirements (-6(b)(2)(ii)(B)).

First eligibility requirement-uniform rate of employee contributions

The uniform rate of employee contributions is satisfied if all employees make employee contributions at the same rate, expressed as a percentage of plan year compensation (the employee contribution rate). A plan does not fail this requirement because it:

- eliminates employee contributions for all employees below a specified point, or
- employee contributions are made at one rate below a specified point and another rate above a specified point.

For example, a plan that requires a participant to contribute 3% of compensation in excess of covered compensation is still considered to require employees to make contributions at a uniform rate.

For example, a plan that requires a participant to contribute 2% of his/her covered compensation plus 3% of his/her excess compensation is still considered uniform because employees are required to make employee contributions at the same tiered rates.

Second eligibility requirement-demographic requirements

The second component of the composition of workforce method is a demographic requirement. A plan satisfies the demographic requirement if it satisfies either the Minimum Percentage Test or the Ratio Test.

The minimum percentage test

This test is satisfied if:

- more than 40 percent of the NHCEs in the plan have attained ages at least equal to the plan's target age, and
- more than 20 percent of the NHCEs in the plan have attained ages at least equal to the average attained age of the HCEs in the plan.

DEFINITION OF TARGET AGE

The target age is the lower of:

- age 50 or
- average attained age of HCEs minus "X" yrs.

  "X" years is 20 minus (5 times the employee contribution rate under the plan)

  "X" years may not be lower than 0.

For example, the average attained age of HCEs in the plan is 53. The employee contribution rate is 2 percent of plan year compensation.

Determining "X" under the above formula (the average attained age of HCEs minus "X" years), "X"= 20-(5 x 2) or 10. The target age is the lower of 50 or 43 (53-10).

Note that the minimum percentage test cannot be used if the plan requires more than one employee contribution rate because the target age definition can only be applied by using one rate.

EXAMPLE 45 Illustrating when plan cannot use minimum % test

A plan requires employee contributions at 2% for compensation at or below covered compensation and 3% above covered compensation. The plan cannot use the minimum percentage test to determine eligibility for the composition of workforce method since there are two rates at which employee contributions are made. Thus, the plan must satisfy the ratio test in order for the plan to be eligible for the Composition of Workforce method.

The ratio test

If the plan does not satisfy the minimum percentage test, the plan can still be eligible for the composition of workforce method if the plan satisfies the ratio test. The ratio test can be defined as:

$$\frac{\text{the NHCE attained age percentage}}{\text{The HCE attained age percentage}}$$

must be greater then or equal to 70%.

The NHCE and HCE attained age percentages are determined by the following steps (note that the NHCE attained age percentages will be explained, but the same steps apply to determine the HCE attained age percentages):

1. The attained ages of the NHCEs (or HCEs) in the plan are determined,

   Note that attained ages must be determined as of the beginning of the plan year.

2. The average attained age of the HCEs in the plan are determined. (Note that this number is used for both the NHCE and HCE attained age percentages),
3. The number of the NHCEs whose attained age exceeds the average attained age of the HCEs are determined (# of NHCEs).
4. The # of NHCEs (determined from the preceding step) are then divided by the total number of non-excludable NHCEs in the controlled group to determine the "NHCE attained age percentage".

   Note that the employer may assume that 50 percent of all HCEs have attained ages at least equal to the average attained age of the HCEs. In this case, the HCE attained age percentage is deemed to be 50%. The advantage with this rule is that the employer would not have to actually determine the number of HCEs who exceed the HCE average attained age (previous step).

5. The NHCE attained age percentage is then divided by the HCE attained age percentage. The ratio test is satisfied if this ratio equals or exceeds 70%.

EXAMPLE 46 Illustrating the ratio test

The Little Man Manufacturing Co. sponsors a contributory DB plan. The plan provides for an integrated or tiered formula for both the employer contributions and employee contributions. Little Man has 700 non-excludable NHCEs and 200 HCEs. The plan benefits 500 NHCEs and 150 HCEs.

The average attained age of the HCEs in the plan is 50 and there are 125 NHCEs in the plan whose attained ages exceed 50. In addition, there are 135 HCEs with attained ages equal or above 50.

Little Man would like to use the composition of workforce method under 1.401(a)(4)-6. Thus, the plan must satisfy either eligibility test, the minimum percentage test or the ratio test.

Since the plan provides for a tiered formula with respect to the required employee contributions, Little Man cannot use the minimum percentage test under section 1.401(a)(4)-6(b)(2)(ii)(B)(2).

With respect to the ratio test, Little Man assumes that 50 percent of all HCEs have attained ages at least equal to the average attained age of the HCEs. The ratio test is calculated as follows:

First, the NHCE attained age percentage is determined by dividing the number of NHCEs in the plan which exceed the average age of the NHCEs by the total number of non-excludable NHCEs in the controlled group.

The NHCE attained age percentage is

$$\frac{125}{700} \quad \text{or} \quad 17.85\%$$

As stated above, the HCE attained age percentage is deemed to be 50%.

The NHCE attained age percentage is divided by the HCE attained age percentage or

$$\frac{17.85\%}{50\%} \text{ or } 35.7\%$$

Since the above ratio is not equal to or greater than 70%, the plan does not satisfy the ratio test and Little Man cannot use the composition of workforce method. Note that if Little Man had an HCE percentage that was below the assumption of 50%, the ratio percentage would increase. However, Little Man's HCE percentage was 135/200 or 67.5%.

EXAMPLE 47

Same facts as above, except that 265 NHCEs have an attained age that equals of exceeds the average attained age of the HCEs. The ratio test is calculated as follows:

The NHCE attained age percentage is:

$$\frac{265}{700} \text{ or } 37.85\%$$

As stated above, the HCE attained age percentage is deemed to be 50%.

The NHCE attained age percentage is divided by the HCE attained age percentage or

$$\frac{37.85\%}{50\%} \text{ or } 75.7\%$$

Little Man satisfies the demographic requirement and can use the composition of workforce method.

DETERMINATION OF EMPLOYER-PROVIDED BENEFIT

Once a plan satisfies the uniformity and the demographic requirements, the plan determines the employer provided benefit under section 1.401(a)(4)-6(b)(2)(iii). There are three categories:

1. A safe harbor plan that does not apply section 401(l),
2. A safe harbor plan that applies section 401(l), and
3. a general test plan.

A SAFE HARBOR PLAN THAT DOES NOT APPLY SECTION 401(L, SECTION 1.401(A)(4)-6(B)(2)(III)(A)

If the plan is not a section 401(l) plan, the employee's entire accrued benefit is treated as employer-provided. Thus, if a non-section 401(l) plan satisfies both the uniformity and the demographic requirements, the plan is considered to be a design based safe harbor within the exception under section 1.401(a)(4)-3(b)(6)(viii).

A SAFE HARBOR PLAN THAT APPLIES SECTION 401(L, 1.401(A)(4)-6(B)(2)(III)(B)

Section 1.401(a)(4)-3(b)(6)(ii) provides that a plan does not fail to be a safe harbor plan because the plan takes permitted disparity into account that satisfies section 401(l) in form. For purposes of determining whether a contributory DB plan satisfies section 401(l) in form, the benefit formula must be apportioned under section 1.401(a)(4)-6(b)(2)(iii)(B) to determine the employer portion of the formula. This apportionment depends on whether the employee contribution rate is one rate or varies (such as a tiered rate).

Apportionment if the employee contribution is one fixed rate

The apportionment is as follows:

- With respect to an excess plan, an employee's base benefit and excess benefit percentage is reduced by subtracting the product of the employee contribution rate and the factor determined under section 1.401(a)(4)-6(b)(2)(iv).
- With respect to an offset plan, an employee's offset percentage is reduced by subtracting the product of the employee contribution rate and the factor determined under section 1.401(a)(4)-6(b)(2)(iv).
- Once the benefit formula is segmented to determine the employer provided portion, the formula can now be analyzed to determine whether it satisfies the safe harbor requirements under section 1.401(a)(4)-3(b), including whether the formula satisfies the permitted disparity requirements of section 1.401(l)-3.

Note that the employee contribution rate is the highest rate of employee contributions applicable to any potential level of plan year compensation for that plan year under the plan.

Apportionment if the employee contribution rate varies

As stated above, the employee contribution rate, when multiplied by the factor described above, is used to determine the employer portion of the plan's benefit formula. For a plan that provides for varying employee contribution rates, the employee contribution used to reduce only the base benefit percentage (or the offset percentage) is the weighted average of the base contribution rate and the excess employee contribution rate.

In determining the weighted average, the weight of the base employee contribution rate is equal to:

$$\frac{\text{Lesser of integration level or contribution break point}}{\text{Integration level}}$$

The weight of the excess employee contribution rate is equal to the difference between one and the weight of the base employee contribution rate.

DETERMINATION OF PLAN FACTOR, SECTION 1.401(A)(4)-6(B)(2)(IV)

Remember, the plan factor is multiplied by employee contribution rate(s) to determine the employee's portion of the benefit formula. As explained above, the benefit formula is then reduced by this employee's portion to determine the employer's portion of the benefit formula.

The factor is determined by determining the average entry age of the employees in the plan. The average entry age is defined as the average attained age of all participants minus the average years of participation (counted as testing service under section 1.401(a)(4)-11(d)(3)) of all employees in the plan.

Once the average entry age is determined, the factor is based on whether the plan determines benefits based on an average compensation benefit formula or another type of formula. An average compensation benefit formula is a formula based on compensation averaged over a specified period not exceeding five consecutive years.

EXAMPLE 48 Illustrating employee contribution as a fixed rate

The Sheister & Crook Brokerage House and Used Car Lots sponsors a contributory DB plan providing a benefit of 2% of average annual compensation at or below covered compensation plus 2.5% of average annual compensation above covered compensation, times years of service up to 35. Average annual compensation under the plan is defined using a 5 year period for purposes of section 1.401(a)(4)-3(e)(2). The plan requires a rate of 4% of plan year compensation for all employees. Assume that the plan satisfies both the uniformity and the demographic requirements thus satisfying the eligibility requirements.

The average attained age for all employees in the plan is 55 and the average years of participation is 10. Thus, the average entry age in the plan is 45. Since the plan is determining benefits based on an average compensation benefit formula, the factor provided in the chart under section 1.401(a)(4)-6(b)(2)(iv) corresponding to an average entry age of 40 and the average compensation formula is .2.

This factor is then multiplied by the employee contribution rate of 4% to determine the employee's portion of the benefit formula of .8%. The employee's portion of the formula reduces both the base benefit percentage to 1.2% (2% less .8%) and the excess benefit percentage to 1.7% (2.5% less .8%) to determine the employer provided portion of the benefit formula. The plan must satisfy the safe harbor requirements of section 1.401(a)(4)-3(b), including the permitted disparity requirements under section 1.401(l)-3.

EXAMPLE 49 Illustrating a plan providing permitted disparity and the employee contribution rate varies

Same facts as previous example, except that the employee contribution rate is 2% of plan year compensation up to the covered compensation (the contribution break point) and 4% of plan year compensation at or above the contribution break point.

Remember, as stated above, since the employee contribution rates vary, the base benefit percentage has to be reduced by a weighted average of the employee contribution rates to determine the employer's portion. In determining the weighted average, the weight of the base employee contribution rate is equal to:

$$\frac{\text{Lesser of integration level or contribution break point}}{\text{Integration level}}$$

In this case, the integration level and the contribution break point are the same, covered compensation. Thus, the weight of the base contribution percentage is 100%.

The weight of the excess employee contribution rate is equal to the difference between one and the weight of the base employee contribution rate. Since the weight of the base contribution percentage is 100%, the weight of the excess employee contribution rate is 0%.

The weighted average of the employee contribution rates is 2%, which is now used to reduce the base contribution percentage. As stated above, the factor is .2 and the reduction factor is 2% x .2 or .4%. The base benefit percentage is reduced to 1.6% (2%-.4%).

Remember, the reduction factor for the excess benefit percentage is 4% (the excess employee contribution rate) multiplied by the factor of .2%. The excess benefit percentage is reduced to 1.7% (2.5%-.8%) (see previous example).

EXAMPLE 50 Illustrating a plan providing permitted disparity and the employee contribution rate varies

Same facts as previous example, except that the employee contribution rate is 2% of plan year compensation up to 40% of covered compensation (the contribution break point) and 4% of plan year compensation at or above the contribution break point.

Remember, as in the previous example, the base benefit percentage has to be reduced by a weighted average of the employee contribution rates to determine the employer provided portion of the benefit. In determining the weighted average, the weight of the base employee contribution rate is equal to:

$$\frac{\text{Lesser of integration level or contribution break point}}{\text{Integration level}}$$

In this case, the contribution break point is less than the integration level. The weighted average of the base employee contribution rate of 2% is:

$$\frac{\text{40\% of integration level}}{\text{Integration level}} \text{ or 40\%}$$

Applying the base employee contribution rate, the weight of this rate is 40% x 2% or .8%.

Remember, the reduction factor for the excess benefit percentage is 4% (the excess employee contribution rate) multiplied by the factor of .2%. The excess benefit percentage is reduced to 1.7% (2.5%-.8%) (see previous example).

The weight of the excess employee contribution rate is equal to 1 minus the weight of the base employee contribution rate. The weight of the excess employee contribution rate is 60%. Applying the excess employee contribution rate, the weight is 60% x 4% or 2.4%.

The weighted average of the employee contribution rates is the sum of the weights of the two rates or .8% plus 2.4% or 3.2% which is now used to reduce the base contribution percentage to determine the employer's provided portion. As stated above, the factor is .2 and the reduction factor is 3.2% x .2 or .64%. The base benefit percentage is reduced to 1.36% (2%-.64%).

Remember, the factor for the excess benefit percentage is 4% (the excess employee contribution rate) multiplied by the factor of .2%. The excess benefit percentage is reduced to 1.7% (2.5%-.8%) (see previous example).

The safe harbor rules, including the permitted disparity rules, are applied using the adjusted base contribution rate of 1.36% and the adjusted excess contribution rate of 1.7%.

EMPLOYER PROVIDED BENEFITS UNDER THE GENERAL TEST

For purposes of applying the general test, the normal and most valuable accrual rates are reduced by the product of the employee contributions (expressed as a percentage of plan year compensation) and the factor determined under section 1.401(a)(4)-6(b)(2)(iv). After the adjustment, the options under section 1.401(a)(4)-3(d)(3) (other than the fresh start alternative) such as imputing permitted disparity and grouping etc. can then be utilized.

EXAMPLE 51 Illustrating determination of employer provided benefits

The Skywalker Religious Book & Movie Company sponsors a contributory DB plan that satisfies the nondiscrimination requirements using the general test. The employee contribution rate is 3% of plan year compensation. Assuming the plan satisfies the eligibility and demographic requirements, the plan can apply the composition of workforce method. The plan determines benefits using average annual compensation of a specified period of 3 years. The average attained age of all employees in the plan is 42 and the average years of participation is 7.

Hans has a normal and most valuable accrual rate of 2% and 3.5% respectively. These rates are segmented into an employee and employer provided portion by the factor under section 1.401(a)(4)-6(b)(2)(iv). as follows. The factor under section 1.401(a)(4)-6(b)(2)(iv) corresponds to an average entry age of 35 (average attained age of 42 less average participation of 7) under the average compensation benefit formula. The employee contribution rate of 3% is multiplied by this factor of .4% to calculate the reduction factor.

The rates are reduced as follows. The employer provided portion of the normal accrual rate is .8% (2%-1.2%) and the employer provided portion of the most valuable accrual rate is 2.3% (3.5%-1.2%). These rates can now be adjusted for imputing permitted disparity, grouping or the other

optional rules under section 1.401(a)-3(d)(3) (other than the fresh start alternative).

MINIMUM BENEFIT METHOD UNDER SECTION 1.401(A)(4)-6(B)(3)

A contributory DB plan that satisfies the uniform rate requirement of section 1.401(a)(4)-6(b)(2)(ii)(A) (all employees make employee contributions at the same rate, expressed as a percentage of plan year compensation-see above) and a minimum benefit requirement under section 1.401(a)(4)-6(b)(3)(ii) may apply the adjustments as in section 1.401(a)(4)-6(b)(2)(iii) (see above) as if the average entry age of employees in the plan were within the rage of 30-40 without regard to the actual demographics in the plan.

Minimum benefit requirement under section 1.401(a)(4)-6(b)(3)(ii)

The minimum benefit requirement is satisfied if each employee will accrue a benefit that equals or exceeds:

- the accrued benefit derived from employee contributions plus
- 50% of the total accrued benefit determined under the plan formula after the effective date of the regulations.

Note that the accrued benefit derived from employee contributions is determined under section 411(c).

EXAMPLE 52 Illustrating when minimum benefit cannot be used

The Adam & Jessica School for New Fathers sponsors a contributory DB plan. Nancy participates and accrues a benefit under the terms of the plan of $3,000. The accrued benefit derived from the employee contribution determined under section 411(c) is $2,000. The minimum benefit method requires Nancy's accrued benefit to be $2,000 plus 50% of $3,000 or $3,500. Since Nancy's accrued benefit is less than $3,500, the plan cannot utilize the minimum benefit method.

DETERMINING WHETHER EMPLOYEE-PROVIDED BENEFITS ARE NONDISCRIMINATORY UNDER SECTION 1.401(A)(4)-6(C)

A contributory DB plan satisfies the amounts requirement under section 1.401(a)(4)-1(b)(2) only if the plan satisfies one of the following requirements:

- The same rate of contribution requirement under section 1.401(a)(4)-6(c)(2),
- The total benefits method under section 1.401(a)(4)-6(c)(3) or
- The grandfather rule for plans in existence May 14, 1990 under section 1.401(a)(4)-6(c)(4).

SAME RATE OF CONTRIBUTION REQUIREMENT UNDER SECTION 1.401(A)(4)-6(C)(2)

This requirement is satisfied for a plan year if the employee contribution rate (within the meaning of section 1.401(a)(4)-6(b)(2)(ii)(A) is the same for all employees for the plan year. The employee contribution rate is expressed as a percentage of plan year compensation. Note that although the employee contribution rate may satisfy the uniformity requirement under section 1.401(a)(4)-6(b)(2)(ii)(A), the rate may not be the same for all employees for the plan year.

EXAMPLE 53 Illustrating same rate of contribution requirement

The J.L. Yuppie Boutique Chain sponsors a contributory DB plan which provides an employee contribution rate of 3% at or below covered compensation and 5% above covered compensation. Although the employee contribution rate is considered uniform under section 1.401(a)(4)-6(b)(2)(ii)(A), the rate is not the same for all employees since the rates vary, depending on the covered compensation for each employee. Thus, the same rate of contribution under section 1.401(a)(4)-6(c)(2) is not satisfied.

EXAMPLE 54

Same facts as above, except that the employee contribution rate is 3% of compensation. The employee contribution rate is the same and the requirement under section 1.401(a)(4)-6(c)(2) is satisfied.

THE TOTAL BENEFITS METHOD UNDER SECTION 1.401(A)(4)-6(C)(3)

This requirement is satisfied if:

- the total benefits (the benefit formula under the plan) satisfies the safe harbor or the general test requirements under section 1.401(a)(4)-3 and
- the plan's contribution requirements satisfy section 1.401(a)(4)-6(b)(2)(ii)(A) which provides that the contribution must be uniform (see above).

THE GRANDFATHER RULES UNDER SECTION 1.401(A)(4)-6(C)(4)

The grandfather rules are satisfied if the plan contained a provision as of May 14, 1990 that satisfies the graded contribution rate requirements of -6(c)(4)(ii) and the prior year compensation requirement of -6(c)(4)(iii).

GRADED CONTRIBUTION RATES REQUIREMENT UNDER -6(C)(4)(II)

This requirement is met if all of the following requirements are met:

a. The provisions as of May 14, 1990 require employee contributions at a greater rate (expressed as a percentage of compensation) at higher levels of compensation than at lower levels of compensation,
b. The required rate of contributions is not increased after May 14, 1990. However, the level of compensation at which employee contributions are required may be increased or decreased.
c. All employees are permitted to make employee contributions at a uniform rate no later than the last day of the first plan year to which these regulations apply under section 1.401(a)(4)-13(a) and (b).
d. The benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation.

PRIOR YEAR COMPENSATION REQUIREMENT UNDER -6(C)(4)(III)

The plans provisions as of May 14, 1990 meet the prior year compensation requirement if:

- they are part of a plan maintained by more than one employer that requires employee contributions and
- the rate of required employee contributions, expressed as a percentage of compensation for the last calendar year before the beginning of the plan year, is the same for all employees.

SECTION VI--COMPREHENSIVE EXAMPLES ILLUSTRATING SAFE HARBOR REQUIREMENTS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

INTRODUCTION

The following 2 examples provide a comprehensive analysis of the safe harbor requirements for both a unit credit and a fractional rule plan. Both of these examples were taken from actual determination cases. Note that although the examples may show that the plan violates more than one of the safe harbor requirements, the plan would be considered a general test plan if only one safe harbor requirement was not satisfied. However, since the purposes of these examples are to illustrate all of the safe harbor requirements, more than one violation was found.

Note that both of these examples cover the permitted disparity requirements, since a plan that provides for permitted disparity must satisfy the requirements under section 401(l) to be considered a safe harbor plan. For an in-depth discussion on permitted disparity, please refer to the chapter in the 1993 CPE text.

EXAMPLE 1 COMPREHENSIVE EXAMPLE ILLUSTRATING A UNIT CREDIT PLAN

Plan V provides that a participant's normal retirement income shall be equal to the sum of the future service benefit plus the past service benefit. The future service benefit equals 60% of the participant's contributions to the plan without interest, payable as an annuity. The past service benefit equals the accrued benefit as of December 31, 1994 under this plan, the W plan, the X plan and Y plan. The participant shall contribute 3.5% of his Covered Compensation plus 4.4% of his Excess Compensation.

If a participant continues to work beyond his Normal Retirement Age, the amount of the accrued benefit shall be determined based on his Compensation and contributions until actual retirement.

Compensation is defined as W-2 compensation plus deferrals under a section 125 or 401(k) plan. Covered Compensation means $10,000. Excess Compensation means Compensation which exceeds Covered Compensation.

Normal Retirement Age is 65.

Normal form of benefit is a single life annuity with all other optional forms of benefit equal to the actuarial equivalent of the normal form. Early Retirement Age is 55 with 10 YOS.

UNIFORMITY REQUIREMENTS

The first uniformity requirement under section 1.401(a)(4)-3(b)(2) is the Uniform Normal Retirement Benefit. In order to determine whether the plan meets this requirement, the plan must satisfy permitted disparity under IRC section 401(l). Remember, section 1.401(a)(4)-3(b)(6)(ii) indicates that if the benefit formula meets 1.401(l)-3, the formula is deemed uniform.

As stated in the facts, this plan is a contributory DB plan. Before the benefit formula can be analyzed for permitted disparity under section 1.401(l)-3, the employer provided benefit must be determined. According to section 1.401(a)(4)-3(b)(6)(viii), in order to be a contributory DB plan and satisfy the safe harbor requirements, the plan benefit formula must provide employer provided benefits at rates determined under Section 1.401(a)(4)-6(b).

EMPLOYER PROVIDED BENEFIT UNDER SECTION 1.401(A)(4)-6(B)

Section 1.401(a)(4)-6 provides several alternative methods of determining the employer provided benefit in a contributory plan. They are:

1. Composition of workforce method
2. Minimum benefit method
3. Grandfather rule for plans in existence on May 14, 1990
4. Government plan method
5. Cessation of employee contributions.

The last three of these rules are special rules for certain situations.

COMPOSITION OF WORKFORCE METHOD

Uniformity requirement of employee contributions

As stated above, the composition of workforce method has two components. The first component requires employee contributions at a uniform rate. This requirement states that employee contributions must be the same percentage of plan year compensation for all employees. A plan still meets this requirement if

1. employee contributions are eliminated for all employees below a specified point or
2. employee contributions are made at one rate below a specified point and at another rate above the specified point.

The above formula meets the second situation. The employee contribution rates are 3.5% of compensation up to $10,000 and 4.4% of compensation over $10,000.

Demographic requirement

The second component of the composition of workforce method is a demographic requirement. A plan must pass one of two tests, the Minimum Percentage Test or the Ratio Test.

Minimum percentage test

This plan cannot use the Minimum Percentage Test since the benefit formula does not provide a single employee contribution rate which is necessary to determine this test.

Ratio test

The Ratio Test is expressed as follows:

$$\frac{\text{the NHCE attained age percentage}}{\text{The HCE attained age percentage}}$$

must be greater then or equal to 70%.

The NHCE and HCE attained age percentages are determined by the following steps:

1) The attained ages of the NHCEs (or HCEs) in the plan are determined,

   Note that attained ages must be determined as of the beginning of the plan year.

2) The average attained age of the HCEs in the plan are determined (for both the NHCE and HCE attained age percentages),

3) The number of the NHCEs (HCEs) whose attained age exceeds the average attained age of the HCEs are determined (# of NHCEs), (# of HCEs).

4) The # of NHCEs (# of HCEs) are then divided by the total number of non-excludable NHCEs (HCEs) in the controlled group to determine the "NHCE attained age percentage" and the "HCE attained age percentage".

   Note that the employer may assume that 50 percent of all HCEs have attained ages at least equal to the average attained age of the HCEs. In this case, the HCE attained age percentage is deemed to be 50%. The advantage with this rule is that the employer would not have to actually determine the number of HCEs who exceed the HCE average attained age (previous step).

5) The NHCE attained age percentage is then divided by the HCE attained age percentage. The ratio test is satisfied if this ratio equals or exceeds 70%.

In this plan, 630 NHCEs have attained ages greater than or equal to the average attained age of the HCEs. There are 1500 non-excludable NHCEs. For HCEs use the assumption provided by the regulations that 50% of all HCEs have attained ages greater than or equal to the average attained age of the HCEs.

The NHCE attained age percentage is:

$$\frac{630}{1{,}500} \text{ or } 42\%$$

The NHCE attained age percentage is divided by the HCE attained age percentage or

$$\frac{42\%}{50\%} \text{ or } 84\%$$

This plan satisfies the Ratio Test of the Composition of Workforce Method. Please note that since the determination of safe harbor status is based on demographic data, if the demographic characteristics change, the plan may no longer be a safe harbor plan. Reliance on a determination letter would apply up until the demographics changed and a methodology change is required.

Since the plan satisfied both the uniformity and the demographic requirement, the employer provided benefit can now be determined.

Computing the employer provided benefit

For purposes of computing the employer provided benefit rate in an IRC section 401(l) plan, the employee's base and excess percentages must be reduced by a factor. The factor is determined by a table in the regulations based on an average entry age of employees in the plan and on compensation used under the plan formula.

For this plan assumes the average entry age is over 40. The plan is a Career Average Pay plan. Consequently the factor is .3. For purposes of determining whether the plan satisfies IRC section 401(l) the employer provided benefit is determined as follows:

Employee contribution rates	3.5%	4.4%
Factor under 1.401(0(4)-6(b)(2)(iv)	X .3	X .3
Employee provided benefit	1.05%	1.32%

Though not stated as a traditional unit credit formula, the years of service requirement is implicitly stated. As stated above, the plan formula is 60% of the required employee contributions or 2.1% for the first $10,000 of compensation plus 2.64% of compensation in excess of $10,000 for each year of service. (Note that covered compensation was assumed to be $10,000 in the facts.) The benefit formula is calculated by taking 60% of 3.5% and 4.4%.

Remember, as stated above, for a plan that provides for varying employee contribution rates, the employee contribution used to reduce only the base benefit percentage is the weighted average of the base contribution rate and the excess employee contribution rate.

In determining the weighted average, the weight of the base employee contribution rate is equal to:

$$\frac{\text{Lesser of integration level or contribution break point}}{\text{Integration level}}$$

The weight of the excess employee contribution rate is equal to the difference between one and the weight of the base employee contribution rate.

Since the contribution break point and the integration level are equivalent, the base employee contribution rate is weighted at 100% and the excess employee contribution rate is weighted at 0%.

The employer provided benefits that are used to determine whether the safe harbor requirements are satisfied are as follows:

Total Benefit	2.10%	2.64%
Less employee provided benefit	1.05%	1.32%
Employer provided benefit	1.05%	1.32%

MINIMUM BENEFIT METHOD

The minimum benefit method allows the use of plan factors for determining the employer provided benefit without actually determining plan demographics for average entry age. There are two components to this test:

The uniformity requirement as discussed in the Composition of Workforce Method.

Each employee must accrue a minimum benefit under the plan at least equal to the sum of:

1) the accrued benefit derived from employee contributions plus
2) 50% of the total accrued benefit determined under the plan formula after the effective date of the regulations.

The formula can be shown to fail the second component. Assume a participant age 22 earns $10,000 during the first plan year. His employee contribution for the year is $350. His accrued benefit for the year would be $210 at age 65. Assume the pre-retirement rate applicable to the employee contribution under IRC section 411(c) is 6% and the annuity purchase rate is $10 per $1 of annual benefit. The $350 employee contribution would grow to $4,287 at age 65. This is equal to an annual benefit of $429. Since the employee derived benefit of $429 exceeds the $210 provided under the plan formula, the minimum benefit method cannot be satisfied.

OTHER METHODS UNDER 1.401(A)(4)-6

The other three methods (the grandfather rule, government plan method and cessation of employee contributions) do not apply to this plan.

PERMITTED DISPARITY

As determined above, the employer provided benefit to be tested under Regs. Section 1.401(l)-3 is a base benefit of 1.05% and an excess benefit of 1.32%. Note that the following analysis will apply the permitted disparity requirements. For a complete discussion of permitted disparity, please see the permitted disparity chapter in the 1993 CPE text.

Section 1.401(l)-3 has the following five requirements which must be met.

1. The plan must be an excess or offset plan
2. The plan must meet the maximum disparity requirements
3. The disparity must be uniform
4. The integration level must meet the requirements of Regs 1.401(l)-3(d)
5. The benefits, rights and features must meet the requirements of Regs 1.401(l)-3(f).

FIRST REQUIREMENT-EXCESS OR OFFSET REQUIREMENT

As indicated above, the employer provided benefit formula is an excess formula since the formula provides a greater rate of benefit for compensation above a certain level than below that level. Since plan compensation is based on a definition that satisfies both IRC section 414(s) and Regs 1.401(a)(4)-3(e)(2), the plan meets the excess requirement.

SECOND REQUIREMENT-MAXIMUM DISPARITY REQUIREMENT

The maximum disparity in an excess plan cannot exceed the lesser of.75% (with certain reductions) or the base benefit percentage. In this plan, the disparity is .27% (1.32%-1.05%). The base benefit percentage is 1.05%. Thus, the maximum disparity cannot exceed .75%, before reducing this percentage by the applicable reductions.

Reductions to the .75%

The first reduction is the reduction for normal and optional forms of benefit. In this plan, all optional forms of benefit are the actuarial equivalent of the normal form straight life annuity. Consequently no reductions are required in the .75%.

The second reduction is for certain integration levels. The integration level under this plan is a flat dollar amount of $10,000. This integration level meets the requirements of Regs 1.401(l)-3(d)(4) for a single dollar amount. The rule requires the single dollar amount not exceed the greater of $10,000 or 50% of the participant's covered compensation. In this case, no reductions are required for this integration level.

The third reduction is for benefits commencing at ages other than social security retirement age (SSRA). Since age 55 is the earliest retirement age under the plan and benefits cannot commence earlier than age 55, a reduction is necessary for early commencement. The table for SSRA of 67 and a commencement age of 55 requires a reduction down to .316% for the maximum excess allowance. Since the plan's maximum employer provided disparity is .27%, the plan satisfies this part of the maximum disparity requirement.

Overall permitted disparity limits

In addition to the maximum disparity requirement, the plan must meet the overall permitted disparity limits. There are two parts to this requirement:

1. The first is an annual disparity limit which limits benefits under more than one plan. In this case assume there is only one plan.

2. The second part is the cumulative disparity limit which limits the disparity for an employee's total years of service. The cumulative disparity fraction must not exceed 35.

For this plan the disparity fraction for each year is .27/.316 = .85443. This plan could calculate benefits for an employee using the plan formula for 40 years of service. Anything over 40.96 years would exceed the limit (40.96 X .85443 = 35). Consequently the plan must limit the years of service to which the benefit formula applies.

THIRD REQUIREMENT-UNIFORM DISPARITY

This requirement states that the disparity is uniform only if the plan uses the same excess and base benefit percentage for all employees with the same number of years of service. Since this plan uses the same base and excess benefit percentage for all participants regardless of the number of years of service, the plan meets this requirement. Note that a lack of uniformity because of the reduction in disparity required by the early commencement of benefits will not be considered to fail this requirement. Also, a benefit limited by the cumulative disparity limit will not fail to satisfy the uniform disparity requirement.

FOURTH REQUIREMENT-INTEGRATION LEVEL

As discussed above under the second reduction to the Maximum Disparity, this plan's integration level meets the requirements of the regulations for a single dollar amount.

FIFTH REQUIREMENT-BENEFITS, RIGHTS AND FEATURES

This requirement states that each benefit, right and feature under the plan must be provided to participants on the same terms with regard to compensation above and below the integration level. For purposes of this example, assume this requirement is satisfied.

CONCLUSION WITH RESPECT TO THE UNIFORM NORMAL RETIREMENT BENEFIT REQUIREMENT

At this point, the benefit formula is considered to meet the Uniform Normal Retirement Benefit Requirement (if the plan formula is amended to comply with the cumulative disparity limit) because the formula falls within the exceptions under the regulations. In addition since the normal form of benefit is a straight life annuity, the benefit is payable in the same form to all participants at the same uniform normal retirement age.

OTHER SAFE HARBOR UNIFORMITY REQUIREMENTS

UNIFORM POST-NORMAL RETIREMENT BENEFIT

In this situation the plan continues to credit a participant with service and give credit for compensation increases as long the participant continues to make the required employee contributions. This requirement is satisfied.

UNIFORM SUBSIDIES

Assume in this situation that all optional forms of benefit are currently available to all participants. This requirement is satisfied.

NO CONTRIBUTORY PLANS ALLOWED

As indicated above this plan meets the exception to the general rule as provided in Regs 1.401(a)(4)-3(b)(6). This requirement is satisfied.

PERIOD OF ACCRUAL REQUIREMENT

Since this plan is a career average pay plan with a unit credit formula, the plan satisfies this requirement. Note that all service that is counted for the future benefit under the plan is also considered to be testing service under section 1.401(a)(4)-11(d)(3). Thus, the years of service over which the benefits are accrued are the same as the years of service over which the benefit is calculated. The normal retirement benefit is the sum of each year's employee and employer provided accrued benefit.

CONCLUSION WITH RESPECT TO THE UNIFORMITY REQUIREMENTS

Overall, the benefit formula satisfies the uniformity requirements. The next section determines whether the benefit formula satisfies the safe harbor accrual requirements.

ACCRUAL REQUIREMENT-SAFE HARBOR FOR UNIT CREDIT PLANS

INTRODUCTION

After the formula is determined to satisfy the safe harbor uniformity requirements, the formula must satisfy the safe harbor accrual requirements under section 1.401(a)(4)-3(b). Since this plan is not a fractional accrual plan, it must meet the safe harbor accrual requirements for unit credit plans.

FIRST ACCRUAL REQUIREMENT-133 1/3 PERCENT RULE

The first safe harbor requirement is that it meets the 133 1/3 percent rule of IRC section 411(b)(1)(B). This plan meets the first requirement under the Regs 1.411(b)-2(i) which requires that the accrued benefit payable at normal retirement age is equal to the normal retirement benefit under the plan. The plan also meets the second requirement under Regs 1.411(b)-(2)(i) which requires that the accrual rate for any later year cannot exceed the accrual rate for any prior plan year by more than 133 1/3%. Consequently, the plan satisfies the first safe harbor requirement.

SECOND ACCRUAL REQUIREMENT-UNIT CREDIT FORMULA

The second safe harbor requirement states that the formula is a unit credit formula. As indicated above, although the formula is not stated as traditional unit credit formula, the years of service requirement is implicitly stated. The employer provided benefit is 1.05% of Compensation up to $10,000 plus 1.32% of Compensation in excess of $10,000. This is a career average pay plan which satisfies the average annual compensation requirement. Consequently, the second safe harbor requirement is satisfied.

IMPACT OF FRESH START

When analyzing the benefit formula, including the past service benefit, the entire formula must be analyzed as to whether it satisfies the safe harbor requirements. In this case, whether the prior formulas would satisfy uniformity and the other requirements is unknown. However, the way the formula is written satisfies the fresh start rules for a Formula Without Wear-Away under Regs. Section 1.401(a)(4)-13(c)(4)(i).

This fresh start formula indicates an employees accrued benefit is the sum of the employee's frozen accrued benefit plus the employee's accrued benefit determined under the plan formula applied to years after the fresh start.

In this particular case, the fresh start date is December 31, 1994. For periods prior to this date the benefit formula is ignored in evaluating the plan for purposes of the safe harbor rules or general test. In other words, the future service benefit is analyzed for the safe harbor requirements. Note that for years prior to 1995, unless the plan can rely on a prior determination letter that covers years after 1988, the plan is relying on good faith for nondiscrimination.

CONCLUSION WITH RESPECT TO THE SAFE HARBOR ACCRUAL REQUIREMENTS

The plan satisfies the safe harbor accrual requirements. Since the plan satisfies both the uniformity requirements and the accrual requirements, the formula is considered to be a safe harbor formula.

WHETHER EMPLOYEE PROVIDED BENEFITS ARE NONDISCRIMINATORY UNDER SECTION 1.401(A)(4)-6(C)

For a contributory DB plan, the employee contributions must be nondiscriminatory under section 1.401(a)(4)-6(c). Regs. Section 1.401(a)(4)-6(c) provides rules in determining whether employee provided benefits satisfy nondiscrimination in amounts testing. The regulations provide three methods:

1. The same rate of contributions method
2. The Total-benefits method
3. Grandfather rules

SAME RATE OF CONTRIBUTIONS METHOD UNDER SECTION 1.401(A)(4)-6(C)(2)

The same rate of contributions method is satisfied if the employee contribution rate is the same for all employees. This plan does not meet this requirement since employee contributions are required at a step rate (3.5% below and 4.4% above $10,000 compensation).

TOTAL-BENEFITS METHOD UNDER SECTION 1.401(A)(4)-6(C)(3)

The total benefits method has two requirements:

1. The total benefit requirement and

2. the uniform rate of contribution requirement under section 1.401(a)(4)-6(b)(2)(ii)(A)

The total benefits requirement

The first requirement is satisfied if the total benefits under the plan (the benefit formula) satisfy either the safe harbor or general test requirements of Regs. Section 1.401(a)(4)-3. Note this does not include cross testing. For this plan to satisfy the safe harbor rules, an analysis similar to the above analysis would be required using the total benefit formula instead of using just the employer provided benefit.

The total benefit of 2.1% below and 2.64% above $10,000 would be analyzed for the safe harbor for unit credit plans, permitted disparity, and the other uniformity rules.

Whether the plan satisfies the safe harbor

In determining whether the total benefit formula satisfies the safe harbor requirement, the formula fails the Maximum Disparity Requirement. The disparity when using total benefits is 2.64% - 2.1% or .54%. This exceeds the maximum disparity for a participant with an SSRA of 67 who commences receiving benefits at age 55. As indicated above, the maximum disparity for this individual is .316%. Consequently, the **total benefit formula** would have to satisfy the general test.

The uniform rate of contribution requirement under section 1.401(a)(4)-6(b)(2)(ii)(A)

The second requirement indicates the plan contribution rate would have to satisfy the uniform rate of employee contribution requirement of the Composition of Workforce Method. As indicated above, the plan satisfies this requirement.

THE GRANDFATHER RULE

The Grandfather rule is for special situations for plans that satisfy the requirements of section 1.401(a)(4)-6(c)(4).

CONCLUSION

Based on the fact that the employee provided benefit does not satisfy uniformity, the total benefit formula has to satisfy the general test.

EXAMPLE 2 COMPREHENSIVE EXAMPLE ILLUSTRATING A FRACTIONAL RULE PLAN

FACTS

Plan T provides that, effective January 1, 1993, the yearly retirement income payable on or after Normal Retirement Date under the plan is determined as follows:

- 53.5% of the participants Average Annual Compensation plus
- 60% of the portion of his Average Annual Earnings in excess of Covered Compensation

multiplied by the ratio that the number of his years of Credited Service bears to the greater of 20 or the number of years of Credited Service he would have had on his Normal Retirement Date up to a maximum of 30.

Accrued Benefit is the yearly retirement income commencing on the participant's Normal Retirement Date determined in accordance with the benefit formula as if the participant's termination of employment occurred on the date of determination.

Earnings are defined as total compensation received from the employer reported on Form W-2 including elective deferrals under a 401(k) or cafeteria plan.

Average Annual Earnings is defined as the highest average Earnings received during any five consecutive years.

Covered Compensation is defined as the average of the taxable wage bases for the 35 calendar years ending with the last day of the calendar year in which a participant attains social security retirement age.

Credited Service is defined as all years of employment with the employer except any plan year in which the participant has less than 1,000 Hours of Service. In addition, the plan grants past service credit that satisfies section 1.401(a)(4)-11(d)(3).

For a participant whose employment continues with the employer after his Normal Retirement Date, the yearly amount of late retirement income payable to such participant will be equal to the greater of (A) or (B):

(A) the yearly retirement income payable at Normal Retirement Date as adjusted by the late retirement Adjustment Factor; and

(B) the yearly retirement income based on the participant's Credited Service and Average Annual Earnings determined as of his retirement date.

The Adjustment Factor for late retirement is defined using the GAM71M mortality table, 3.5% interest. Assume these factors are reasonable in the aggregate.

Normal form of benefit is a Ten year certain and life annuity with optional forms being defined as the actuarial equivalent of the normal form.

Normal Retirement Age is 65 or 5th anniversary of participation which ever is later. Vested participants are eligible to receive benefits commencing with Normal Retirement Age.

Post Retirement COLA is defined as the ratio of the Consumer Price Index for January divided by the Consumer Price Index for January of the preceding year. In no event will the adjustment be more than 104% or less than 96% of the current retirement income or less than the base retirement income.

SAFE HARBOR UNIFORMITY REQUIREMENTS

UNIFORM NORMAL RETIREMENT BENEFIT

In order to determine whether the plan meets this requirement, the plan must provide the benefit payable in the same form to all employees commencing at the same uniform normal retirement age. In this case, the normal form is the same Ten Year Certain form. The retirement age meets the definition of uniform normal retirement age under Regs. Section 1.401(a)(4)-12. These two requirements are satisfied.

In addition, the regulations provide that the plan must satisfy Regs. Section 1.401(l)-3.

PERMITTED DISPARITY

Regs. Section 1.401(l)-3 has the following five requirements which must be met.

1. The plan must be an excess or offset plan
2. The plan must meet the maximum disparity requirements
3. The disparity must be uniform
4. The integration level must meet the requirements of Regs. Section 1.401(l)-3(d)

5. The benefits, rights and features must meet the requirements of Regs 1.401(l)-3(f)

First requirement-Excess or Offset requirement

The employer provided benefit formula is an excess formula since the formula provides a greater rate of benefit for compensation above a certain level than below that level. Since plan compensation is based on a definition that satisfies both IRC section 414(s) and Regs. Section 1.401(a)(4)-3(e)(2), the plan satisfies this requirement.

Second requirement-Maximum Disparity Requirement

The maximum disparity in an excess plan cannot exceed the lesser of .75% with certain reductions or the base benefit percentage for each plan year. In this plan, the base benefit percentage is 53.5% and the excess percentage is 60%.

The lowest yearly base benefit percentage is 1.78% (53.5%/30 years, 30 being the slowest accrual rate in this plan). The lowest yearly excess benefit is 60%/30 or 2%. Thus, the lowest disparity is .22%.

The highest yearly base benefit percentage is 2.675% (53.5%/20) and the highest excess benefit percentage is 3% (60%/20). Thus, the highest disparity is .325%.

The disparity ranges from .22% through .325%, depending on the years of accrual for a participant. The .75% (maximum disparity limit) must be analyzed for the applicability of the reductions.

First reduction to the maximum disparity limit

The first reduction is for normal and optional forms of benefit. In this plan, all optional forms of benefit are the actuarial equivalent of the normal Ten Year Certain form. Since the plan offers an increased straight life annuity, an adjustment is required to the .75% factor based on the actuarial equivalent using reasonable assumptions. In this case the adjustment decreases the factor to .68%.

The post retirement COLA

Section 1.401(l)-3(b)(4)(iii)(D) provides that a COLA can be ignored for disparity purposes if the plan provides that:

(A) The cola is included in the accrued benefit of all employees and

(B) the COLA is no greater than the Social Security COLA.

In this case, the COLA is not limited to the Social Security COLA. As a result, section 1.401(l)-3(b)(4)(iii)(C) requires that the "respective portions" (the base portion and the excess portion) of the COLA be normalized, as defined in section 1.401(a)(4)-12, into a life annuity.

For a defined benefit excess plan, the respective portions are the portion of the optional form attributable to average annual compensation up to the integration level (the base portion) and the portion of the optional form attributable to the average annual compensation in excess of the integration level (the excess portion).

For plans with a post retirement COLA, the employer should be required to show that such a COLA either satisfies the two requirements of section 1.401(l)-3(b)(4)(iii)(D) or show the particular adjustment required under section 1.401(l)-4(b)(4)(iii)(C).

Second reduction to the permitted disparity limit

The second reduction is for certain integration levels. Since the plan uses covered compensation as the integration level, the requirements of Regs. Section 1.401(l)-3(d)(4) are satisfied and no adjustment is required for this item.

Third reduction

The third reduction is for benefits commencing at ages other than social security retirement age (SSRA). Since age 65 is the earliest benefits can commence under the plan, a reduction is necessary for commencement prior to social security retirement age. The table for SSRA of 67 and a commencement age of 65 requires a reduction down to .65% for the maximum excess allowance. The cumulative reductions in this plan are .442% (.65% x .68%) (disregarding any cost of living adjustment that might be required under section 1.401(l)-4(b)(iii)(C), see above). The plan satisfies this part of the maximum disparity requirement.

Overall permitted disparity limits

In addition to the maximum disparity requirement, the plan must meet the overall permitted disparity limits. There are two parts to this requirement:

1. The first is an annual disparity limit which limits benefits under more than one plan. In this case assume there is only one plan.

2. The second is the cumulative disparity limit. This limits the disparity for an employee's total years of service. The cumulative disparity fraction must not exceed 35.

This plan's maximum disparity is 6.5% (60%-53.5%, see the benefit formula above). The maximum cumulative disparity allowed for this plan would be .442% x 35 or 15.74%. This plan satisfies the overall permitted disparity limits because the cumulative disparity is 6.5%.

Third requirement-Uniform Disparity

A plan that uses the fractional accrual rule is uniform only if it meets one of the requirements under section 1.401(l)-3(c)(2)(ii) or (iii). Section 1.401(l)-3(c)(2)(ii) provides the requirements for a fractional accrual plan providing disparity for 35 years. For a fractional accrual plan with less than 35 years of disparity, section 1.401(l)-3(c)(2)(iii) requires that the plan provide:

(A) the same base and the same excess benefit for all employees during the initial period which provides for the disparity, and

(B) a uniform percentage of average annual compensation equal to the excess benefit percentage during the years after the initial period.

This plan provides a disparity for less than 35 years (see benefit formula above). This plan fails both requirements. The plan does not satisfy the first requirement (providing the same base and the same excess benefit for all employees during the initial period). As stated above, the excess benefit percentage can range from .22% through .325%. In addition, the plan does not satisfy the second requirement (provide for any benefit beyond the initial period (20-30 years)). As a result, the formula does not satisfy the uniform disparity requirement.

Fourth requirement-Integration Level

As indicated above the integration level is acceptable.

Benefits, Rights and Features

This requirement states that each benefit, right and feature under the plan must be provided to participants on the same terms with regard to compensation above and below the integration level. For purposes of this example assume this requirement is satisfied.

CONCLUSION WITH RESPECT TO SECTION 401(L)

At this point the plan fails the uniform disparity requirement for meeting IRC section 401(l). Consequently, the plan fails the safe harbor Uniform Normal Retirement Benefit Requirement and cannot be considered a safe harbor plan. Although the analysis can stop at this point, the analysis continues so that the other safe harbor requirements can be illustrated.

OTHER SAFE HARBOR REQUIREMENTS

UNIFORM POST-NORMAL RETIREMENT BENEFIT

Since this plan indicates the participant will receive the larger of an actuarial increased benefit or the benefit accrued under the formula, the plan must be evaluated to determine if the actuarial increase can be disregarded under Regs 1.401(a)(4)-3(f)(3). This regulation has two requirements in order to disregard the actuarial increase:

1. The same uniform normal retirement age applies to all employees. This is satisfied in this plan.

2. The actuarial factor increasing benefits must be no greater than the largest factor that could be used under standard mortality and interest.

In order to evaluate the second requirement, compare the actuarial increase using the plan assumptions to the actuarial increase using standard interest and mortality. The actuarial increase would be the ratio of the annuity purchase rate (APR) at the uniform normal retirement age divided by the APR at the commencement age increased by interest for the period between the two ages.

In this plan the increase satisfies the requirement and can be ignored. Since the actuarial increase can be ignored, the plan satisfies this requirement.

UNIFORM SUBSIDIES

Assume in this situation that all optional forms of benefit are currently available to all participants. This requirement is satisfied.

NO CONTRIBUTORY PLANS ALLOWED

No employee contributions are allowed in this plan so this requirement is satisfied.

PERIOD OF ACCRUAL REQUIREMENT

In this plan, the benefit is based on Average Annual Earnings over Credited Service up to a range of 20 to 30 years. Both Average Annual Earnings and Credited Service are based on all years of employment with the employer. The only exception for service is for less than 1,000 HOS in a plan year.

Regs. Section 1.401(a)(4)-3(b)(6)(iv) allows a plan to disregard a period of accrual because of IRC section 411(b)(4) without failing the safe harbor requirements. IRC section 411(b)(4)(C) allows the plan to disregard years in which less than 1,000 HOS are credited for benefit accrual. In addition Regs 1.401(a)(4)-3(b)(6)(v) allows limits on the period of accrual without failing the safe harbor requirements. Thus, the period of accrual requirement is satisfied with respect to the years of service that are taken into account.

Note that compensation used in calculating the benefit must be determined over the same period that the participant receives an accrual. For example, if a participant performs service for a member of a controlled group, the plan may provide that such service is not taken into account for an accrual. However, if that service is taken into account when measuring average annual compensation, the period of accrual requirement is not satisfied.

With respect to the above plan, since Average Annual Earnings is calculated over a period of 5 consecutive years (without any exceptions for years that the participant did not receive an accrual), there is the possibility that earnings could be used to determine benefits from a period in which a participant did not accrue a benefit. For example, compensation can be used for a year in which the employee earned less than 1,000 hours of service. Consequently the plan fails the period of accrual requirement.

SAFE HARBOR ACCRUAL RULE FOR PLANS USING THE FRACTIONAL RULE

The plan is not a unit credit plan since it could fail the 133 1/3% rule. The plan must be evaluated under the safe harbor rules for fractional accrual plans.

FIRST ACCRUAL REQUIREMENT-FRACTIONAL RULE REQUIREMENT

The first requirement under the safe harbor fractional accrual rule is that it meets the fractional rule under section 411(b). This rule states that the accrued benefit cannot be less than the fractional rule benefit times a years of service fraction. The denominator of the fraction (YOS/YOS to NRA) in this plan is limited to between 20 and 30 YOS. The limits on accruals are allowed under Regs 1.401(a)(4)-3(b)(6)(v) and the examples in Regs 1.401(a)(4)-3(b)(4)(ii). This plan satisfies the fractional rule.

SECOND ACCRUAL REQUIREMENT-MODIFIED FRACTIONAL RULE REQUIREMENT

The modified fractional rule under the regulations is similar to the fractional rule requirement except that the modified fractional rule requires the same ratable accrual of the fractional rule benefit to determine the accrued benefit prior to normal retirement age. In many plans, this modified fractional rule is the same as the fractional rule.

Although the plan takes into account all years of service, including the past service credit that satisfies section 1.401(a)(4)-11(d)(3), the plan does not limit compensation taking into account average compensation for not more than 10 years of service immediately prior to the determination.

As stated above, in order to satisfy the modified fractional rule, the plan must specifically satisfy the definition of the fractional rule benefit. Note that for purposes of the fractional accrual rule, the accrual is a minimum benefit and the fractional rule benefit does not have to specifically limit compensation to the prior 10 years of service as long as the plan provide for the minimum benefit calculated under the fractional accrual rule. However, for purposes of the modified fractional rule, the plan must specifically apply the fractional rule benefit.

The plan fails the modified fractional accrual rule because unlike under the fractional accrual rule above, the plan's failure to limit compensation could cause a faster accrual than the modified fractional rule requires if the participant's high five is outside the immediately preceding 10 years. For example, if the participant's high five is $30,000 and the high five during the immediately preceding 10 years is only $28,000 the accrual under the plan is faster than under this requirement.

THIRD ACCRUAL REQUIREMENT-MUST SATISFY ONE OF THREE ALTERNATIVES

The third requirement indicates the plan must satisfy one of three alternatives:

1. The 1/3 rule under section 1.401(a)(4)-3(b)(4)(i)(C)(1),

2. the flat benefit with a minimum 25 years of service rule under section 1.401(a)(4)-3(b)(4)(i)(C)(2) or
3. the non-design based safe harbor under section 1.401(a)(4)-3(b)(4)(i)(C)(3).

First alternative

This plan does not satisfy the first alternative since an employee can accrue a benefit more than one third greater than another employee. For example, an employee with 20 or less years of service until retirement will accrue 3% for each year of service while an employee with 30 or more years of service will accrue only 2% per year. 3% is more than 1/3 larger than 2% (50% larger than 2%).

Second alternative

This plan also fails the second requirement since the full flat benefit can accrue in less than 25 years. This plan only requires 20 years for some employees.

Third alternative

The third alternative is the non-design based safe harbor, which requires a demographic demonstration. As long as the average accrual rate for NHCE's is at least 70% of the HCE's accrual rate, this part of the third alternative is satisfied.

An additional requirement is that the benefit must be a flat benefit, which is the same percentage of average annual compensation for all employees who have a minimum number of years of service at normal retirement age with a pro-rata reduction for service less than the minimum.

This plan satisfies this requirement. For any participant with less than 20 years of service at normal retirement age, there would be a 1/20th reduction.

CONCLUSION AS TO THE ACCRUAL REQUIREMENTS

Since the plan failed the modified fractional accrual rule, the plan does not satisfy the safe harbor accrual requirements under section 1.401(a)(4)-3(b)(4).

SECTION VII-FRESH START

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

FRESH START SECTION

INTRODUCTION

The nondiscrimination requirements must generally be addressed each year. A defined benefit (DB) plan's past history of benefits and related features, however, could affect the current year's testing and cause some plans to be ineligible to use a safe harbor and others to alter their application of the general test. Satisfaction of the fresh start rules allows a DB plan to be tested in the current year and in future years without considering the effect of certain benefits earned in past years.

The easiest way to understand how the fresh start rules operate is to consider a situation where they might be used. To meet a unit credit safe harbor, a DB plan must apply the plan's (current) formula to an employee's years of service (YOS) and (if applicable) average annual compensation. If the plan used a different formula for benefits earned before a certain date, the plan would not be able to meet the safe harbor. This earlier

formula might also make it impossible for the plan to satisfy the general test.

The fresh start rules allow a plan that meets the applicable requirements to change its formula prospectively (that is, ignore accruals prior to a specific date) in a way that it may continue to meet a safe harbor or to satisfy the general test.

To protect employees from the effects of inflation while they are working, a plan may base pension benefits on compensation in the employees' most highly-paid years, usually those immediately preceding retirement. Employees often come to expect these increases as part of the benefit promise. If a benefit formula, however, is changed and the benefit frozen (even under a fresh start), absent special rules, increases to the frozen benefit based on compensation after the fresh start date would take the plan out of the safe harbor and might also cause it to fail the general test. The fresh start rules for compensation increases allow a plan that meets the requirements to grant compensation "up-ticks" to a previously frozen benefit in a way that it may continue to meet a safe harbor or to satisfy the general test.

APPLICATION TO SAFE HARBOR PLANS

A DB plan may still be a safe harbor plan under Treas. Reg. section 1.401(a)(4)-3(b)(6)(vii) if it uses a benefit formula and accrual method for benefits based on service after a fresh start date which are different from those used before that date. To do so, the plan must satisfy the requirements of a fresh start under Treas. Reg. section 1.401(a)(4)-13(c) for a fresh start group of employees as of a fresh start date.

Fresh Start Date Defined

Generally, a fresh start date is the last day of any plan year. A plan may, however, use a fresh start date which is not the last day of a plan year if the plan satisfies the safe harbor rules for DB plans from the beginning of the year until the fresh start date, or if the fresh start group is an acquired group of employees and the fresh start date is the latest date of hire or transfer into an acquired trade or business for any of the employees included in the acquired group.

Fresh Start Group Defined

Generally, a fresh start group consists of all employees who have an accrued benefit as of the fresh start date and have at least one hour of service with the employer after that date. The fresh start group, however, may be limited to employees who are IRC section 401(a)(17) employees (employees who have a plan accrued benefit before the IRC section 401(a)(17) effective date: to determine this, use compensation exceeding the IRC section 401(a)(17) limit in one or more years), or employees who are members of an acquired group of employees (but only if the fresh start date pertains to that acquired group of employees, as described above.)

GENERAL REQUIREMENTS FOR A FRESH START

In order for a safe harbor plan to use the fresh start option, the plan must meet the three requirements (which are contained in Treas. Reg. section 1.401(a)(4)-13(c)):

1. Freeze benefits as of a fresh start date
2. Determine benefits using a fresh start formula, and
3. Ensure that the consistency requirement is met.

Benefits Must be Frozen as of a Fresh Start Date

A frozen benefit is determined as if the employee terminated employment as of the fresh start date (or the date he actually terminated employment, if earlier) without considering any plan amendments adopted after that date, other than amendments recognized as effective as of or before that date under IRC section 401(b) or Treas. Reg. section 1.401(a)(4)-11(g)(which outlines retroactive correction).

Adjustments for subsequent compensation increases (described below) may be made to frozen benefits with regard to the fresh start date. Frozen top-heavy minimum benefits may also reflect required compensation increases. If certain other requirements are met, new optional forms may be provided for a frozen benefit. (See Treas. Reg. section 1.401(a)(4)-13(c)(3)(iii).)

Benefits Must be Determined under a Fresh Start Formula

There are three basic types of fresh start formulas described in Treas. Reg. section 1.401(a)(4)-13(c)(4), one of which must be used to determine an employee's accrued benefit under the plan:

1. Formula without wear away
2. Formula with wear away
3. Formula with extended wear away.

Formula without Wear Away

This formula is also known as the "sum-of" formula. Under this formula, an employee's accrued benefit at a particular date equals the sum of:

1. The accrued benefit frozen as of the fresh start date, and
2. The accrued benefit calculated when the current formula (the formula applicable to benefit accruals in the current plan year) is applied only to service after the fresh start date.

EXAMPLE 1 Illustrating formula without wear-away

The Able Company has maintained a DB plan with a benefit of $300 per year for each year of the employee's service. Effective January 1, 1995, Able amends the plan to determine benefits under a formula which provides a benefit of 1% of average annual compensation (AAC) times years of service after December 31, 1994. Able uses a fresh start date of December 31, 1994 and determines benefits using the formula without wear away.

In other words, an Able employee's annual accrued benefit is the SUM OF the following:

1. $300 times YOS before January 1, 1995
2. 1% times AAC times YOS after December 31, 1994.

Able hired Smith and Smith began plan participation on January 1, 1990. Under the fresh start formula without wear away, his accrued benefit on January 1, 2002, assuming AAC of $25,000, is the sum of:

1.	$300 times 5 years	$1,500
2.	$25,000 times 7 years times .01	1,750
	TOTAL	$3,250

Formula with Wear away

This formula is also known as the "greater of" formula. Under this Formula, an employee's accrued benefit at a particular date equals the greater of:

1. The accrued benefit frozen as of the fresh start date, and
2. The accrued benefit calculated under the current formula applied to all service both before and after the fresh start date.

EXAMPLE 2 Illustrating formula with wear-away

The Baker Company maintains a DB plan with a formula of $300 per year for each year of the employee's service. Effective January 1, 1995, Baker amends the plan to determine benefits under a formula which provides a benefit of 1% of AAC times all YOS (subject, of course, to the requirement of IRC section 411(d)(6) that no participant's accrued benefit may be reduced). Baker uses a fresh start date of December 31, 1994 and determines benefits using the formula with wear away.

In other words, an employee's annual accrued benefit is the GREATER OF:

1. $300 times YOS before January 1, 1995
2. 1% times AAC times all YOS.

Baker hires Jones and Jones begins plan participation on January 1, 1990. Under the fresh start formula without wear away, his accrued benefit on January 1, 2002, assuming AAC of $25,000, is the greater of:

1. $300 times 5 years or $1500
2. $25,000 times 12 years times .01 or 3000

<u>Formula with Extended Wear away</u>

Under this formula, an employee's accrued benefit at a particular date equals the greater of the benefits under the formula with wear away and the formula without wear away.

<u>EXAMPLE 3 Illustrating formula with extended wear-away</u>

The Cooper Company has maintained a DB plan with a formula of $300 per year for each year of the employee's service (old formula). Effective January 1, 1995, the plan is amended to determine benefits under a formula which provides a benefit of 1% of AAC times all YOS (new formula), provided that the benefit will never be less than the sum of the old formula applied to service before January 1, 1995 plus the new formula applied to service after December 31, 1994. Cooper uses a fresh start date of December 31, 1994 and is determining benefits using the formula with extended wear away.

In other words, an employee's annual accrued benefit is the

GREATER OF:

1. 1% times AAC times all YOS.
2. The sum of:
   a. $300 times YOS before January 1, 1995
   b. 1% times AAC times YOS after December 31, 1994.

Cooper hires Johnson and Johnson begins plan participation on January 1, 1990. Under the fresh start formula with extended wear away, her accrued benefit on January 1, 2002, assuming AAC of $25,000, is the greater of:

1. $25,000 times 12 years times .01 or $3,000
2. The sum of:

a.	$300 times 5 years or	$1,500
b.	$25,000 times 7 years times .01 or	1,750
TOTAL		$3,250
GREATER OF (1) OR (2)		$3,250

Consistency Requirement Must Be Met

All the fresh start rules must be applied consistently to all employees in the fresh start group. For example, the same fresh start date and the same fresh start formula must apply to all employees in the fresh start group.

ADDITIONAL REQUIREMENTS TO ADJUST FOR COMPENSATION

A safe harbor plan must satisfy additional requirements in order to disregard (for purposes of determining whether or not the plan meets a safe harbor) compensation increases (taking place after the fresh start date) that are applied to benefits earned prior to the fresh start date. These requirements were established in order to be sure that the compensation adjustments to previously earned benefits provide a real improvement for a broad group of employees, not just the HCEs. Generally, an employee's adjusted accrued benefit, defined below, may be substituted for his or her frozen accrued benefit in the fresh start formula if the benefit satisfies following requirements (in addition to the regular fresh start requirements above):

1. Plan Provision Requirements

An employee's accrued benefit under the plan for service before the fresh start date must be affected by compensation changes after the fresh start date. The plan, however, does not satisfy this requirement if the Commissioner determines, based on all the relevant facts and circumstances, that the plan provision concerning compensation was added primarily to provide additional benefits to HCEs that will be disregarded under these fresh start rules.

The accrued benefit of each employee in the fresh start group after the fresh start date must be no less than the adjusted accrued benefit, as defined below.

2. Meaningful Coverage Requirement

The plan must provide meaningful coverage as of the fresh start date, i.e., the group of employees with accrued benefits under the plan as of the fresh start date satisfied the minimum coverage requirements of IRC section 410(b) in effect on that date.

3. Meaningful Ongoing Coverage Requirement

The plan must have satisfied the minimum coverage requirements of IRC section 410(b) for all plan years from the first plan year beginning after the fresh start date through the current plan year. Because this is a difficult requirement to satisfy in practice as time (since the fresh start date) passes, the requirement is deemed satisfied if the fresh start:

a. Group satisfied the minimum coverage requirements of IRC section 410(b) for the first five years beginning after the fresh start date; or

b. Group satisfied the ratio percentage test of Treas. Reg. section 1.410(b)-2(b)(2) as of the fresh start date; or

c. Group is an acquired group of employees that satisfied the minimum coverage requirements of IRC section 410(b) as of the fresh start date; or

d. Date is before the effective date of these regulations.

4. Meaningful Current Benefit Accrual Requirement

The benefit formula and accrual method that apply to the fresh start group must provide benefit accruals in the current plan year (other than increases in benefits accrued as of the fresh start date) at a rate that is meaningful in comparison to the rate at which benefits accrued for the fresh start group in plan years beginning before the fresh start date.

5. Minimum Benefit Adjustment

If the plan is an IRC section 401(l) plan or imputes permitted disparity, adjust the frozen accrued benefit, if necessary, to comply with the specific rules of Treas. Reg. section 1.401(a)(4)-13(d)(7) before applying the adjustment for compensation below.

ADJUSTED ACCRUED BENEFIT DEFINED

General Rule

The adjusted accrued benefit is the employee's frozen accrued benefit, modified as follows:

1. If necessary, first make the minimum benefit adjustment described above.
2. Multiply the result by the following fraction (not less than one):

$$\frac{\text{employee's compensation for the current plan year}}{\text{employee's compensation as of the fresh start date (determined under the same definition)}}$$

Generally, in making this adjustment, use the same definition to determine the frozen accrued benefit or AAC.

The limits of IRC section 401(a)(17) generally apply in determining the numerator and denominator of the fraction. However, there are special rules for 401(a)(17) employees. See Treas. Reg. section 1.401(a)(17)-1(e)(4). Also, the plan may limit the increase in the frozen accrued benefit to a percentage (not more than 100 percent) of the amount provided by the above method. It may also terminate future adjustments at any time.

EXAMPLE 4 Illustrating adjustment to accrued benefit

The Davis Company maintains a DB plan which uses a fresh start date of December 31, 1995. The safe harbor benefit formula used prior to that date was based on a participant's AAC; the plan was not a IRC section 401(l) plan as of the fresh start date.

Effective December 31, 1998, the plan would like to provide for compensation increases to the frozen benefit that was determined on December 31, 1995. The plan met the Meaningful Coverage Requirement on December 31, 1995 and continues to meet the Meaningful Ongoing Coverage and Meaningful Current Benefit Accrual requirements described above.

Employee Campbell had an accrued benefit of $1500 as of December 31, 1995. His AAC as of December 31, 1995 was $30,000 and as of December 31, 1998 was $40,000. Campbell's adjusted accrued benefit is::

$$\$1{,}500 \text{ times } \frac{\$40{,}000}{\$30{,}000} \text{ equals } \underline{\$2{,}000}$$

ALTERNATIVE FORMULA FOR PRE-EFFECTIVE DATE FRESH STARTS

There is an alternative formula available for determining the adjusted accrued benefit if the fresh start date is prior to the effective date of these regulations. (See Treas. Reg. section 1.401(a)(4)-13(d)(8)(ii).)

SECTION VIII-GENERAL TEST

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

INTRODUCTION

If a plan does not satisfy one of the safe harbor requirements, the plan must satisfy the general test. The general test is based on whether "rate groups" pass coverage under IRC section 410(b). CPE 93, Chapters 2 and 3.

Please note that in the CPE 93 text, chapter 2 covers the general test for defined contribution plans and chapter 3 covers the general test for defined benefit plans.

This guide will review the general test rules primarily for defined benefit plans because the development of the accrual rates for defined benefit plans are more complex than the development of allocation rates for defined contribution plans. However, the rules for defined contribution plans will be summarized.

Also, note that once the allocation rates and accrual rates are determined (along with applying the optional rules such as imputing permitted disparity and cross testing), the remaining rules for the general test are essentially the same for both defined contribution and defined benefit plans. The rules for forming rate groups are very similar for both DC and DB plans (one rate for DC plans and two rates for DB plans) and applying the coverage rules to rate groups are identical for both types of plans.

OVERVIEW OF THE THREE MAJOR STEPS IN RUNNING THE GENERAL TEST

There are three steps:

1. The allocation or accrual rates for each participant are determined. CPE 93, pages 2-3, 3-4

2. Once the allocation or accrual rates are determined, they are used to form rate groups. CPE 93, pages 2-2, 3-9

3. Once the rate groups are determined, each rate group must satisfy the IRC section 410(b) coverage requirements. CPE 93 page 2-7, 3-14

DETERMINING THE ALLOCATION OR ACCRUAL RATES FOR EACH PARTICIPANT. CPE 93 PAGES 2-3, 3-4

For defined contribution plans, there is one allocation rate. The allocation rate equals the sum of the employer contributions allocated to the employees account for the plan year, expressed either as a percentage of plan year compensation or as a dollar amount. Also, see section 1.401(a)(4)-2(c)(2)

For defined benefit plans , there are two different types of accrual rates

Normal accrual rates and

Most valuable accrual rates.

To determine these accrual rates, apply the following formulas:

Accrued benefit	Most valuable optional benefit
Testing service	Testing service

The accrued benefit, most valuable optional form of benefit and testing service are measured during the measurement period.

DEFINITIONS APPLICABLE TO DETERMINING ACCRUAL RATES

The measurement period is the period over which the testing service and accrued benefit are measured. There are three possible measurement periods that can be chosen by the plan. CPE 93 page 3-6

The accrued benefit used to determine the normal accrual rate is the accrued benefit (within the meaning of IRC section 411(a)(7)(A)(i)) provided under the plan. CPE 93 page 3-4

The most valuable optional form of benefit used to determine the most valuable accrual rate reflects the value of all benefits accrued or treated as accrued that are payable in any form and at any time under the plan. CPE 93 page 3-8

The testing service comprises the years of service in which the employee benefits under the plan (and can include other service taken into account by the plan). CPE 93 page 3-5

DETERMINING THE ACCRUAL RATES-EXAMPLES ILLUSTRATING THE DIFFERENT MEASUREMENT PERIODS

Introduction the current plan year (annual method) measurement period

If the measurement period is the current plan year (the annual method), the accrued benefit earned for that year is calculated and is divided by the amount of the testing service earned during that year, which is "1" under Treas. Reg. section 1.401(a)(4)-3(d)(1)(iv)(B)(2). Since the accrued benefit earned for that year is divided by "1", the accrual rate is the accrued benefit earned during the plan year. Remember, the measurement period determines the amount of accrued benefit and the years of service to be taken into account in order to determine the accrual rate.

EXAMPLE 1 Illustrating current plan year measurement period

The Foster DB plan has the following benefit formula: 2% x years of service x high 3 years average compensation for the first 10 years, 1.5% x years of service x high 3 years average compensation for the next 10 years, and 1% x years of service x high 3 years average compensation for all years thereafter. Normal retirement age is 65. Mr. Jenkins is age 40 and worked for the company for 15 years. His high 3 years average compensation is $50,000. The measurement period is the current plan year.

The accrual rate would be determined based on a applying the formula 1.5% x 1 year of service x 50,000 or $750 per year divided by "1" (the testing service) or $750 per year. This benefit can be expressed as either a dollar amount or a percentage of average annual compensation (defined below).

EXAMPLE 2

The Fuzzy Co. DB plan provides a benefit formula of 2% of high three years AAC X YOS. On 1/1/92, Employee Floofy had 20 YOS and AAC of $45,000 for an annual benefit of $18,000. On 1/1/93, Floofy has 21 YOS and AAC of $47,000 for an annual benefit of $19,740. Floofy's accrual for 1992 is $1,740 which may be expressed as a percentage of compensation.

What example shows

This example shows that with the current year method, the percentage provided in the benefit formula is not necessarily going to be the accrual rate for testing purposes.

In this example, the benefit formula provides for 2% per year for high three years AAC x YOS. At the end of 1992, Floofy had an AAC of $47,000. The example shows that Floofy had an accrual rate for 1992 of $1,740. As a percentage of AAC, the accrual rate is 3.7% ($1,740/$47,000).

Breakdown-why the accrual rate is not the benefit rate

Note that in addition to the 2% accrual for the year, the AAC went up an additional $2,000 (from $45,000 to $47,000). Thus, Floofy's accrued benefit is increased by an additional $800, which is the additional accrued benefit earned due to the salary increase.

Thus, $1,740 accrued benefit can be broken down:

$940 (2% x $47,000-current year accrual)

$800 (20 years x 2% x $2,000-increase in compensation in 1992 applied to prior years of service).

Introduction the current years and all prior years (accrued to date method) measurement period

If the measurement period is the current plan year and all prior years (the accrued to date method), the accrued benefit taken into account is the total accrued benefit earned by the employee up to the current plan year. The testing service is also determined by looking at all past years up to the current plan year.

EXAMPLE 3 Illustrating accrued to date method

Same facts as Example 1 although the plan takes into account the current plan years and all prior years. Thus, the accrual rate would be based on the benefit earned by Mr. Jenkins up to the current plan year. The testing service would be 15 years, taking into account the current and all prior years. The accrual rate is calculated as follows:

Accr. ben.- 2% x 10 years x $50,000 plus 1.5% x 5 years x $50,000
Testing service-15 years

or a benefit of $917 per year. This benefit can be expressed as either a dollar amount or a percentage of average annual compensation (defined below).

Introduction current plan year and all prior and future years (projected method)

If the measurement period is the current year and all prior and future years (the projected method), the accrued benefit taken into account is the total accrued benefit projected to be earned by the employee up to the employee's testing age. The testing service is also determined by looking at all years up to the employee's testing age.

EXAMPLE 4 Illustrating the projected method

Same facts as Example 1 although the plan takes into account the current plan years and all prior and future years. Thus, the accrual rate would be based on the benefit earned by Mr. Jenkins up to the testing age or 65. The testing service would be 40 years, taking into account the current, all prior and future years. The accrual rate is calculated as follows:

accr. ben.-(2% x 10 yrs)+(1.5% x 10 yrs)+(1% x 20 yrs) x $50,000)
Testing service-40 years

or $688 per year. This benefit can be expressed as either a dollar amount or a percentage of average annual compensation (defined below). The percentage would be 1.38% ($688/$50,000), assuming $50,000 satisfies the requirements for average annual compensation.

Impact of years of service not being recognized under section 1.401(a)(4)-11(d)(3) on the calculation of the accrual rates

Even though the plan provides for a benefit for years of service, such as past service, imputed service etc., such service may not be recognized for the amounts requirement if the requirements under section 1.401(a)(4)-11(d)(3) are not satisfied. If years of service is not recognized, the nondiscrimination in amounts requirement is applied as if the service does not exist. Thus, the period over which the benefit is accrued does not include the service that does not satisfy the requirements of section 1.401(a)(4)-11(d)(3).

Unless years of service are recognized under section 1.401(a)(4)-11(d)(3), these years are not counted when determining the "testing service" when calculating the accrual rate (accrued benefit/testing service). However, the accrued benefit in the numerator does not change. The effect of not counting such service is to increase the accrual rate, since the denominator (testing service) is reduced.

EXAMPLE 5 If pre-participation service does not satisfy the requirements under -11(d)(3)

Same facts as previous example, except that Foster Inc. acquired Bud Inc in 1997. The DB plan grants pre-participation service for all employees of Bud. Mr. Jenkins has worked for Bud for 15 years and is granted 15 years of service under the plan.

Assume that the pre-participation service under the plan does not satisfy section 1.401(a)(4)-11(d)(3). The plan uses the projected method in calculating the accrual rate. The accrual rate is calculated as follows:

accr. ben.-(2% x 10 yrs)+(1.5% x 10 yrs)+(1% x 20 yrs) x $50,000)
Testing service-**25 years**

or $1,100. As a percentage of compensation, the accrual rate is 2.2% ($1,100/$50,000). Note that if the service had been counted, the accrual rate would be 1.38% ($688/$50,000) as calculated in the previous example.

EXAMPLE 6 Illustrating Example 65 using accrued to date method

Same facts as previous example, except that the plan uses accrued to date method. Assume that the pre-participation service under the plan does not satisfy section 1.401(a)(4)-11(d)(3). The accrual rate is calculated as follows:

Accr. ben.- 2% x 10 years x $50,000 plus 1.5% x 5 years x $50,000
Testing service-**1 year**

or $13,750. As a percentage of compensation, the accrual rate is 27.5%. Note that if the pre-participation service satisfied section 1.401(a)(4)-11(d)(3), the accrual rate would be $917 or 1.8% of compensation (see above).

Average annual compensation

The accrual rates used in testing plans must be expressed either as a dollar amount or determined as a percentage of each employee's average annual compensation. Please see the safe harbor section above for a further explanation of average annual compensation.

DETERMINING ALLOCATION OR ACCRUAL RATES, OVERVIEW OF OPTIONAL RULES FOR ADJUSTING ACCRUAL OR ALLOCATION RATES

Once the allocation or accrual rates are determined using the above formulas, the rates can be adjusted prior to forming rate groups. There are four optional rules that adjust the allocation or accrual rates:

Grouping of allocation or accrual rates

Cross testing,

Imputing permitted disparity and

Fresh start.

The following explanations are a brief overview of these optional rules. However, see below for a more detailed discussion of these rules.

Grouping of allocation or accrual rates, CPE 93 page 3-24

Grouping allows an employer to treat certain allocation or accrual rates as equal if these rates fall within a certain range. The employer would choose a midpoint rate. Any rates that are within a specified range are treated as having an accrual rate equal to the midpoint rate.

For normal accrual rates (and allocation rates), the rates must be within 5% (not five percentage points) of the midpoint rate.

For most valuable accrual rates, the rates must be within 15% (not 15 percentage points) of the midpoint rate.

The ranges chosen by the employer cannot overlap. In addition, the employer cannot choose a midpoint if the accrual rates of the HCEs within the range around the midpoint are "significantly higher" than the accrual rates of NHCEs within the range.

Cross testing, CPE 93, chapter 6

Section 401(a)(4) requires that either the contributions or benefits provided under the plan do not discriminate in favor of the highly compensated employees. This section does not specify which type of plan (defined benefit or defined contribution) are to test nondiscrimination on a contributions basis or benefits basis. Thus, the regulations under section 1.401(a)(4)-8 allows either a defined contribution or a defined benefit plan to test on either a contributions or benefits basis.

Cross testing is a series of steps by which a defined contribution plan can convert the allocations to an equivalent benefit or a defined benefit plan can convert the benefits to equivalent allocations.

Fresh start rules

The fresh start rules allow a plan to be tested without regard to benefits accrued before a selected fresh start date. See fresh start section above with respect to the safe harbor requirements or CPE 93, chapter 10. Also, see fresh start section below with respect to the general test.

Imputing permitted disparity CPE 93 page 3-25, also chapter 5

With imputing permitted disparity, the allocation or accrual rates are adjusted as if permitted disparity had applied to the plan.

II. ONCE THE ALLOCATION OR ACCRUAL RATES ARE DETERMINED, THEY ARE USED TO FORM RATE GROUPS. CPE 93 PAGE 3-9

After the allocation or accrual rates are determined, then rate groups are formed by using each HCE's allocation rate or normal and most valuable accrual rate.

The members of the rate group include the HCE that formed the rate group and every other participant (NHCE or HCE) who has an equal or greater allocation rate or normal and most valuable accrual rate. Once determined, each rate group must satisfy the coverage rules of IRC section 410(b) as if each group was a separate plan (see next section).

EXAMPLE 7 Illustrating the formation of rate groups

The Stone Construction Co. has a defined benefit plan. The normal and most valuable accrual rates of some of its employees are as follows:

Employee	Normal AR	Most valuable AR
Sidney HCE	2.0	2.7
Fran NHCE	1.7	2.8
Bob NHCE	2.2	2.9

Explanation-Example 7

Sidney is an HCE. Any employees having both a normal and a most valuable accrual rate greater or equal than 2.0 and 2.7 respectively could be a member of the Sidney rate group.

Fran would not be a member of the rate group. Although she has a most valuable accrual rate greater than 2.7, she has a normal accrual rate of less than 2.0. To be a member of the rate group, both the normal and the most valuable accrual rate has to be greater or equal to the accrual rates of the HCE who formed the rate group (in this example, Sidney).

Bob would be a member of the rate group. Both his normal accrual rate and most valuable accrual rate are greater than 2.0 and 2.7 (Sidney's rates) respectively.

The following are the members of the rate group:

Sidney
Bob

Fran is not a member of the rate group.

EXAMPLE 8 Illustrating the formation of rate groups

The Phillips Co. has a defined benefit plan with the following employees (and their accrual rates):

Employee	***HCE/NHCE***	***Normal Accrual rate***	***Most valuable Accrual rate***
Joe	HCE	1.7	3.2
Lucy	HCE	2.5	3.0
Tom	NHCE	2.7	3.3
Hawkeye	NHCE	1.9	2.9
Murphy	NHCE	2.0	3.2
Fuzzy	NHCE	2.6	3.1

Explanation-Example 8

Joe and Lucy are HCEs. Thus, there are two rate groups, Joe's group which has a normal accrual rate and most valuable accrual rate of 1.7 and 3.2 respectively (Joe's accrual rates), and Lucy's group which has a normal and most valuable accrual rate of 2.5 and 3.0 respectively (Lucy's accrual rates). The members of each group must have equal or greater accrual rates than these rates.

Tom would be a member of both Joe's and Lucy's groups since his normal and most valuable accrual rates of 2.7 and 3.3 exceed both Joe's and Lucy's rates.

Hawkeye would not be a member of either Joe's group or Lucy's group. With respect to Joe's group, although Hawkeye's normal accrual rate of 1.9 exceeds Joe's normal accrual rate of 1.7, his most valuable accrual rate of 2.9 is less than Joe's most valuable accrual rate of 3.2. With respect to Lucy's group, both Hawkeye's normal and most valuable accrual rates of 1.9 and 2.9 respectively are less than Lucy's normal and most valuable accrual rate of 2.5 and 3.0 respectively.

Murphy would be a member of Joe's group since her normal accrual rate of 2.0 exceeds Joe's normal accrual rate of 1.7 and her most valuable accrual rate of 3.2 is equal to Joe's most valuable accrual rate of 3.2. She would not be a member of Lucy's group since her normal accrual rate of 2.0 is less than Lucy's normal accrual rate of 2.5.

Fuzzy would be a member of Lucy's group since both his normal and most valuable accrual rates of 2.6 and 3.1 respectively exceed Lucy's normal and most valuable accrual rate of 2.5 and 3.0 respectively. Fuzzy would not be a member of Joe's group since his most valuable accrual rate of 3.1 is less than Joe's most valuable accrual rate of 3.2.

Note that Lucy or Joe would not be a member of the other's rate group. Joe's normal accrual rate is less than Lucy's rate and Lucy's most valuable accrual rate is less than Joe's rate.

The following are members of Joe's group and Lucy's group:

Joe's group	Lucy's group
Joe HCE	Lucy (HCE)
Tom	Tom
Murphy	Fuzzy

The following are non-members of Joe's group and Lucy's group:

Joe's group	Lucy's group
Lucy (HCE	Joe(HCE)
Hawkeye	Hawkeye
Fuzzy	Murphy

EXAMPLE 9 Illustrating the formation of rate groups

The Slate Manufacturing Co. has a defined benefit plan with the following employees and accrual rates:

Employee	*HCE/NHCE*	*Normal Accrual rate*	*Most valuable Accrual rate*
Samantha	HCE	1.5	2.0
Fred	HCE	1.5	3.1
Wilma	HCE	2.0	2.65
Rob	NHCE	1.0	1.4
Ken	NHCE	1.7	3.2
Barney	NHCE	1.9	2.65
Betty	NHCE	2.3	2.8

Explanation-Example 9

The following are members of Samantha's, Fred's and Wilma's groups:

Samantha's group	*Fred's group*	*Wilma's group*
Samantha (HCE)	Fred (HCE)	Wilma HCE
Fred (HCE)	Ken	Betty
Wilma (HCE)		
Ken		
Barney		
Betty		

The following are **non-members** of Samantha's, Fred's and Wilma's groups:

Samantha's group	***Fred's group***	***Wilma's group***
Rob	Samantha (HCE)	Samantha (HCE)
	Wilma (HCE)	Fred (HCE)
	Rob	Rob
	Barney	Ken
	Betty	Barney

Samantha, Fred and Wilma are HCEs. Thus, there are three rate groups for this plan, Samantha's group with a normal and most valuable accrual rate of 1.5 and 2.0 (Samantha's rates), Fred's group with a normal and most valuable accrual rate of 1.5 and 3.1 (Fred's rates) and Wilma's group with a normal and most valuable accrual rate of 2.0 and 2.65 (Wilma's rates).

Rob is not a member of any group since his rates of 1.0 and 1.4 are less than Samantha's, Fred's or Wilma's rates (please refer to the chart above).

Ken is a member of Samantha's and Fred's groups since his normal accrual rate of 1.7 exceed both Samantha's and Fred's normal accrual rate of 1.5 and his most valuable accrual rate of 3.2 exceeds Samantha's most valuable accrual rate of 2.0 and Fred's most valuable accrual rate of 3.1. With respect to Wilma's group, since Ken's normal accrual rate of 1.7 is less than Wilma's normal accrual rate of 2.0, he would not be a member of that group.

Barney is a member of Samantha's group. Barney's normal accrual rate of 1.9 is greater than Samantha's and Fred's normal accrual rate of 1.5. Barney's most valuable accrual rate of 2.65 is greater than Samantha's most valuable accrual rate of 2.0 but is less than Fred's most valuable accrual rate of 3.1. Thus, Barney is not a member of Fred's group. Barney is not a member of Wilma's group since his normal accrual rate of 1.9 is less than Wilma's normal accrual rate of 2.0.

Betty is a member of Samantha's and Wilma's groups. Her normal and most valuable accrual rates of 2.3 and 2.8 exceed Samantha's and Wilma's normal and most valuable accrual rates. With respect to Fred's group, her most valuable accrual rate of 2.8 is less than Fred's most valuable accrual rate of 3.1.

Remember, HCEs can be members of groups other than the group that they define as long as their rates are greater or equal to the rate of another group. Fred is a member of Samantha's group since his normal accrual rate is equal to Samantha's normal accrual rate and his most valuable accrual rate is greater than Samantha's most valuable accrual rate. Fred is not a member of Wilma's group since his normal accrual rate is less than Wilma's normal accrual rate. Wilma is a member of Samantha's group since her rates exceed Samantha's rates. Wilma is not a member of Fred's group since her most valuable accrual rate is less than Fred's rate. Samantha is not a member of either Fred's or Wilma's group since her most valuable accrual rate is less than the rates of those groups.

III. ONCE THE RATE GROUPS ARE DETERMINED, EACH RATE GROUP MUST SATISFY COVERAGE CPE 93 PAGE 3-14

To satisfy the general test, each rate group must satisfy either the ratio percentage test or the average benefits test as if it were a separate plan. The members of the group considered are the only participants that are considered benefitting. Thus, all other nonexcludable employees of the employer's controlled group are considered as not benefitting even if they actually benefit under the plan.

COVERAGE RULES FOR A RATE GROUP

As with the coverage rules applicable to the entire plan, there are two basic tests, the ratio percentage test and a "modified" average benefits test.

The ratio percentage test is the same as in coverage under section 410(b). The rate group's ratio percentage must be at least equal to 70%.

IF A RATE GROUP FAILS THE RATIO PERCENTAGE TEST-MODIFIED AVERAGE BENEFITS TEST

If a rate group does not pass the ratio percentage test, a modified average benefits test is applicable.

Remember, for coverage under section 410(b), there are two tests under the average benefits test, the nondiscriminatory classification and the average benefits percentage test.

For the nondiscriminatory classification test, there are two tests, the reasonable classification test (facts and circumstances) and the nondiscriminatory classification test (safe and unsafe harbor analysis).

The regulations modify the average benefits test for rate groups in the following manner: <u>CPE 93 page 3-20 or section 1.401(a)(4)-2(c)(3)</u>

For the nondiscriminatory classification test, a rate group is considered to pass both the reasonable classification test and the nondiscriminatory classification test if the ratio percentage of the rate group is greater than or equal to the lesser of

- The ratio percentage of the plan, or
- The midpoint between the safe and the unsafe harbor percentage applicable to the plan.

With respect to the average benefits percentage test, a rate group satisfies this test if the plan of which it is a part satisfies the average benefits test. Thus, the average benefits percentage test of the plan (and not just the rate group) must be tested.

INTRODUCTIONDETERMINING THE RATIO PERCENTAGE OF A RATE GROUP

One of the coverage tests that a rate group can satisfy is the ratio percentage test. This test, described in IRC section 410(b)(1)(A), is performed for each rate group, treating the employees who are members of the rate group as benefitting under the rate group "plan". All other nonexcludable employees (whether or not they benefit under the employer's plan) are considered as not benefitting for purposes of determining the ratio percentage of the rate group "plans".

The ratio percentage of each rate group must be at least equal to 70%. The ratio percentage for a rate group is:

$$\frac{\text{\% NHCEs who are members of the rate group "plan"}}{\text{\% HCEs who are included in the rate group "plan"}}$$

The percentage of NHCEs or HCEs (which both make up the ratio percentage) is the proportion of the NHCEs or HCEs as members of the rate group "plan" as compared to all nonexcludable NHCEs or HCEs of the employer.

The % NHCEs who are included in the rate group is the following ratio:

NHCEs who are members of the rate group
All nonexcludable NHCEs

The % HCEs who benefit under the rate group is the following ratio:

HCEs who are members of the rate group
All nonexcludable HCEs

EXAMPLE 10 Calculating ratio percentage of rate groups

The Hollywood Executive Hair Services has a defined benefit plan covering 7 employees. Bob and Carol are HCEs. Eleanor does not benefit under the plan. There are no employees that are excludable under Treas. Reg. section 1.410(b)-6. The employees' normal and most valuable accrual rates are as follows:

Employee	Normal Accrual Rate	Most Valuable Accrual rate
Bob-HCE	1.0	2.0
Carol-HCE	2.5	3.5
Ted-NHCE	1.0	1.5
Alice-NHCE	2.0	2.5
Dave-NHCE	2.5	2.5
Brian-NHCE	2.5	3.5
Eleanor-NHCE	0	0

.
Explanation-determining rate groups

Since Bob and Carol are HCEs, there are two rate groups, Bob's group with a normal and most valuable accrual rate of 1.0 and 2.0 respectively and Carol's group with a normal and most valuable accrual rate of 2.5 and 3.5 respectively.

The following employees are members of Bob's and Carol's groups:

Bob's group	Carol's group
Bob -HCE	**Carol (HCE)**
Carol-HCE	**Brian**
Alice	
Dave	
Brian	

The following employees are not members of Bob's or Carol's group but are considered non-excludable employees for purposes of the coverage tests:

Non excludable employees

Bob's group	Carol's group
Ted	**Alice**
Eleanor	**Dave**
	Brian
	Ted
	Eleanor

Remember, the ratio percentage for a rate group is:

% NHCEs who are members of the rate group "plan"
% HCEs who are members of the rate group "plan"

The % NHCEs who are included in the rate group is the following ratio:

NHCEs who are members of the rate group
All nonexcludable NHCEs

The % HCEs who benefit under the rate group is the following ratio:

HCEs who are members of the rate group
All non-excludable HCEs

With respect to Bob's group, the percentage of NHCEs is:

3 (members of Bob's group)
5 (all non-excludable NHCEs including Ted and Eleanor)

or 60%.

The percentage of HCEs is:

2 (members of Bob's group)
2 (all non-excludable HCEs)

The ratio percentage is 60%/100% or 60%. Thus, this rate group fails the ratio percentage test.

With respect to Carol's group, the percentage of NHCEs is:

1 (the member of Carol's group)
5 (all non-excludable NHCEs including Dave, Ted and Eleanor).

or 20%.

The percentage of HCEs is:

$$\frac{1 \text{ (the member of Carol's group)}}{2 \text{ (all non-excludable HCEs)}}$$

or 50%.

The ratio percentage is 20%/50% or 40%. This rate group also fails the ratio percentage test. Remember, that each rate group must pass coverage. Otherwise, the plan fails the general test.

MODIFIED COVERAGE UNDER THE GENERAL TEST-INTRODUCTION

If the rate group does not satisfy the ratio percentage test, the rate group must pass a "modified" average benefits test as required under section 1.401(a)(4)-2(c)(3)(ii) and (iii).

The regulations modify both the nondiscriminatory classification test and the average benefit percentage test.

Nondiscriminatory classification test

A rate group is considered to satisfy the nondiscriminatory test if the ratio percentage of the rate group is greater or equal to the lesser of:

- The ratio percentage of the plan

- or the midpoint between the safe and the unsafe harbor percentages applicable to the plan. (There is a chart in the 410(b) regulations). See 1.410(b)-4(c)(4) for the table.

Also, remember, the safe harbor-unsafe harbor chart is based on the NHCE concentration percentage for the plan.

Average benefit percentage test

The average benefit percentage test of the rate group is considered satisfied if the plan as a whole satisfies the average benefits percentage test.

Applying example to modified average benefits test

Nondiscriminatory classification test

Bob's rate group's ratio percentage is 60% and Carol's rate group's ratio percentage is 40%.

Determine the plan's ratio percentage

Plan's ratio percentage is taking into account all employees benefitting under the plan. The plan's ratio percentage is:

$\frac{4/5 \text{ NHCE benefitting percentage}}{2/2 \text{ HCE benefitting percentage}}$

or 80%.

Since neither rate group's ratio percentage is equal to 80%, both rate groups' ratio percentage must be equal to or greater than the midpoint between the safe and unsafe harbor.

Midpoint between safe and unsafe harbor

First, must determine the safe and unsafe harbor. To determine these numbers, first determine the NHCE concentration percentage, then go to the corresponding safe and unsafe percentages in the table.

The NHCE concentration percentage is:

5/7 or 71%.

Based on 71% NHCE concentration percentage, the safe and unsafe harbor is 41.75% and 31.75% respectively. The midpoint is 36.75%. Since each rate groups' ratio percentage is above 36.75%, both rate groups satisfy the modified nondiscriminatory classification test.

Average benefit percentage test

Each rate group satisfies the average benefits percentage test if the plan, as a whole, satisfies the average benefits percentage test.

To determine the average benefits percentage test, first determine the average of the NHCEs normal accrual rate and the HCEs normal accrual rate. Then, divide the NHCEs average normal accrual rate by the HCEs average accrual rate, and the result must equal 70%.

Applying Example 10

Average NHCE is:

$\frac{1.0 + 2.0 + 2.5 + 2.5 + 0}{5}$

Average HCE is:

$\frac{1.0 + 2.5}{2}$

or 1.6% 1.75%

Divide the averages:

1.6/1.75 is 91%.

Since the plan satisfies the average benefits percentage test, both rate groups satisfy the average benefits percentage test.

Thus, the general test is satisfied because both rate groups satisfy both the modified nondiscriminatory classification test and the average benefits percentage test.

EXAMPLE 11 Illustrating how to calculate the ratio percentage of rate groups

Applying ratio percentage test to Example 9, the Slate Manufacturing Co., remember that plan with the following employees and accrual rates:

Employee	*HCE/NHCE*	*Normal Accrual rate*	*Most valuable Accrual rate*
Samantha	HCE	1.5	2.0
Fred	HCE	1.5	3.1
Wilma	HCE	2.0	2.65
Rob	NHCE	1.0	1.4
Ken	NHCE	1.7	3.2
Barney	NHCE	1.9	2.65
Betty	NHCE	2.3	2.8

We determined the following employees to be members of Samantha's, Fred's and Wilma's groups:

Samantha's group	*Fred's group*	*Wilma's group*
Samantha (HCE)	Fred (HCE)	Wilma HCE
Fred (HCE)	Ken	Betty
Wilma (HCE)		
Ken		
Barney		
Betty		

We determined the following employees to be non-members of Samantha's, Fred's and Wilma's groups:

Samantha's group	*Fred's group*	*Wilma's group*
Rob	Samantha (HCE)	Samantha (HCE)

	Wilma (HCE)	Fred (HCE)
	Rob	Rob
	Barney	Ken
	Betty	Barney

Applying the ratio percentage test to Samantha's, Fred's and Wilma's, with respect to Samantha's group:

The % NHCEs who are included in the rate group is the following ratio:

NHCEs who are included under the rate group
All nonexcludable NHCEs

The % HCEs who benefit under the rate group is the following ratio:

HCEs who are included in the rate group
All non-excludable HCEs

The ratio percentage for a rate group is:

% NHCEs who are included in the rate group "plan"
% HCEs who are included in the rate group "plan"

With respect to Samantha's group, the percentage of NHCEs is

3 (members of Samantha's group) or 75%
4 (all non-excludable NHCEs

The percentage of HCEs is:

3 (members of Samantha's group) or 100%
3 (all non-excludable HCEs)

The ratio percentage for Samantha's group is 75%/100% or 75%. Thus, Samantha's group passes the ratio percentage test.

With respect to Fred's and Wilma's group, the percentage of NHCEs is:

1 (member of Fred's or Wilma's group) or 25%.
4 (all non-excludable NHCEs)

The percentage of HCEs is:

1 (member of Fred's or Wilma's group) or 33%.
3 (all non-excludable HCEs

Thus, the ratio percentage for both groups 2 and 3 is 25%/33% or 76%. Thus, these groups pass the ratio percentage test.

OPTIONAL RULES (INCLUDING CROSS TESTING AND AGE WEIGHTING:

Fresh Start

Grouping,

Cross testing,

Imputing permitted disparity

FRESH START-GENERAL REQUIREMENTS

As noted above, a DB plan may choose a measurement period that includes (in addition to the current year) all prior years. If the plan benefit was changed at some point in the past, the plan may want to test over a period that includes some past years, but excludes the period before the change. Under certain circumstances, to perform the general test, the plan can ignore accruals before a given date. Put in more formal terms, a DB plan using the general test may limit the measurement period to the period after a fresh start date with respect to a fresh start-group if the consistency requirement (described above in safe harbor section) is satisfied (See Treas. Reg. section 1.401(a)(4)-3(d)(3)(iii)). The plan need not freeze the benefits nor use a fresh start formula.

If the plan, however, wants to ignore increases in accrued benefits prior to the fresh start date due to compensation increases taking place after the fresh start date, the plan must satisfy the Additional Requirements to Adjust for Compensation below.

Additional Requirements to Adjust for Compensation

To disregard compensation adjustments to the benefit accrued prior to the fresh start date in the general test, the plan must meet the requirements listed below.

1. Plan amendment. A bona-fide amendment that freezes the benefits in accordance with APPLICATION TO SAFE HARBOR PLANS; General Requirements for a Fresh start above must be

made to the benefit formula and/or accrual method under the plan.

2. Consistency requirement. The consistency requirement of must be met.

3. Further requirements. The five requirements of Additional Requirements to Adjust for Compensation above must be met and the benefit must be adjusted as described in APPLICATION TO SAFE HARBOR PLANS; Adjusted Accrued Benefit Defined.

GROUPING

Introduction-grouping of accrual rates

Grouping of accrual rates and the imputing permitted disparity adjust the accrual rates for testing purposes. Under grouping, an employer may treat certain accrual rates as equal if these rates fall within a certain range. The employer would choose a midpoint rate. All employees who have accrual rates within a specified range above and below the chosen midpoint rate would be treated as having an accrual rate equal to that rate. Accrual rates may not be grouped if the accrual rates of HCEs within the range are significantly higher than the accrual rates of NHCEs in the range. Thus, if most of the HCEs' accrual rates are substantially above the midpoint rate, and most of the NHCEs' accrual rates are substantially below the midpoint rate, these accrual rates may not be grouped.

The size of the range are as follows. For normal accrual rates, the lowest and highest accrual rates in the range must be within five percent (not five percentage points) of the midpoint rate. For most valuable accrual rates, the lowest and highest accrual rates in the range must be within 15 percent (not 15 percentage points) of the midpoint rate. If accrual rates are determined as a percentage of average annual compensation, the lowest and highest accrual rates can be below or above the midpoint rate by one twentieth of a percentage point (.05% or .0005).

EXAMPLE 12 Illustrating grouping

The employees of the McManus Co. have the following normal accrual rates (determined as a percentage of average annual compensation): .8%, .83%, .9%, 1.9%, 2.0% and 2.1%.

For the first three rates, the employer chooses a midpoint rate of .85%. Note that within this range of rates, the accrual rates of the HCEs cannot be significantly higher than the accrual rates of the NHCEs. Since these accrual rates fall within .05 percentage points (.0005) of the midpoint rate, these rates are treated as being .85%. Note that using the alternative range of .05 percentage points within the midpoint rate produces a greater

range than using the range of 5% within the midpoint rate (.0085 x 5% is less than .0005).

For the last three rates, the employer chooses a midpoint rate of 2.0%. Again, note that within this ranges of rates, the accrual rates of the HCEs cannot be significantly higher than the accrual rates of the NHCEs. Since these rates are no more than 5 percent of the rate above or below this rate, these rates are treated as being 2.0%.

CROSS TESTING (INCLUDING AGE WEIGHTING

Once the allocations are calculated, they must be normalized (or converted) to equivalent accrual rates. Once converted to an equivalent accrual rate, these rates must satisfy the general test.

Normalizing the allocations,

Once the allocations are determined, they must be normalized. This is accomplished in two steps:

Calculate the future value or the amount available to purchase an annuity

Then annuitize this future value or calculate how much an annuity can be purchased with the future value

Calculating the future value

The first step is to calculate the future value of each allocation by assuming a standard interest rate and compounding the allocation until the participant reaches normal retirement (or testing) age.

A standard interest rate is the range between 7.5%-8.5%.

Example-calculating the future value

The allocation for an HCE is $30,000 and the individual has 15 years until retirement.

Thus, assuming 8.5% interest, the $30,000 will be worth ($30,000 x 1.085^{15}) or $101,992.22 when HCE 1 reaches age 65.

Annuitizing the future value, or determining how much an annuity can be purchased with the future value

Essentially, the future value will be used to buy an annuity, which assumes a standard mortality and 8.5% interest.

Note the interest rate that is assumed to determine the annuity factor can be different than it was to determine the future value.

For this example, the annuity factor or the cost to purchase a $1 annuity starting at age 65 is $7.948575.

> HCE's future value of $101,992.77 is divided by $7.948575 to get an annuity of $12,832. This dollar amount can then be divided by the plan year compensation to arrive at the equivalent accrual rate. If the HCE's compensation is $150,000, the equivalent accrual rate is 8.55%.

Each allocation is normalized for each participant

A similar calculation is done for each participant to determine the equivalent accrual rate. Note that the same interest and straight life annuity factor must be used for each participant.

For more information as to any of the above requirements, including the calculation of the equivalent accrual rates, please see alert guidelines, page 2-242 and CPE 1993, 4213-013, chapter 6, Cross Testing.

EXAMPLE 13 Illustrating cross testing

Starr Inc. has 3 employees (EEs), 1 HCE and 2 NHCEs. Starr's profit sharing plan has been in effect for 2 years, has a normal retirement age (NRA) of 65, and has the following contribution and compensation data for the current year.

Using a measurement period of one year, show that the plan is nondiscriminatory in amount on the basis of benefits.

Employee	Current Age	Current Compensation	Year 2 allocation	Allocation rate
HCE	55	$100,000	$20,000	20%
NHCE 1	45	$50,000	$5,000	10%
NHCE 2	25	$35,000	$3,500	10%

Note, that if tested on the basis of contributions, the rate group for the HCE has only one employee, the HCE, in it. Thus, the plan cannot pass the ratio test of IRC section 410(b) as its ratio would be zero (which is also below the unsafe harbor for the plan for purposes of passing the nondiscriminatory classification test).

Testing on the basis of benefits, a pre- and post-retirement interest rate of 8%, and the UP-1984 Mortality Table (which produces an age 65 annuity factor of 8.1958):

Results when cross testing

Employee	Increase-projected to Age 65	Equivalent Annuity Benefit	Equivalent Accrual Rate
HCE 1	$(20,000)(1.08)^{10}$= 43,179	$5,268	5.27%
NHCE 1	$(5,000)(1.08)^{20}$= 23,305	$2,844	5.69%
NHCE 2	$(3,500)(1.08)^{40}$= 76,036	$9,277	26.51%

The rate group for the HCE has all 3 EEs in it. Since it has 100% of the NHCEs and 100% of the HCEs, it passes the ratio test of IRC section 410(b).

EXAMPLE 14 Illustrating cross testing using accrued to date method

The facts are the same as in Example 14. Given the following account balances for each participant, show that the plan is nondiscriminatory on the basis of benefits, using a measurement period that includes the current plan year and all prior years. All three employees have 2 years of plan participation and no distributions have been made since the plan was established.

EE	Account Balance
HCE	$41,600
NHCE 1	9,860
NHCE 2	6,740

Using an interest rate of 8% (pre- and post-retirement), and the UP-1984 Mortality Table (which produces an age 65 annuity factor of 8.1958) the results are:

Employee	Account balance increase/testing service	Age 65 Amount	Equivalent Annuity Benefit	Equivalent Accrual Rate
HCE	$20,800	$(20,800)(1.08)^{10}$ = 44,906	$5,479	5.48%
NHCE 1	$4,930	$(4,930)(1.08)^{20}$ = 22,979	$2,804	5.61%
NHCE 2	$3,370	$(3,370)(1.08)^{40}$ = 73,212	$8,933	25.52%

Here, the rate group determined by the HCE includes all 3 participants, and, therefore, passes the ratio test of IRC section 410(b).

Note that the increase in account balance for the year was determined by taking the entire account balance and dividing it by the number of years of plan participation (or number of year participant benefitted under the plan). For example, for NHCE 1, the increase was determined by dividing $9,860 by 2 years of plan participation.

A profit sharing plan may consider using accrued to date for cross testing cross testing because the varying amounts of contributions would be averaged out over the years.

AGE-WEIGHTED DEFINED CONTRIBUTION PLANS

Defined contribution plans are often preferred by small businesses because they are easier to understand and, generally, less costly to administer than defined benefit plans. One drawback to a DC plan for the older business owner, however, is that the contribution to such a DC plan is usually allocated in proportion to compensation, regardless of the age of the employee. On the other hand, a defined benefit plan allows the older employee to receive a benefit whose value is more than proportional to his or her compensation.

Since the rules for cross-testing allow a DC plan to be tested for nondiscrimination on the basis of benefits (in essence, as if it were a DB plan), an opportunity arises to give larger benefits to older employees, yet still meet the applicable nondiscrimination requirements.

More specifically, in an age-weighted profit sharing plan, the employer's contribution to the plan is allocated among employees based on factors which combine compensation with deferred annuity factors based on age. The higher the age, of course, the larger the factor and the larger the allocation to the participant.

EXAMPLE 15 Illustrating "Age Weighted Profit Sharing" Defined contribution plans

A DC plan with 1 HCE and 2 NHCEs provides for the following contributions (15% of total compensation) to be made for the 1994 plan year.

NRA = 65; i = 8% (pre and post retirement); post-retirement mortality determined using UP-1984 Mortality Table; annuity factor for $1 per year paid monthly beginning age 65 = 8.1958

Employee	Current Age	Compensation	Factor.[i]	Allocation	Percentage of comp.
HCE 1	55	$150,000	.825347	$29,712.49	19.81%
NHCE 1	45	$50,000	.127432	4,587.55	9.18%
NHCE 2	35	$40,000	.047221	1,699.96	4.25%
Totals		$240,000	1.00000	$36,000.00(15 % x 240,000)	

To test on the basis of benefits, using 8% and UP-1984, and a one year measurement period:

Annuity Benefit At Testing Age = 65	Accrual Rate
HCE $[(29{,}712.49)(1.08)^{10}]/8.1958=7{,}826.82$	5.22%
NHCE 1 $[(4{,}587.55)(1.08)^{20}]/8.1958=2{,}608.94$	5.22%
NHCE 2 $[(1{,}699.96)(1.08)^{30}]/8.1958=2{,}087.18$	5.22%

Here, only 1 rate group exists, having all 3 employees in it. The rate group passes the IRC section 410(b) ratio test.

The assumptions used in producing the plan factors should be the standard assumptions to be used in the testing. It is also important to review the allocations to be sure that top-heavy minimum requirements have been met. Since the plan is a DC plan, the $30,000 (or 25 percent of compensation, if lesser) limitation under IRC section 415 applies to each participant.

[1]. The factor used here for determining the participant's portion of the contribution is equal to the product of (1) the testing age annuity factor, discounted back to the current age, times (2) the participant's compensation, divided by (3) the sum of the products of (1) and (2).

IMPUTING PERMITTED DISPARITY

Introduction

With imputing permitted disparity, the actual accrual rates are adjusted as if permitted disparity had applied to the plan. Remember, imputing permitted disparity adjusts both the normal and the most valuable accrual rate.

Imputing permitted disparity is accomplished by adjusting all employees' accrual rate as if they were receiving an accrual rate equal to the excess benefit percentage.

The affect of imputing permitted disparity is that resulting differences (after imputation) in those rates do not reflect permitted disparity.

Any differences in the accrual or allocation rates will not be due to permitted disparity, even if the plan does not provide for disparity. The purpose is to enable the general test plans to take advantage of permitted disparity. General test plans take advantage of permitted disparity by taking the effect of permitted disparity out of the rates.

Formulas, based on integration level

The integration level is the covered compensation. If an employee's average annual compensation is greater than covered compensation, then one formula applies. If AAC is below the employee's covered compensation, then another formula applies.

Covered compensation-definition

Under Treas. Reg. section 1.401(l)-1(c)(7), covered compensation is defined as the average of the taxable wage bases (without indexing) in effect for each calendar year during the 35 year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age.

Note that the covered compensation is different for each employee (since the 35 year period will be different for each employee).

Taxable wage base is the contribution and benefit base under section 230 of the Social Security Act (42 U.S.C. Section 430).

Formula if does not exceed covered compensation

If the employee's annual average compensation does not exceed the employee's covered compensation, the employee's accrual rate is adjusted (using the regular formulas to calculate the excess benefit percentages). The rates would be lesser of the following:

- 2 x accrual rate or
- the accrual rate plus the permitted disparity factor.

Note that these formulas calculate the employee's excess benefit percentage, using the accrual rate as the base benefit percentage.

Formula if AAC exceeds employee's covered compensation

If an employee's AAC exceeds the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the following formulas:

$$\frac{\text{Employer provided accrual}}{\text{AAC-1/2 covered compensation}}$$

or

$$\frac{\text{Employer provided accrual + (permitted disparity factor x covered compensation)}}{\text{AAC}}$$

Permitted disparity factor

The permitted disparity factors key in to the permitted disparity factors under section 401(l). Thus, for defined benefit plans, the permitted disparity factor is .75% For DC plans, 5.7%.

The permitted disparity factor is averaged over the measurement period

The permitted disparity factor is the average of the permitted disparity factors over the measurement period.

This factor is calculated by adding the annual permitted disparity factors for each of the years in the measurement period and dividing that sum by the employee's testing service during that measurement period.

An average is only required if the permitted disparity factors are different for different years.

Remember, that there are no adjustments to the permitted disparity factor when the employee's testing age is the same as the employee's social security retirement age. However, if the ages are different, an adjustment may be required under 1.401(l)-3(e).

EXAMPLE 16 Illustrating Imputing Permitted Disparity

Asbury Travel, Inc. has a DB plan which uses the current plan year as the measurement period, and has age 65 as its NRA.

Norton has a normal accrual rate of 1.48%, an AAC of $21,000, yielding an employer provided accrual of $311 (.0148 x $21,000=$310.80).

Trixie has a normal accrual rate of 1.7%, an AAC of $106,000 for an employer provided accrual of $1,802.

The covered compensation for both employees is $25,000 and the social security retirement age for both employees is 65. Neither employee has testing service of more than 35 years and neither has ever participated in another plan.

Norton's adjusted accrual rate

Since Norton's AAC is less than his covered compensation, his adjusted accrual rate is the lesser of:

- 2.96% (2 x 1.48), or
- 2.23% (1.48% + .75%).

or 2.23%

Trixie's adjusted accrual rate

Since Trixie's AAC is greater than her covered compensation, her adjusted accrual rate is the lesser of:

- 1.93% ($1,802/$106,000-(.5 x $25,000)) or
- 1.88% (($1,802 + .75% x $25,000)/$106,000)

or 1.93%

Remember, Trixie's (HCE) original normal accrual rate was 1.7% and Norton's original normal accrual rate was 1.48. After imputing permitted disparity, when the general test is applied and the rate groups are determined, Norton's normal accrual rate is now higher than Trixie's (2.23%) and Trixie's normal accrual rate is 1.88%.

Tips about example

This example is an application of imputing permitted disparity. This example shows the affect of imputing permitted disparity on the accrual rates.

In the example, only the normal accrual rate was adjusted. Note that both rates are adjusted by imputing permitted disparity.

Another point about the example is that it was assumed that the permitted disparity factor was .75%. However, in certain cases, an adjustment may have to be made to this factor.

Before the calculation is made, the covered compensation would have to be determined for each employee because it may not be the same for each employee. Remember that the covered compensation for the employee determines which set of formulas to use.

Also note that after imputing permitted disparity, Norton's (an NHCE) normal accrual rate is higher than Trixie's (an HCE) normal accrual rate even though Norton had a lower normal accrual rate before the calculation.

EXAMPLE 77 COMPREHENSIVE EXAMPLE ILLUSTRATING THE GENERAL TEST

Employer maintains a DC plan only and the plan covers all nonexcludable employees.

HCE	Allocation rates as a % of Comp	Allocation Rates after grouping
A	6.8%	
B	6.0%	

NHCE	Allocation rates as a % of Comp	Allocation Rates after grouping
C	6.4%	
D	6.2%	
E	5.0%	

Hint: The employer groups employees A, C and D and uses the midpoint of the grouping range as the allocation rates for these employees.

Questions

What are the rate groups.

Show the ratio percentage for each rate group.

For any rate group that does not pass the ratio percentage test, calculate the average benefit test (2 prong test).

Solution

HCE	Allocation rates as a % of Comp	Allocation Rates after grouping
A	6.8%	6.5%
B	6.0%	6.0%

NHCE	Allocation rates as a % of Comp	Allocation Rates after grouping
C	6.4%	6.5%
D	6.2%	6.5%
E	5.0%	5.0%

In testing, the rate group with HCE A uses the midpoint of the grouping range as the adjusted allocation rates for A, C and D. In addition, could have also used 6.6% as the midpoint.

Grouping: The employer wants to group NHCEs C and D with HCE A because they have close allocation rates. The employer decided to try the midpoint of 6.5%. To use this as a midpoint, the range below 6.5% plus or minus (6.5% x .05%) or .0325%. Thus, the range would be from 6.175 to 6.825. Any allocation rate equal or above 6.175% and equal or below 6.825% would be adjusted to 6.5%.

Rate groups: A rate group will exist for each HCE and all other EEs (both HCEs and NHCEs) who have allocation rates greater than or equal to the HCE's allocation rate. Thus, the rate groups are:

HCE	**Rate Group**	**Ratio percentage test**
A	A, C and D (all 6.5%)	2/3 (NHCEs in rt grp./nonex. NHCEs 1/2 (HCEs in rt grp./nonex. HCEs)

or ratio percentage is 133%-above 70%

B	B, A, C and D	2/3 (NHCEs in rt grp./nonex. NHCEs 2/2 (HCEs in rt grp./nonex. HCEs)

or ratio percentage is 66.7%, fails ratio percentage go to average benefits test.

Remember, there are two tests, nondiscriminatory classification test and average benefits percentage test.

Nondiscriminatory classification test

Remember, the rate group satisfies the reasonable classification test if the rate group's ratio percentage is greater or equal to either the plan's ratio percentage test or the midpoint between the safe and unsafe harbors (using the NHCE concentration percentage of the plan).

Plan's ratio percentage

The plan's ratio percentage is $\frac{\text{\%NHCEs benefit}}{\text{\%HCEs benefit}}$

The plan's ratio percentage is 100%/100% or 100%.

Since the rate group's ratio percentage is less than the plan's ratio percentage, must determine if the rate group's ratio percentage is greater than the midpoint between the safe and unsafe harbor.

Midpoint between safe and unsafe harbor

NHCE concentration percentage is:

$\frac{\text{3 (total nonex NHCEs)}}{\text{5 (total nonexc. EEs)}}$ or 60%

The safe harbor and unsafe harbor corresponding to 60% NHCE concentration percentage is 50% and 40%. The midpoint is 45%. Since the rate group's ratio percentage of 66.7% is greater than 45%, the rate group passes nondiscriminatory classification test.

Average benefit percentage test

A rate group passes the average benefit percentage test if the plan of which it is a part passes the average benefit percentage test.

Aver. Ben. Percentage of NHCEs is:

$\frac{6.5+ 6.5+5.0}{3}$ or 6%

Average benefit percentage of HCEs is:

$\frac{6.5+ 6.0}{2}$ or 6.25%

Average benefit percentage of plan is:

6.0%/6.25 or 96%

Results of general test

Since each rate group satisfies coverage, the plan satisfies the general test and the nondiscriminatory amount requirement.

SUMMARY OF THE GENERAL TEST

Remember the three overall requirements of the nondiscrimination regulations, amounts, benefit rights and features, and amendments.

Under the regulations, one of the requirements is that the benefits or contributions under a plan must be nondiscriminatory in amount. This requirement can be satisfied by meeting either one of the safe-harbors or meeting the general test.

Remember the steps to the general test:

1. Determine the accrual rates which are used to determine the rate groups.

   Remember the adjustments to the accrual rates, such as cross testing, imputing permitted disparity, grouping and fresh start.

2. Decide who are the members of the rate group

3. Decide whether the rate groups satisfy coverage under IRC section 410(b),

SECTION IX, NEW COMPARABILITY-ADDITIONAL REQUIREMENTS FOR CROSS TESTED PLANS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),

- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

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INTRODUCTION

Final regulations under section 401(a)(4), published in the Federal Register on June 29, 2001 (the "final cross-testing regulations") amend sections 1.401(a)(4)-8, 1.401(a)(4)-9 and 1.401(a)(4)-12 of the Income Tax Regulations.

The final cross-testing regulations describe the conditions under which defined contribution plans, and defined contribution and defined benefit plans that are tested together, are permitted to demonstrate compliance with nondiscrimination requirements on a benefits basis.

The regulations are effective for plan years beginning on or after January 1, 2002.

Determination Letter Applications

For determination letter applications filed on or after August 22, 2001, employers may request a determination that takes the final cross-testing regulations into account. The employer's demonstration must show both

(1) that the plan satisfies the requirements of the final regulations that allow the plan to test on a benefits basis and

(2) that the plan is nondiscriminatory in amount when tested on a benefits basis.

If a demonstration involving cross-testing relates to the 2002 or later plan year, the demonstration **must address the requirements of the regulations**. Estimated data for the 2002 plan year may be used for purposes of this demonstration.

If the final cross-testing regulations have not been taken into account (i.e., the demonstration relates to a pre-2002 plan year and consideration of the final regulations has not been requested), the letter will cease to provide reliance on the nondiscrimination in amount requirement beginning in 2002.

Permitted Amendment of Pending Specimen Plans in Conjunction with GUST

Practitioners that sponsor volume submitter plans with "cross-testing formulas" or provisions may wish to amend their specimen plans for the regulations to help adopting employers ensure that their plans will be eligible to cross-test.

In order to facilitate the amendment of specimen plans for the final cross-testing regulations during the GUST plan restatement process, the Service will allow practitioners to submit final regulation amendments to their specimen defined contribution plans to be reviewed in conjunction with the review of the plan for compliance with GUST, provided the amendments are submitted by October 22, 2001.

When submitting such amendments, practitioners should include a cover letter that identifies the specimen plan to which the amendments relate and the status of the application (if known) and that describes the nature of the amendments. The Service will not issue an advisory letter for a defined contribution specimen plan before October 22, 2001, without first obtaining the concurrence of the practitioner.

Permitted Amendment of Previously Approved Specimen Plans

Practitioners that have already received a GUST advisory letter for a defined contribution specimen plan may resubmit the plan by October 22, 2001, to include final regulation amendments.

The submission should include the plan and any amendments, a copy of the GUST advisory letter, and a cover letter which describes the nature of the changes to the specimen plan and indicates that the application is being submitted pursuant to Announcement 2001-77.

In this case, a favorable advisory letter issued with respect to the amendments will be treated as the initial GUST advisory letter for the specimen plan for purposes of determining the 12-month period under Rev. Proc. 2000-20.

BACKGROUND

Under the section 401(a)(4) regulations, a plan can demonstrate that either the contributions or the benefits provided under the plan are nondiscriminatory in amount. Defined contribution plans generally satisfy the regulations by demonstrating that contributions are nondiscriminatory in amount, through certain safe harbors provided for under the regulations or through general testing.

A defined contribution plan (other than an ESOP) may, however, satisfy the regulations on the basis of benefits by using cross-testing pursuant to rules provided in Section 1.401(a)(4)-8 of the regulations.

Under this cross-testing method, contributions are converted, using actuarial assumptions, to equivalent benefits payable at normal retirement age, and these equivalent benefits are tested in a manner similar to the testing of employer-provided benefits under a defined benefit plan.

Defining "new comparability" plans, including "super integrated plans

In general, new comparability plans are defined contribution plans that have built-in disparities between the allocation rates for classifications of employees that consist wholly or mostly of highly compensated employees (HCEs) and the allocation rates for other employees. In a typical new comparability plan, HCEs receive high allocation rates, while non-highly compensated employees (NHCEs), regardless of their age or years of service, receive comparatively low allocation rates.

> For example, HCEs in such a plan might receive allocations of 18 or 20% of compensation, while NHCEs might receive allocations of 3% of compensation.

To understand "Super Integrated Plans", it may be helpful to remember the structure of a permitted disparity formula for DC plans.

When a plan's integration level is the social security taxable wage base, the contribution percentage for pay above the integration level (excess percentage) may exceed the contribution percentage for pay below the integration level (the base percentage) by the lesser of:

- 5.7% or
- the percentage for pay below the integration level.

Thus, when the base percentage is equal to or less than 5.7%, the excess percentage cannot be more than twice the base percentage. For example,

- 2% of pay below the integration level, excess percentage is limited to 4% of pay above the integration level.

When the base percentage is more than 5.7%, the excess percentage cannot be more than the base percentage plus 5.7%.

A super-integrated plan looks similar to an integrated plan, by providing for an additional allocation rate that applies only to compensation in excess of a specified threshold (similar to the integration level). However, a super-integrated plan does not satisfy the requirements of section 401(l). The specified threshold (e.g., $ 100,000) or the additional allocation rate (e.g., 10%) **is higher** than the maximum threshold and rate allowed under the permitted disparity rules of section 401(l).

New Comparability and super integrated plans rely on cross testing to satisfy the nondiscrimination rules.

New comparability and similar plans rely on the cross-testing method to demonstrate compliance with the nondiscrimination rules by comparing the actuarially projected value of the employer contributions for the younger NHCEs with the actuarial projections of the larger contributions (as a percentage of compensation) for the older HCEs. The contributions are converted, using actuarial assumptions, to equivalent benefits payable at normal retirement age, and an equivalent accrual rate is determined. The plan is then tested for nondiscrimination in amount on the basis of equivalent accrual rates rather than on the basis of allocation rates.

As a result, these plans are able generally to provide higher rates of employer contributions to HCEs, while NHCEs are not allowed to earn the higher allocation rates as they work additional years for the employer or grow older. The difference in the allocation rates is due to the higher amounts projected to be earned by the younger employees, since they have more years until retirement for the contributions to earn amounts than the older HCEs.

Additional nondiscrimination rules for new comparability – the gateway test

Although new comp and super-integrated plans met the prior (a)(4) reg requirements, these plans defeated the purpose of the nondiscrimination regulations. Under these plans, the NHCEs could never grow into the higher contribution rates. As a result, the Treasury Department and IRS became concerned that these plans were not consistent with the basic purpose of the nondiscrimination rules under section 401(a)(4).

The final regulations remedy this situation by req*UIRING THESE PLANS TO PASS A MINIMUM ALLOCATION* gateway requirement. Plans with broadly available allocation rates and plans with certain age-based allocation rates are exempt from the minimum allocation gateway requirement.

Plans with broadly available allocation rates were exempt from the minimum gateway because these plans provided different allocation rates to different, nondiscriminatory groups of employees.

Plans that base allocation rates on age or years of service are exempt from the gateway requirements because these plans provide an opportunity to “grow into” higher allocation rates as the participants age or accumulate additional service with the employer.

THE FINAL REGULATIONS

OVERVIEW

Section 1.401(a)(4)-8(b)(1)(i)(B) requires that for plan years beginning on or after January 1, 2002, a defined contribution plan may not be tested on a benefits basis unless the plan satisfies one of the three following conditions:

1. **the plan has broadly available allocation** rates (within the meaning of –8(b)(1)(iii) for the plan year;
2. the plan has **age-based allocation** rates that are based on either:
   - a gradual age or service schedule(within the meaning of -8(b)(1)(iv)) or
   - a uniform target benefit allocation (within the meaning of –8(b)(1)(v)) for the plan year; or
3. the plan satisfies the **minimum allocation gateway** of –8(b)(1)(vi).

The regulations permit a DB/DC plan to test on a benefits basis in the same manner as under current law (i.e. no minimum gateway requirement) if the DB/DC plan either

Is primarily defined benefit in character or

consists of broadly available separate plans.

If the DB/DC plan is not primarily defined benefit in character and does not consist of broadly available separate plans, the DB/DC plan must satisfy a minimum aggregate allocation gateway in order to be tested on a benefits basis.

BROADLY AVAILABLE ALLOCATION RATES

GENERAL RULE –8(b)(1)(iii)(A)

If a plan has "broadly available allocation rates", it does not have to satisfy the gateway requirements.

A plan has broadly available allocation rates for the plan year if each allocation rate under the plan is currently available during the plan year (within the meaning of Section 1.401(a)(4)-4(b)(2)) to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test of section 1.410(b)-5).

> For this purpose, if two allocation rates could be permissively aggregated under section 1.401(a)(4)-4(d)(4), assuming the allocation rates were treated as benefits, rights or features, they may be aggregated and treated as a single allocation rate. In addition, the disregard of age and service conditions described in section 1.401(a)(4)-4(b)(2)(ii)(A) does not apply for purposes of this paragraph (b)(1)(iii)(A).

For example, a plan allocation formula provides the following:

- one group receives an allocation rate of 10% and
- a second group receives an allocation rate of 3%.

For purposes of determining whether the plan has broadly available allocation rates, the allocation rates of these two groups can be aggregated (and treated as a single rate) if the group of employees receiving the 10% allocation rate satisfies 410(b) (without regard to the average benefit percentage test)..

In addition, the final regulations provide that, in determining whether a plan provides broadly available allocation rates, differences in allocation rates resulting from any method of permitted disparity provided for under the section 401(l) regulations are disregarded

TRANSITION ALLOCATIONS MAY BE DISREGARDED, -8(b)(1)(iii)(B)

Note that under 1.401(a)(4)-8(b)(1)(iii)(B), an employee's allocation may be disregarded to the extent that the allocation is a transition allocation for the plan year. The allocation must comply with –8(b)(1)(iii)(C) and must be either:

- A defined benefit replacement allocation within the meaning of paragraph –8(b)(1)(iii)(D) or
- A pre-existing replacement allocation or a pre-existing merger and acquisition allocation, within the meaning of paragraph –8(b)(1)(iii)(E).

The transition allocations must be provided to a closed group of employees and must be established under plan provisions.

See these sections above for further details. Also see Rev. Rul. 2001-30, 2001-29 I.R.B. 46, which describes specific conditions that must be met for an allocation to be treated as a defined benefit replacement allocation.

GRADUAL AGE OR SERVICE SCHEDULE (-8(B)(1)(IV)

If a plan's allocation formula has a gradual age or service schedule, the plan does not have to satisfy the gateway requirements. To have such a schedule, the plan's allocation formula for all employees under the plan must provide a single schedule of allocation rates which meets two requirements:

(1) The schedule defines a series of bands based solely on

- age,
- years of service, or
- the number of points representing the sum of age and years of service (age and service points),

under which the same allocation rate applies to all employees whose age, years of service, or age and service points are within each band; and

(2) The allocation rates under the schedule **increase smoothly** (within the meaning of -8(b)(iv)(B)) **at regular intervals** (within the meaning of -8(b)(iv)(C)).

SMOOTHLY INCREASING SCHEDULE OF ALLOCATION RATES –8(b)(IV)(B)

A schedule of allocation rates increases smoothly if:

- the allocation rate for each band within the schedule is greater than
- the allocation rate for the immediately preceding band (i.e., the band with the next lower number of years of age, years of service, or age and service points) **but by no more than 5 percentage points**.

  (So, to determine smooth increases, the difference between a band and the immediately preceding band must be 5 percentage points or less).

However, a schedule of allocation rates **will not** be treated as increasing smoothly if the ratio of the allocation rate for any band to the rate for the immediately preceding band:

- is more than 2.0, or
- exceeds the ratio of allocation rates between the two immediately preceding bands.

Example 1-illustrating increasing smoothly

Plan M, a defined contribution plan without a minimum service requirement, provides an allocation formula under which allocations are provided to all employees according to the following schedule:

Completed years of service	Allocation rate (in percent)
0-5	3.0
6-10	4.5
11-15	6.5
16-20	8.5
21-25	10.0
26 or more	11.5

- The schedule of allocation rates under Plan M does not increase by more than 5 percentage points between adjacent bands.

Completed years of service	Allocation rate (in percent)	Increase of allocation rates between adjacent bands
0-5	3.0	N/A

6-10	4.5	1.5 (4.5-3.0)
11-15	6.5	2.0 (6.5-4.5)
16-20	8.5	2.0 (8.5-6.5)
21-25	10.0	1.5 (10.0-8.5)
26 or more	11.5	1.5 11.5-10.0)

- the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band is never more than 2.0 and does not increase.

Completed years of service	Allocation rate (in percent)	Ratio of: Allocation rate for band to rate for immediately preceding band)
0-5	3.0	N/A
6-10	4.5	1.5 (4.5/3.0)
11-15	6.5	1.44 (6.5/4.5)
16-20	8.5	1.31 (8.5/6.5)
21-25	10.0	1.18 (10.0/8.5)
26 or more	11.5	1.15 (11.5/10.0)

Therefore, the allocation rates increase smoothly as described in paragraph (b)(1)(iv)(B) of this section.

REGULAR INTERVALS, -8(b)(IV)(C)

A schedule of allocation rates has regular intervals of age, years of service or age and service points, **if each band** is the same length (other than the band associated with the highest age, years of service, or age and service points).

For this purpose, if the schedule is based on age, the first band is deemed to be of the same length as the other bands if it ends at or before age 25. If the first age band ends after age 25, then, in determining whether the length of the first band is the same as the length of other bands, the starting age for the first age band is permitted to be treated as age 25 or any age earlier than 25.

For a schedule of allocation rates based on age and service points, the rules of the preceding two sentences are applied by substituting 25 age and service points for age 25.

For a schedule of allocation rates based on service, the starting service for the first service band is permitted to be treated as one year of service or any lesser amount of service.

Example 2-Illustrating regular intervals

The allocation rates are based on the following years of service:

Completed years of service
0-5
6-10
11-15
16-20
21-25
26 or more

Plan M provides that allocation rates for all employees are determined using a single schedule based solely on service, as described in paragraph (b)(1)(iv)(A)(1) of this section, and the allocation rates under the schedule increase smoothly at regular intervals.

Therefore, Plan M has a gradual age or service schedule and does not have to satisfy the minimum allocation gateway in order to test on a benefits basis.

MINIMUM ALLOCATIONS –8(b)(IV)(D)

A schedule of allocation rates under a plan does not fail to increase smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iv)(B) and (C), merely because:

- a minimum uniform allocation rate is provided for all employees or
- the minimum benefit described in section 416(c)(2) is provided for all non-key employees (either because the plan is top heavy or without regard to whether the plan is top heavy).

The schedule must satisfy one of the following conditions-

1. The allocation rates under the plan that are greater than the minimum allocation rate can be included in a hypothetical schedule of allocation rates that increases smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iv)(B) and (C), where the hypothetical schedule has a lowest allocation rate no lower than 1% of plan year compensation; **(-8(b)(1)(iv)(D)(i)) or**
2. For a plan using a schedule of allocation rates based on age, for each age band in the schedule that provides an allocation rate

greater than the minimum allocation rate, there could be an employee in that age band with an equivalent accrual rate that is less than or equal to the equivalent accrual rate that would apply to an employee whose age is the highest age for which the allocation rate equals the minimum allocation rate. **(-8(b)(1)(iv)(D)(ii)).** Thus, under this condition, the allocation rates above the minimum allocation rate do not rise more steeply than expected under an age weighted profit sharing plan generally intended to provide the same accrual rate at all ages.

Example 2-illustrating Minimum allocations and hypothetical schedule

The facts are the same as in Example 1, except that the 4.5% allocation rate applies for all employees with 10 years of service or less.

Completed years of service	Allocation rate (in percent)	Ratio of Allocation rate for band to allocation rate for immediately preceding band)
0-10	4.5	N/A
11-15	6.5	1.44 (6.5/4.5)
16-20	8.5	1.31 (8.5/6.5)
21-25	10.0	1.18 (10.0/8.5)
26 or more	11.5	1.15 (11.5/10.0)

Plan M provides that allocation rates for all employees are determined using a single schedule based solely on service.

Therefore, if the allocation rates under the schedule increase smoothly at regular intervals, then the plan has a gradual age or service schedule.

The bands (other than the highest band) in the schedule are not all the same length, since the first band is 10 years long while other bands are 5 years long. Thus, the schedule does not have regular intervals.

However, the schedule of allocation rates does not fail to increase smoothly at regular intervals merely because the minimum allocation rate of 4.5% results in a first band that is longer than the other bands, if either of the above conditions is satisfied.

In this case, the schedule of allocation rates satisfies the condition in paragraph (b)(1)(iv)(D)(1) because:

the allocation rates under the plan that are greater than the 4.5% minimum allocation rate can be included in the following

hypothetical schedule of allocation rates that increases smoothly at regular intervals and has a lowest allocation rate of at least 1% of plan year compensation:

Completed years of service	Allocation rate (in percent)	Ratio of Allocation rate for band to allocation rate for immediately preceding band)
0-5	**2.5 (hypothetical rate)**	N/A
6-10	4.5	**1.8** (4.5/2.5)
11-15	6.5	1.44 (6.5/4.5)
16-20	8.5	1.31 (8.5/6.5)
21-25	10.0	1.18 (10.0/8.5)
26 or more	11.5	1.15 (11.5/10.0)

Accordingly, the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section. Plan M will satisfy the nondiscrimination in amount requirement of section 1.401(a)(4)-1(b)(2) on the basis of benefits if it satisfies paragraph regular cross testing rules). In this case, the plan will not have to satisfy the minimum allocation gateway of paragraph (b)(1)(vi) of this section.

Example 3-Illustrating hypothetical schedule

Plan O, a defined contribution plan, provides an allocation formula under which allocations are provided to all employees according to the following schedule:

Age	Allocation rate (in percent)	Ratio of Allocation rate for band to allocation rate for immediately preceding band
Under 40	3	N/A
40-44	6	2
45-49	9	1.5
50-54	12	1.33
55-59	16	1.33
60-64	20	1.25
65 or older	25	1.25

Plan O provides that allocation rates for all employees are determined using a single schedule based solely on age, as described in paragraph (b)(1)(iv)(A)(1) of this section.

> Therefore, if the allocation rates under the **schedule increase smoothly at regular intervals** as described in paragraph (b)(1)(iv)(A)(2) of this section, then the plan has a gradual age or service schedule described in paragraph (b)(1)(iv) of this section.

The bands (other than the highest band) in the schedule are not all the same length, since the first band is treated as 15 years long while other bands are 5 years long. Thus, the schedule does not have regular intervals as described in paragraph (b)(1)(iv)(C) of this section.

However, under paragraph (b)(1)(iv)(D) of this section, the schedule of allocation rates does not fail to increase smoothly at regular intervals merely because the minimum allocation rate of 3% results in a first band that is longer than the other bands, if either of the conditions of paragraph (b)(1)(iv)(D)(1) or (2) of this section is satisfied.

In this case, in order to define a hypothetical schedule that could include the allocation rates in the actual schedule of allocation rates, each of the bands below age 40 would have to be 5 years long (or be treated as 5 years long). Accordingly, the hypothetical schedule would have to provide for a band for employees under age 30, a band for employees in the range 30-34 and a band for employees age 35-39.

The ratio of the allocation rate for the age 40-44 band to the next lower band is **2.0.** Accordingly, in order for the applicable allocations rates under this hypothetical schedule to increase smoothly:

> the ratio of the allocation rate for each band in the hypothetical schedule **below age 40** to the allocation rate for the immediately preceding band would have to be 2.0.

Hypothetical schedule under –8(b)(1)(iv)(D)(1)

Age	Allocation rate (in percent)	Ratio of Allocation rate for band to allocation rate for immediately preceding band
Under 30 (Hypo)	***.75 (Hypo***	***2.0 (Hypo) (1.5/.75)***
30-34 (Hypo)	***1.5 (Hypo***	***2.0 (Hypo) (3/1.5)***
35-39 (hypo)	***3 (hypo)***	***2.0 (Hypo) (6/3)***
40-44	6	2
45-49	9	1.5
50-54	12	1.33
55-59	16	1.33
60-64	20	1.25
65 or older	25	1.25

Thus, the allocation rate for the hypothetical band applicable for employees under age 30 would be.75%, the allocation rate for the hypothetical band for employees in the range 30-34 would be 1.5% and the allocation rate for employees in the range 35-39 would be 3%.

Because the lowest allocation rate under any possible hypothetical schedule is less than 1% of plan year compensation, Plan O will be treated as satisfying the requirements of paragraphs (b)(1)(iv)(B) and (C) of this section only if the schedule of allocation rates satisfies the steepness condition described in paragraph (b)(1)(iv)(D)(2) of this section.

In this case, the steepness condition is not satisfied because the equivalent accrual rate for an employee age 39 is **2.81%.** However, there is no hypothetical employee in the band for ages 40-44 with an equal or lower equivalent accrual rate (since the lowest equivalent accrual rate for hypothetical employees within this band is 3.74% at age 44).

Since the schedule of allocation rates under the plan does not increase smoothly at regular intervals, Plan O's schedule of allocation rates is not a gradual age or service schedule.

Further, Plan O does not provide uniform target benefit allocations (it is not a target benefit plan).

Therefore, under paragraph (b)(1)(i) of this section, Plan O cannot satisfy the nondiscrimination in amount requirement of Section 1.401(a)(4)-1(b)(2) for the plan year on the basis of benefits unless either Plan O:

Provides for broadly available allocation rates for the plan year as described in paragraph (b)(1)(iii) of this section (i.e., **the allocation rate at each age is provided to a group of employees that satisfies section 410(b) without regard to the average benefit percentage test**), or

Satisfies the minimum allocation gateway of paragraph (b)(1)(vi) of this section for the plan year.

MINIMUM ALLOCATION GATEWAY, -8(B)(1)(VI)

A. GENERAL RULE

A plan satisfies the minimum allocation gateway of this paragraph (b)(1)(vi) if each NHCE has an allocation rate **that is at least one third of the allocation rate of the HCE with the highest allocation rate**.

B. DEEMED SASTISFACTION

Deemed satisfaction. A plan is deemed to satisfy the minimum allocation gateway of this paragraph (b)(1)(vi) if:

each NHCE receives an allocation of at least 5% of the NHCE's compensation within the meaning of section 415(c)(3), measured over a period of time permitted under the definition of plan year compensation. This is further explained below.

OTHER RULES OF APPLICATION

IMPUTING PERMITTED DISPARITY IS NOT PERMITTED WHEN DETERMINING ALLOCATION RATE, -8(B)(1)(VII),

For purposes of paragraph (b)(1)(i)(B), allocations and allocation rates are determined under section 1.401(a)(4)-2(c)(2), but without taking into account the imputation of permitted disparity under section 1.401(a)(4)-7.

DIFFERENCES IN RATES ATTRIBUTABLE TO PERMITTED DISPARITY ARE DISREGARDED IN DETERMINING BROADLY AVAILABLE ALLOCATION RATES

However, in determining whether the plan has broadly available allocation rates as provided in paragraph (b)(1)(iii) of this section, differences in allocation rates attributable solely to the use of permitted disparity described in section 1.401(l)-2 are disregarded.

RULES UNDER SECTION 410(B) ALSO APPLY TO THESE REGULATIONS

The general rules and regulatory definitions applicable under section 410(b) apply also for purposes of these regulations. For example, these regulations do not change the general rule prohibiting aggregation of a 401(k) plan or 401(m) plan with a plan providing nonelective contributions. Accordingly, matching contributions are not taken into account for purposes of the gateway.

Similarly, pursuant to section 1.410(b)-6(b)(3), if a plan benefits employees who have not met the minimum age and service requirements of section 410(a)(1), the plan may be treated as two separate plans,

- one for those otherwise excludable employees and
- one for the other employees benefiting under the plan.

In this case, there will be no minimum required allocations under the gateway for the employees who have not met the section 410(a)(1) minimum age and service requirements if the plan cross-tests the portion of the plan benefiting the nonexcludable employees.

415(C)(3) DEFINITION OF COMPENSATION DEFINITION IS REQUIRED FOR 5% OF COMPENSATION ALLOCATION, BUT NOT FOR 1/3 COMPONENT OF THE GATEWAY TEST.

The final regulations allow a plan to satisfy the gateway by providing an allocation of at least 5% of compensation within the meaning of section 415(c)(3).

The definition of compensation can be limited to compensation paid during the period of participation within the plan year.

Note that there are different definitions of compensation for the 1/3 allocation rate comparison and the 5% of compensation allocation component. The 5% of compensation allocation component requires the use of section 415(c)(3) compensation. For purposes of the "one third" component of the gateway, however, a definition of compensation that satisfies section 414(s) suffices.

Example 5, illustrating gateway

Plan P is a profit-sharing plan maintained by Employer A that covers all of Employer A's employees, consisting of two HCEs, X and Y, and 7 NHCEs. Employee X's compensation is $ 170,000 and Employee Y's compensation is $ 150,000.

The allocation for Employees X and Y is $ 30,000 each, resulting in an allocation rate of 17.65% for Employee X and 20% for Employee Y.

Under Plan P, each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3), measured over a period of time permitted under the definition of plan year compensation.

Employee	Compensation	Contribution	Allocation Rate
X—HCE	$170,000	$30,000	17.65%
Y—HCE	$150,000	$30,000	20%
NHCE 1-7			5%

Because the allocation rate for X (or Y) is not currently available to any NHCE, Plan P does not have broadly available allocation rates. Furthermore, Plan P does not provide for age based-allocation rates. (There are no series of bands based solely on age, years of service, age and service points etc.).

Thus, Plan P can satisfy the nondiscrimination in amount requirement of section 1.401(a)(4)-1(b)(2) for the plan year on the basis of benefits **only if** Plan P satisfies the minimum allocation gateway for the plan year.

The highest allocation rate for any HCE under Plan P is 20%.

Accordingly, Plan P would satisfy the minimum allocation gateway if:

- all NHCEs have an allocation rate of at least 6.67%, or
- all NHCEs receive an allocation of at least 5% of compensation within the meaning of section 415(c)(3) (measured over a period of time permitted under the definition of plan year compensation).

Under Plan P, **each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3)** (measured over a period of time permitted under the definition of plan year compensation). Accordingly, Plan P satisfies the minimum allocation gateway. Plan P satisfies the nondiscrimination in amount requirement of section 1.401(a)(4)-1(b)(2) on the basis of benefits if the equivalent accrual rates under Plan P are nondiscriminatory).

APPLICATION TO DEFINED CONTRIBUTION PLANS THAT ARE COMBINED WITH DEFINED BENEFIT PLANS (DB/DC PLANS)

INTRODUCTION

These regulations prescribe rules for testing defined contribution plans that are aggregated with defined benefit plans for purposes of sections 401(a)(4) and 410(b). These rules apply in situations in which the employer aggregates the plans because one of the plans does not satisfy sections 401(a)(4) and 410(b) standing alone.

These rules **do not apply**

- to safe harbor floor-offset arrangements described in section 1.401(a)(4)-8(d), or
- to the situation in which plans are aggregated solely for purposes of satisfying the average benefit percentage test of section 1.410(b)-5.

The combination of a defined contribution plan and a defined benefit plan may demonstrate nondiscrimination on the basis of benefits if the combined plan (the DB/DC plan) is:

1. primarily defined benefit in character,
2. consists of broadly available separate plans (as these terms are defined in the regulations), or
3. satisfies a minimum aggregate allocation gateway requirement that is generally similar to the minimum allocation gateway for defined contribution plans that are not combined with a defined benefit plan.

PRIMARILY DEFINED BENEFIT IN CHARACTER

A DB/DC plan that is primarily defined benefit in character is not subject to the gateway requirement and may continue to be tested for nondiscrimination on the basis of benefits as under former law.

A DB/DC plan is primarily defined benefit in character if, for more than 50% of the NHCEs benefiting under the plan:

the normal accrual rate attributable to benefits provided under defined benefit plans for the NHCE

exceeds

the equivalent accrual rate attributable to contributions under defined contribution plans for the NHCE.

For example, a DB/DC plan is primarily defined benefit in character where:

- the defined contribution plan covers only salaried employees,
- the defined benefit plan covers only hourly employees, and
- more than half of the NHCEs participating in the DB/DC plan are hourly employees participating only in the defined benefit plan.

BROADLY AVAILABLE SEPARATE PLANS

A DB/DC plan that consists of broadly available separate plans may continue to be tested for nondiscrimination on the basis of benefits as under current law, even if it does not satisfy the gateway requirement.

A DB/DC plan consists of broadly available separate plans if:

the defined contribution plan and

the defined benefit plan, tested separately,

would **each** satisfy the requirements of section 410(b) and the nondiscrimination in amount requirement of section 1.401(a)(4)-1(b)(2), assuming satisfaction of the average benefit percentage test of section 1.410(b)-5.

Thus, the defined contribution plan must separately satisfy the nondiscrimination requirements (taking into account these regulations as applicable), but for this purpose assuming satisfaction of the average benefit percentage test.

Similarly, the defined benefit plan must separately satisfy the nondiscrimination requirements, assuming for this purpose satisfaction of the average benefit percentage test. In conducting the required separate testing, all plans of a single type (defined contribution or defined benefit) within the DB/DC plan are aggregated, but those plans are tested without regard to plans of the other type.

This alternative is useful in the following situation.

The employer maintains:

- a defined contribution plan that provides a uniform allocation rate for all covered employees at one business unit,
- a safe harbor defined benefit plan for all covered employees at another unit and

The group of employees covered by each of those plans is a group that satisfies the nondiscriminatory classification requirement of section 410(b).

Because the employer provides broadly available separate plans, it may continue to aggregate the plans and test for nondiscrimination on the basis of benefits, as an alternative to using the qualified separate line of business rules or demonstrating satisfaction of the average benefit percentage test.

GATEWAY FOR BENEFITS TESTING OF COMBINED PLANS

In order to apply this minimum aggregate allocation gateway, the employee's aggregate normal allocation rate is determined by adding the employee's allocation rate under the defined contribution plan to the employee's equivalent allocation rate under the defined benefit plan. This aggregation allows an employer that provides NHCEs with both a defined contribution and a defined benefit plan to take both plans into account in determining whether the minimum aggregate allocation gateway is met.

Under the gateway,

> if the aggregate normal allocation rate of the HCE with the highest aggregate normal allocation rate under the plan (HCE rate) **is less than 15%**,
>
> > the aggregate normal allocation rate for all NHCEs <u>must be at least one-third of the HCE rate</u>.
>
> If the HCE rate **is between 15% and 25%**,
>
> > the aggregate normal allocation rate for all NHCEs <u>must be at least 5%</u>.
>
> If the HCE rate **exceeds 25%,**
>
> > then the aggregate normal allocation rate for each <u>NHCE must be at least 5% plus one percentage point for each 5-percentage-point increment (or portion thereof) by which the HCE rate exceeds 25%</u>
>
> For example, the NHCE minimum is 6% for an HCE rate that exceeds 25% but not 30%, and 7% for an HCE rate that exceeds 30% but not 35%.

In determining the equivalent allocation rate for an NHCE under a defined benefit plan, a plan is permitted to treat each NHCE who benefits under the defined benefit plan as having an equivalent allocation rate equal to:

> the average of the equivalent allocation rates under the defined benefit plan for all NHCEs benefiting under that plan.

This averaging rule recognizes the grow-in feature inherent in traditional defined benefit plans (i.e., the defined benefit plan provides higher equivalent allocation rates at higher ages).

SECTION X, OVERVIEW OF DEMONSTRATIONS

CAUTION-REPRINTED MATERIALS

This chapter contains republished material from the CPE 1997 text on coverage and nondiscrimination. Although there is a new chapter on new comparability regulations and an updated chapter on the new demonstrations, the reprinted portion has not been updated to reflect the changes subsequent to 1997, including:

- The new comparability regulations
- New determination procedures
- Repeal of 415(e),
- 401(k) safe harbor provisions and
- HCE definition.

Although these above changes have affected the application of the coverage and nondiscrimination requirements, this chapter was reprinted because the methodology with respect to the coverage and nondiscrimination tests has not changed. Thus, with the exceptions noted above, the coverage, average benefits test, safe harbor uniformity and accrual requirements, and the other special rules that were comprehensively covered in the CPE 1997 chapter remain the same and are still relevant when processing determination letter applications. The portions of the CPE 1997 text with regards to applying coverage and nondiscrimination on an examination have been omitted.

OVERVIEW OF DEMONSTRATIONS

ANNOUNCEMENT 2001-77

Ann. 2001-77 made several changes to the way determination letters are processed. The changes allow more flexibility for the plan sponsor to choose the level of reliance they desire for coverage and nondiscrimination.

BACKGROUND

BRIEF PROCEDURAL HISTORY

Rev. Proc. 93-39

Rev. Proc. 93--39, 1993--2 C.B. 513, set forth additional procedures regarding applications for determination letters on the qualified status of pension, profit-sharing, and annuity plans under section 401(a) or 403(a) of the Code filed with the Service on or after October 12, 1993. Rev. Proc. 93--39 reflected changes to the plan qualification requirements made by the Tax Reform Act of 1986 (TRA '86), Pub. L. 99--514, as well as the final nondiscrimination regulations under section 401(a)(4) that were published in 1993.

Rev. Proc. 94-37

Rev.Proc. 94-37, 1994-1 C.B. 683,made three modifications to 93-39—

- Changed procedures with respect to benefits, rights and features,
- Limited circumstances under which applicants must provide information concerning plan provisions and amendments that provide for past service, pre-participation service, and imputed service, and
- Reduced information that must be provided by adopters of standardized master or prototype (M&P) or regional prototype plans that are applying for determination letters (e.g., because [*2] they maintain another plan or are terminating the standardized plan).

Rev. Proc. 96-6 superceded Rev. Proc. 93-39

Rev. Proc. 96-6, 1996-1 C.B. 525 superceded Rev. Proc. 93—39 by incorporating Rev. Proc. 93-39 and 94-37 procedures into Rev. Proc. 96-6 (and subsequent revenue procedures). Currently, the procedures are in Rev. Proc. 2002-6.

In addition, along with Rev. Proc. 96-6, Schedule Q was issued, taking the place of the Attachment A that was required by section 5.03 of Rev. Proc. 93--39 to be included with determination letter applications. (A model attachment was included in Appendix A of Rev. Proc. 93--39.) Rev. Proc. 96-6 required Schedule Q (Form 5300) to be filed with all determination letter applications, except for applications:

- filed on Form 6406, Short Form Application for Determination for Minor Amendment of Employee Benefit Plan;
- relating to the qualified status of group trusts;
- relating solely to the requirements of section 420 of the Code, regarding the transfer of assets in a defined benefit plan to a health benefit account described in section 401(h).

Summary of procedures prior to Announcement 2001-77

Prior to the issuance of Ann. 2001-77, plans were reviewed for compliance with form and certain operational issues. Plans were automatically reviewed for:

- Coverage, if it satisfied the ratio percentage test
- The use of a design based safe harbor allocation or benefit formula, and

- A plan's benefits, rights or features if covering the same group as those participants benefiting under the plan.

If the plan did not satisfy theses requirements then the employer had to choose to have these issues reviewed. As stated above, those elections were made using Schedule Q.

NEW PROCEDURES

The new procedures allow plan sponsors to elect to have a plan reviewed for compliance with:

- form requirements only, or
- with both form **and** the coverage, participation and nondiscrimination requirements of section 410(b), 401(a)(26) and 401(a)(4) respectively.

CHANGES TO APPLICATION FORMS

- The filing of Schedule Q is now optional.
- Certain questions are being eliminated from Schedule Q, including those related to section 401(a)(26). A defined benefit plan will be reviewed for 401(a)(26) if the application requests consideration of section 410(b), or if the cover letter requests consideration of 410(a)(26).
- Questions related to the ratio percentage test and design based safe harbors have been moved to Forms 5300 and 5307 and are now optional.
- Questions related to coverage and nondiscrimination in amounts are also being added to Form 5310.

RELIANCE

Under prior procedures, the determination letter contained caveats that indicated the plan satisfied specific requirements with respect to coverage and nondiscrimination. The actual level of reliance depended on the specific information submitted with the request.

Ann. 2001-77 eliminates the use of caveats for coverage and nondiscrimination, although the extent of reliance on a letter has not changed. The reliance will still depend on the specific information submitted with the application. The taxpayer will be required to retain the application and the specific information submitted with the request in order to obtain reliance.

EFFECTIVE DATES AND TRANSITION RULES

Applications submitted prior to July 23, 2001 must comply with prior procedures.

Under Announcement 2001-122, 2001-51 I.R.B. 604, all applications submitted after March, 2002 must be submitted using the revised Forms. Thus, applications submitted between July 23, 2001 and March 31, 2002 have several options:

1. submit the revised Forms 5300 or 5307 (revised September 2001) with or without the revised Schedule Q (Revised August 2001),
2. submit the prior version of Forms 5300 or 5307 with the prior Schedule Q, following prior procedures under Rev Proc 2001-6,
3. submit the prior version of Forms 5300 or 5307 omitting Schedule Q, or
4. submit the prior version of Forms 5300 or 5307 with the prior Schedule Q completing only Part I and those lines relating to the specific coverage and nondiscrimination issues for which a determination is requested.

User fees will depend on the forms submitted and whether the applicant requests consideration of the average benefit test or general test.

OVERVIEW OF DEMONSTRATIONS ("DEMOS")

Below is an explanation of the demos that would be required if the employer chooses to have these issues reviewed when submitting for a determination letter.

- Demo 1 is a demonstration of the gateway test for separate lines of business under section 414(r).

  See 1994 CPE, chapter 2 for an example of the gateway test as well as the 1996 CPE chapter on examining separate lines of business.

- Demo 3 is a demonstration that a benefit, right or feature satisfies current availability under section 1.410(b)-4.
- Demo 4 is a demonstration for satisfying coverage when the plan is mandatorily disaggregated (when the plan has a section 401(k)

feature), permissively aggregated (an optional rule under coverage) or restructured (an optional rule under nondiscrimination).

- Demo 5 is the average benefits test demonstration (see below)
- Demo 6 is a demonstration that the plan satisfies either the general test or the non-design based safe harbor (see below).
- Demo 7 is a demonstration that is required if the plan exceeds the 5 year safe harbor grant of past service or pre-participation service.

  If the plan grants more than 5 years grant of past service, the amendments and special circumstances requirement under section 1.401(a)(4)-5 may not be satisfied.
- Demo 9 is a demonstration showing that the plan's definition of compensation or the definition used for average annual compensation in determining the accrual rates is nondiscriminatory.

PROCESSING PLANS FOR COVERAGE AND NONDISCRIMINATION

Schedule Q instructions contain specific line item instructions which provide a brief explanation of the purpose of the demonstration. Schedule Q instructions also contain specific information that must be in the demonstrations, which is under the section “Guidelines for certain demonstrations”.

REVIEWING THE EMPLOYER'S DEMONSTRATIONS

- When reviewing the plan for a determination letter, the agent must ensure that the employer's demonstration satisfies the schedule Q guidelines.

  The employer's demonstration should show that:

- the plan satisfies the relevant tests.
- the methodology used by the employer, as stated in the demonstration, meets the requirements of the regulations.

The sponsor's demonstrations must indicate where each element in the guidelines is addressed.

Remember, the employer's submission will not have all the demonstrations. The demonstrations submitted depend on the type of plan and the choices made by the plan sponsor.

THE EMPLOYER'S DEMONSTRATIONS CONTAIN BOTH FACTUAL REPRESENTATIONS AND ILLUSTRATIONS OF METHODOLOGY

The employer's demonstrations consist of a mixture factual representations and illustrations of methodology.

The employer listing the rate groups of the plan would be a factual representation because the demonstration would not have sufficient information for the agent to verify that the rate groups have been formed correctly.

Illustrating imputing permitted disparity by an example would be illustrating methodology. With this example, the agent could determine that the methodology is being applied correctly.

The agent reviewing for a determination letter will not look at employee records to verify any factual representations. These representations may be verified when the plan is examined.

For example, the agent will not look at the employer records to verify the accrual rates used to form the rate groups shown in the demonstration. However, if the plan is examined at a later date, the factual representations in the demonstrations will then be compared to the underlying records of the plan. If the records do not support these representations, the employer will not have reliance on its determination letter. See Chapter 2, CPE 1996, Rev. Proc. 93-39 Examinations.

Some factual representations can be verified by looking at the plan document

There are some representations made in the demonstration that can be verified by looking at plan provisions.

For example, if the demonstration states the plan uses a 414(s) safe harbor definition, the agent should check this definition. If the submission states that the plan is using a safe harbor formula, the agent should review the plan's formula.

Thus, a representation that can be verified by the plan provisions should be verified.

Additional information should be requested if there are inconsistencies between the demonstrations

There may be instances in which the various demonstrations will not have the same information. For example, Demo 6 might show a different number of employees than Form 5300. Note that additional information should be requested to resolve these inconsistencies. Also, additional information should be requested if the employer's demonstration does not contain all the information required by the minimum elements.

When the employer no longer has reliance on its determination letter-change of facts

If the facts and circumstances have changed requiring the application of different methodology to satisfy coverage or nondiscrimination, the employer no longer has reliance on its determination letter for that particular issue.

EXAMPLE 1 ILLUSTRATING A CHANGE IN FACTS

A plan receives a determination letter by passing the ratio percentage. If the plan does not pass the ratio percentage test in a particular year, the employer does not have reliance for coverage for that particular year.

EXAMPLE 2

Demo 6 shows that all the plan's rate group satisfies the ratio percentage test. In one plan year, one rate group does not satisfy the ratio percentage test, but satisfies the modified average benefits test. The employer no longer has reliance on its determination letter for nondiscrimination ,

Employer may have reliance on determination letter if the employer received a favorable determination letter on incorrect methodology

If the employer applied incorrect methodology, but receives a favorable determination letter, the employer may have reliance as long as it continues to apply that methodology and satisfies the test using the incorrect methodology. The agent should follow the procedures under section 7805(b) and apply for technical advice to the National Office to determine whether a taxpayer has reliance on its determination letter.

SUMMARY OF FORM 5300, SCHEDULE Q-

QUESTION 1-SEPARATE LINES OF BUSINESS

This question asks whether an employer is using separate lines of business to satisfy participation or coverage. An employer would answer

yes to this question if the employer is being divided into separate lines of business.

The employer is representing that it is eligible to use the SLOB rules. The agent would not determine if the plan actually satisfies the separate line of business requirements. Thus, the determination letter does not give the employer reliance on this issue. The determination letter gives the employer reliance on the gateway test. With Demo 1, the employer has to demonstrate that the plan satisfies the gateway test.

If the plan is under examination, the agent would verify that the plan is eligible for separate line of business treatment (see chapter on SLOBs, CPE 1996). If the employer applied the coverage rules on a SLOB basis and the agent determines that the employer does not satisfies the SLOB requirements, the employer would not have reliance on the determination letter because the coverage rules were applied incorrectly.

The guidelines as provided in the Form 5300, Schedule Q (revised August 2001) requires the following information to be submitted with Demo 1:

1. The Code section(s) for which the employer is testing on a separate line of business basis (i.e., section 410(b) or section 401(a)(26)),
2. The separate lines of business that have employees benefiting under the plan,
3. A demonstration of how the plan meets the nondiscriminatory classification requirement of section 410(b)(5)(B) and Regulations section 1.414(r)-8(b)(2) on an employer-wide basis, and
4. If the requirements of section 410(b) or section 401(a)(26) are to be applied to this plan on an employer-wide basis under the special rules for employer-wide plans, a demonstration of how the plan meets the requirements of the applicable special rule in Regulations sections

QUESTION 2

A determination letter issued for a defined benefit plan that requests a determination regarding section 410(b) will also be a determination regarding section 401(a)(26).

QUESTION 3, BENEFITS, RIGHTS AND FEATURES

This question asks whether the employer is requesting a determination that specified benefits, rights or features are currently available. The employer can choose whether they want reliance on a benefit, right or feature (BRF) that does not cover the same coverage group as for contributions or benefits. Thus, if the BRF covers a different coverage group, the employer would answer yes and attach Demo 3 if the employer wants reliance for this particular BRF. A determination letter provides reliance for benefits, rights or features that are currently available to all employees in the plan's coverage group as long as the plan itself satisfies coverage.

The following is the specific guidelines under Schedule Q.

1. An applicant requesting a determination that a plan satisfies the nondiscriminatory current availability requirement of Regulations section 1.401(a)(4)-4(b) for any benefit, right, or feature ("BRF") specified by the applicant should ordinarily demonstrate the following for each BRF that the applicant wants considered:

   a. Identify the specific BRF, including terms pertaining to the BRF, such as eligibility conditions, timing, election rights, etc.

   b. Cite the plan provisions that describe the BRF and all terms relating to the BRF.

   c. Describe any conditions on the availability of the BRF that were disregarded in determining current availability.

   d. If the BRF is contingent on an unpredictable event, describe the contingency and determine current availability as if the event had occurred.

   e. If applicable, describe how the special rule in Regulations section 1.401(a)(4)-4(d)(3), relating to early retirement window benefits, has been applied.

2. If the BRF is an optional form of benefit, ancillary benefit, or other right or feature that has been aggregated, for testing purposes, with another optional form of benefit, ancillary benefit, or other right or feature, respectively, show how the requirements of Regulations section 1.401(a)(4)-4(d)(4)(i)(A) and (B) are satisfied.

3. Describe the group of employees to whom the BRF is available and indicate if this group includes any non-excludable employees with accrued benefits who are not currently benefiting ("frozen plan participants").

4. Demonstrate one of the following with respect to the specified BRF:

   a. The group of employees to whom the benefit is currently available satisfies the section 410(b) ratio percentage test.

b. The BRF has been prospectively eliminated and satisfies the section 410(b) ratio percentage test as of the elimination date.

c. The BRF is available only to an acquired group of employees and the requirements of Regulations sections 1.401(a)(4)-4(d)(1)(i)(A) and (B) are satisfied.

d. The plan is a permissively aggregated plan and the BRF is a spousal benefit described in Regulations section 1.401(a)(4)-4(d)(5).

e. The plan is an ESOP and the BRF is an investment diversification right or feature or distribution option available only to all qualified participants (as defined in section 401(a)(28)(B)(iii)) or the failure of the BRF to satisfy current availability results solely from the restrictions of section 409(n).

f. The plan is a permissively aggregated defined benefit/defined contribution (DB/DC) plan; the BRF is not a single sum benefit, loan, ancillary benefit, or benefit commencement date (including the availability of in-service withdrawals); the BRF is provided under only one type of plan; and the BRF is currently available to all NHCEs in all plans of the same type as the plan under which it is provided.

5. If the BRF is available to frozen plan participants, show how one of the requirements in Regulations sections 1.401(a)(4)-4(d)(2)(i) through (iv) is satisfied.

QUESTION 4, MANDATORILY DISAGGREGATED ETC

This question asks whether the plan is mandatorily disaggregated, permissively aggregated or restructured.

If the plan has a 401k or 401m feature, the plan has to be mandatorily disaggregated with the profit sharing component of the plan and the employer must submit Demo 4 showing the coverage that is satisfied for each component.

Demo 4 is required even if all the disaggregated elements cover the same employees. In such a case, Demo 4 would simply represent that all disaggregated portions benefit the same employees and that each element satisfies the ratio percentage test.

If the plan uses the optional rules of permissive aggregation or restructuring, a Demo 4 is required.

The specific instructions are as follows:

Explain the basis of the disaggregation, permissive aggregation, or restructuring, identifying the aggregated or separate disaggregated

plans or component plans, and demonstrate how any restructured component plans satisfy section 410(b) as if they were separate plans.

Any other plan that has been permissively aggregated with this plan should be identified by:

- Name,
- Plan number, and
- Employer Identification Number (EIN).

Describe the benefit or allocation formula of the other plan and indicate if that plan has received or applied for a determination letter.

QUESTION 5---AVERAGE BENEFITS TEST

Question 5 is limited to the average benefit test. The following is the Guidelines with respect to Demonstration 5 as required by Schedule Q

Comments:

Some of the elements required in Demo 5 is the same information required in Demo 6 because the accrual or allocation rates to determine the employee benefit percentages for the average benefits percentage test are the same as those used in determining the general test. However, the employer does not have to use the same optional rules for the average benefits percentage test as those used for the general test.

Item 1

1) An applicant requesting a determination that a plan satisfies the average benefit test **must demonstrate compliance with the nondiscriminatory classification test of Regulations section 1.410(b) including**, if applicable, the facts and circumstances determination under Regulations section 1.410(b)-4(c)(3).

   Note. *The determination regarding the average benefit test is not available to a plan that satisfies the ratio percentage test.* The demonstration for the average benefit test should provide, for each Highly Compensated Employee (HCE) and each Non-Highly Compensated Employee (NHCE) the compensation used in the test, the allocation or benefit being tested and the actual benefit percentages. The average benefit percentages for HCEs and NHCEs must be provided.

Comments

This element illustrates the nondiscriminatory classification test showing the NHCE concentration percentage and whether the plan's ratio percentage satisfies the safe or unsafe harbor.

If the plan's ratio percentage is below the safe harbor percentage but above the unsafe harbor percentage, the plan must satisfy a facts and circumstances test. The employer would submit the facts and circumstances with this element.

This element also requires the employer to represent the average benefit percentage of NHCEs and HCEs. Note that the NHCE percentage is divided by the HCE percentage and must be at least equal to 70% to satisfy the average benefits percentage test.

Remember, the average benefits percentage of the NHCEs is the average the employee benefit percentages of all the non-excludable NHCEs of the entire controlled group. The benefit percentages also take into account all the plans of the controlled group, even 401(k) and ESOPs. The mandatory disaggregation rules do not apply to the average benefits percentage test, see 1.410(b)-7(e).

As with Demo 6, Demo 5 does not have to show the actual employee benefit percentages that determines the averages. However, if the submission indicates that not all non-excludable employees were included, additional information should be requested. See Element 4(c) below, definition of testing group and pages 9-10.

Item 2-special rule

2) A plan that is deemed to satisfy the average benefit percentage test under the special rule in Regulations section 1.410(b)-5(f) must demonstrate that the plan would satisfy the ratio percentage test if:

the excludable employee and

mandatory disaggregation rules for collectively bargained and non-collectively bargained employees

did not apply.

Comments

The element refers to a special rule, if the plan benefits both collectively bargained employees and non-collectively bargained employees. If this

special rule applies, the average benefit percentage test need not be submitted.

Item 3—determining the employee benefit percentages

3) In addition to the above information, the average benefit percentage demonstration must identify and describe the method used for determining employee benefit percentages (see Regulations sections 1.410(b)-5(d) and (e)), include the information listed below, under the heading **All Plans** , as applicable.

   Note. *The demonstration must include the portion of the coverage test showing the data used in the calculations and the calculations for each participant. Participants need not be identified. However, the IRS may request that additional information be submitted if necessary.*

Comments

As stated above, the average benefit percentage demonstration should identify and describe the method used for determining employee benefit percentages. In some cases, plans overlook this introductory language and do not submit such a description.

Remember, employee benefit percentages are determined by using the allocation or accrual rates. For defined benefit plans, the employee benefit percentage is determined by using the normal accrual rate.

In addition to the above description, the employer has to submit information with respect to the elements described below. Most of the information required by Demo 5 relates to showing how the employee benefit percentages were developed. Since the employee benefit percentages are the allocation rates and normal accrual rates under the general test, most of the elements required by the fourth item in Demo 5 are the same elements as required by Demo 6.

In explaining these elements, part II of Explanation 5C, Part I (a)-(r) of the alert guidelines primarily reference to the general test requirements of Demo 6. Also, refer to comments below with respect to Items 1 through 11 of Demo 6.

Information required for all plans

All plans using the average benefit test must also include the following information on Demo 5:

1) The testing period (see Regulations section 1.410(b)-5(e)(5) for an optional averaging rule).

2) The definition of testing service (including imputed and pre-participation service).
3) A description of the testing group (see Regulations section 1.410(b)-7(e)).

   Comment: This element is sometimes misunderstood. For purposes of the average benefits percentage test, all plans in the testing group is considered, including those that are mandatorily disaggregated, such as 401ks and ESOPs. All the non-excludable employees of all plans in the controlled group are considered, and all non-excludable employees are considered.

   For example, Employer X maintains Plan A and Employer Z maintains Plan B, a 401(k) plan. Employer X and Z are related companies. If Plan A is submitting for a determination letter and has requested a determination on the average benefits test, the benefits of Plan B and all non-excludable employees (and Plan B) of Employer Z must be included and averaged with all the non-excludable employees of Employer X.

4) Whether the employee benefit percentages are determined on a contributions or benefits basis.
5) Whether permitted disparity under Regulations section 1.401(a)(4)-7 is imputed in determining employee benefit percentages.
6) A explanation of how allocation or accrual rates are grouped on the test.
7) A description of how contributions or benefits are normalized, including actuarial assumptions used.
8) The definition of section 414(s) compensation used in determining plan year compensation or average annual compensation and a demonstration showing the definition as nondiscriminatory.

   If plan year compensation or average annual compensation is determined using a definition of compensation that satisfies Regulations section 1.414(s)-1(c)(2) or (3), the explanation should state whether the definition satisfies section 1.414(s)-1(c)(2) or (3).

   For guidance pertaining to this demonstration, see the guidelines under the Demo 9 instructions on page 5 pertaining to nondiscriminatory compensation.

9) A description of the method of determining compensation used in determining employee benefit percentages.

   Comment: This element is referring to the methods of determining average annual compensation. As required by Demo 6, this element requires the employer to show the method in determining average annual compensation or to describe the period used in

determining plan year compensation. Remember, average annual compensation is required to be used if the allocation or accrual rates are stated as a percentage of compensation. Plan year compensation can be used with respect to allocation rates

10) The testing age of employees (not applicable to defined contribution plans testing on a contribution basis).

Plans with Defined Benefit Plans in the Testing Group Plans with DBP's in the testing group must also provide the following information if applicable.

11) Show if accruals after normal retirement age are taken into account and, if such accruals are disregarded as provided in Regulations section 1.401(a)(4)-3(f)(3), the basis on which they are disregarded.

12) Show if most valuable rates must be used under Regulations section 1.410(b)-5(d)(7), and, if so, show how those rates are determined.

13) Show if a defined benefit plan disregards offsets described in Regulations section 1.401(a)(4)-3(f)(9), give a description of such offsets, and show how they satisfy Regulations section 1.401(a)(4)-3(f)(9).

14) Show if any disability benefits are taken into account in determining employees' accrued benefits under Regulations section 1.401(a)(9)-3(f)(2), and, if so, cite the plan provisions that permit these disability benefits to be taken into account.

15) Show if any other special rules in testing a plan for nondiscrimination in amounts are applied, e.g., the rules applicable to the determination of benefits on other than a plan-year basis described in Regulations section 1.401(a)(4)-3(f)(6), the adjustments for certain plan distributions provided in Regulations section 1.401(a)(4)-3(f)(7), and the adjustment for certain qualified pre-retirement survivor annuity charges as provided in Regulations section 1.401(a)(4)-3(f)(8).

16) Plans with employee contributions not allocated to separate accounts: give a description of the method for determining the employer-provided accrued benefit under Regulations section 1.401(a)(4)-6(b) and the location of relevant plan provisions. If the method for determining the employer-provided accrued benefit is the composition-of-workforce method, the demonstration must show that the eligibility requirements of Regulations section 1.401(a)(4)-6(b)(2)(ii) are satisfied; if the grandfather rule of Regulations section 1.401(a)(4)-6(b)(4) is used, the demonstration must show, if applicable, that the benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation.

Employee Benefit Percentages Determined Using Cross-Testing

17) Provide a description of the method used to determine equivalent allocations and benefits.

QUESTION 6, THE GENERAL TEST

A request for a determination that a plan satisfies any of the general tests in Regulations sections

- 1.401(a)(4)-2(c),
- 1.401(a)(4)-3(c),
- 1.401(a)(4)-8(b)(2),
- 1.401(a)(4)-8(c)(2),
- 1.401(a)(4)-8(c)(3)(iii)(C), or
- 1.401(a)(4)-9(b)

must include a nondiscrimination test showing that the plan passes the relevant general test, and provide the information listed under All Plans (unless otherwise noted), and if applicable, under Defined Benefit Plans Only or Cross-Tested Plans Only . However, the IRS may request that additional information be submitted if necessary.

All Plans (unless otherwise noted)

All plans must submit the information requested in items 1 through 11 (below).

1) Provide the portion of the nondiscrimination test that provides the data for each participant and demonstrates that the plan satisfies 401(a)(4). Participants need not be identified by name.

   Tests that include two or more component plans (such as profit-sharing, money purchase, 401(k) and 401(m)) should show the allocations or benefits under each component plan.

Item 2, identify each rate group

2) Identify **each rate group** under the plan and include a demonstration of how each rate group satisfies section 410(b). If the plan is a DBP that is being tested on the basis of the amount of benefits, rate groups must be determined on the basis of both normal and most valuable accrual rates which are expressed as a dollar amount or a percentage of compensation. If the most valuable accrual rate is determined in accordance with the special rule in Regulations section 1.401(a)(4)-3(d)(3)(iv) (floor on most valuable accrual rate), this must be indicated.

Comment on item 2

This element requires that the make-up of the rate groups be shown, and that the taxpayer submits information showing how each rate group satisfies coverage. However, the agent will not have enough information as to whether the rate groups were formed correctly since the employer is not required to submit each employee's allocation or accrual rates. Thus, the identification of all the rate groups is an employer representation.

With this element, the employer may submit the employee accrual rates for each rate group. If so, the agent should determine that the rate groups were formed correctly. Remember that within each rate group, all the allocation or accrual rates of the NHCEs and HCEs will be at least equal or greater than the HCE who forms the rate group.

SHOWING COVERAGE FOR THE RATE GROUPS

The submission must show the NHCE and HCE benefiting percentage for each rate group and show the ratio percentage.

Remember, that if a rate group fails the ratio percentage test, the submission must show how the rate group satisfies the modified average benefits test. (See above).

> Thus, with respect to the nondiscriminatory classification test, the employer must show the employer's NHCE concentration percentage and the midpoint between the safe and unsafe harbors. The employer must also demonstrate that the ratio percentage of the rate group is higher than either this midpoint or the plan's ratio percentage.
>
> With respect to average benefits percentage test, the employer must provide the information relevant to running the average benefit percentage test with respect to the entire plan. This is an area that can cause confusion because the employer may submit Demo 5, the average benefits test demonstration, to satisfy this requirement of Demo 6.

If the employer submits Demo 5, the agent should ensure that the general test rules are still applied. Thus, the employer should still use the midpoint, which is used to determine that the nondiscriminatory classification test is satisfied. In addition, the employer should also compare this midpoint with the rate group's ratio percentage (and not the plan's ratio percentage). For a comparison of the average benefits test under coverage and the modified average benefits test under nondiscrimination, please see below.

Item 3-plan tested on contributions or benefits basis

3) State whether the plan is being tested on a contributions or benefits basis.

Comment

These elements ask for whether the plan is being tested on a contributions or benefits basis. Remember, a DC or DB plan can be tested on either a contributions or benefits basis. If it is a DC plan and the employer states that it is being tested on a benefits basis, this plan is being cross-tested.

Please refer to the new-comparability chapter for further information on certain cross-tested plans.

4) Provide the plan year being tested.

Item 5-description of accrual rate

5) Provide a description of the method of determining allocation or accrual rates, and if the plan is tested on a benefits basis, the measurement period and definition of testing service (including imputed and pre-participation service).

This is an important element of this demonstration. Determining the allocation or accrual rates is the first step in running the general test. The taxpayer should represent the methodology that is being used to determine these rates.

The employer should describe the accrued benefit, testing service and the measurement period that is being used to determine the accrual rates.

The employer will probably submit an example illustrating how the accrual rates are determined, showing the following fraction. (See page 23)

$$\frac{\text{accrued benefit}}{\text{testing service}}$$ (Determined over measurement period).

Items 6 and 7

6) State whether the test is imputing permitted disparity under Regulations section 1.401(a)(4)-7.

7) Provide an explanation of how allocation or accrual rates are grouped.

Comments

These elements relate to the optional rules of grouping and imputing permitted disparity. Remember, these optional rules adjust the accrual rates for forming the rate groups. The employer should provide examples with respect to both optional rules.

For grouping, the agent should ensure that the specified ranges do not overlap.

For imputing permitted disparity, the agent should carefully review the formulas used by the employer.

Item 8, converting to single life annuity

8) Provide an explanation of how benefits are normalized on the test, including the actuarial assumptions used (not applicable to defined contribution plans testing on a contributions basis).

Comments

This element pertains to the requirement that all benefits be converted to a single life annuity. Thus, for plans that provide the normal form of benefits in J&S form, these benefits have to be converted or normalized to a single life annuity.

Item 9-average annual compensation

9) State the definition of section 414(s) compensation used in determining plan year compensation or average annual compensation and a demonstration showing the definition as nondiscriminatory.

If plan year compensation or average annual compensation is determined using a definition of compensation that satisfies Regulations sections 1.414(s)-1(c)(2) or (3) state whether the definition satisfies 1.414(s)-1(c)(2) or whether the definition satisfies 1.414(s)-1(c)(3). See the guidelines under the Demo 9 instructions pertaining to nondiscriminatory compensation for guidance pertaining to this demonstration.

Comments

This element requires the employer to provide the compensation definition used in determining average annual or plan year compensation. If the

definition of compensation is not one of the safe harbor 414(s) definitions, the employer must also show that the definition is nondiscriminatory

Item 10, determining average annual compensation

10) Provide the method of determining average annual compensation used in testing the plan for nondiscrimination as defined in Regulations section 1.401(a)(4)-3(e)(2) or give a description of the period used in determining plan year compensation.

Comments

This element requires the employer to show the method in determining average annual compensation or to describe the period used in determining plan year compensation. Remember, average annual compensation is required to be used if the allocation or accrual rates are stated as a percentage of compensation. Plan year compensation can be used with respect to allocation rates. Please see the safe harbor section for a further discussion on average annual compensation.

Item 11-testing age, or age upon which benefit is based

11) Provide the testing age of employees, include fractions of year if test is based on fractional age (not applicable to a Defined Contribution Plan (DCP) testing on a contributions basis).

Defined Benefit Plans Only

These are elements pertaining to special rules for defined benefit plans. Basically, the items consist of benefits that are allowed to be disregarded or included as part of the general test analysis.

All DBP's must also provide the following information if applicable:

Item 12-safety valve

12) State whether accruals after normal retirement age are taken into account, and if such accruals are disregarded as provided in Regulations section 1.401(a) (4)-3(f)(3), provide the basis on which they are disregarded.

Comments

This is the safety valve element, which shows facts and circumstances that allows the plan to disregard up to 5% of the rate groups. Please refer to the alert guidelines for further information.

Other special rules-Items 13-19,)

The following items cover the special rules for DB plans. Please refer to the special rules chapter for further information.

13) State whether early retirement window benefits are taken into account in determining accrual rates and whether such benefits are being disregarded under Regulations section 1.401(a)(4)-3(f)(4)(ii). Also provide the basis on which they are disregarded.
14) State whether any unpredictable contingent event benefits were taken into account in determining accrual rates under Regulations section 1.401(a)(4)-3(f)(5) and provide the basis on which they are taken into account.
15) State whether the plan disregards offsets described in Regulations section 1.401(a)(4)-3(f)(9), provide a description of such offsets, and show how they satisfy Regulations section 1.401(a)(4)-3(f)(9).
16) State whether any disability benefits are taken into account in determining employees' accrued benefits under Regulations section 1.401(a)(4)-3(f)(2), and if so, cite the plan provisions that permit these disability benefits to be taken into account.
17) State whether any other special rules in Regulations section 1.401(a)(4)-3(f) are applied in testing a plan for nondiscrimination in amount, for example:
    - The rules applicable to the determination of benefits on other than a plan-year basis described in Regulations section 1.401(a)(4)-3(f)(6),
    - The adjustment for certain plan distributions provided in Regulations section 1.401(a)(4)-3(f)(7), and
    - The adjustment for certain qualified pre-retirement survivor annuity charges as provided in Regulations section 1.401(a)(4)-3(f)(8).
18) Plans with employee contributions not allocated to separate accounts should include:
    - A description of the method for determining whether employee-provided accrued benefits are nondiscriminatory under Regulations section 1.401(a)(4)-6(c),
    - The method for determining the employer-provided accrued benefit under Regulations section 1.401(a)(4)-6(b), and
    - The location of relevant plan provisions.

If the method for determining the employer-provided accrued benefit is the composition-of-workforce method, the demonstration must

show that the eligibility requirements of Regulations section 1.401(a)(4)-6(b)(2)(ii) are satisfied. If the grandfather rule of Regulations section 1.401(a)(4)-6(b)(4) is used, the demonstration must show, if applicable, that the benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation

19) If the plan would otherwise fail to satisfy the general test in Regulations section 1.401(a)(4)-3(c)(1), and a determination is being sought that the failure may be disregarded as permitted by the special rule in Regulations section 1.401(a)(4)-3(c)(3), describe the relevant facts and circumstances that support the use of this rule.

Cross-Tested Plans Only

20) Provide a description of the method used to determine equivalent allocations and benefits.
21) For defined contribution plans, the demonstration must list each participant's allocation rate for the plan being tested and list the equivalent benefit accrual rate (including component plans) for each participant.

Comments

This is the cross testing element. To satisfy this element, the submission should describe a step by step analysis showing the methodology of converting allocations into accrual rates.

For cross tested plans, the employer may submit a computer run showing the conversion of the actual allocation rates into equivalent accrual rates and label the run Demo 6. Although some of the Demo 6 elements may be represented, additional information should be requested if the computer run does not provide all the elements and provide an adequate description of converting the allocation rates. For further information about cross testing, please see the general test section above.

Also, please refer to the new comparability chapter for further requirements on cross-tested plans.

Demo 6 –Safe Harbor for Uniform Points Plans

Each demonstration of the safe harbor for uniform points plans in Regulations section 1.401(a)(4)-2(b)(3) should include the following information:

1) Provide a description of the plan's allocation formula and the location of relevant plan provisions.

2) State the definition of section 414(s) compensation used in determining plan year compensation and give a demonstration showing the definition as nondiscriminatory. If the plan determines plan year compensation using a definition of compensation that satisfies Regulations section 1.414(s)-1(c)(2) or (3), state whether the definition satisfies 1.414(s)-1(c)(2) or (3). See the guidelines in Demo 9 below pertaining to nondiscriminatory compensation for guidance pertaining to this demonstration.

3) Provide the portion of the nondiscrimination test that provides the data for each participant and demonstrates that the plan satisfies 401(a)(4). The data must include the units for each participant being tested and the underlying basis for the units such as age, years of service, or compensation. Show the allocation rate for each eligible participant. Show the average of the allocation rates (determined without imputing permitted disparity) for the highly compensated and for the non-highly compensated employees benefiting under the plan.

Demo 6 –Alternative Safe Harbor for Flat Benefit Plans

Each demonstration of the alternative safe harbor for flat benefit plans in Regulations section 1.401(a)(4)-3(b)(4)(i)(C)(3) must set forth the average of the normal accrual rates for all non-highly compensated non-excludable employees and the average of the normal accrual rates for all highly compensated non-excludable employees. In addition, the demonstration should provide the additional information described under **Demo 6 – General Test** , relating to the determination of normal accrual rates, except for the information described in paragraphs numbered 1, 2, 6, 18, and 19.

DEMO 7 –TEST FOR PRE-PARTICIPATION OR IMPUTED SERVICE

If a determination is being requested, attach a schedule that includes the following:

1) A description of the nature of the grant of past service or pre-participation or imputed service,

2) The location of the various plan provisions that provide for the granting of the service, and

3) In the case of pre-participation or imputed service, state if the service is being taken into account in determining if the plan satisfies Regulations section 1.401(a)(4)-1(b)(2).

DEMO 8 –TEST FOR FLOOR OFFSET ARRANGEMENT

If a determination is being requested, attach a statement giving the name, EIN, and plan type (e.g., defined benefit or profit-sharing) of the other plan that is part of the arrangement. Also indicate if the other plan has received a favorable determination letter or is requesting a determination letter simultaneously with this application.

DEMO 9 –NONDISCRIMINATORY COMPENSATION

If a determination is being requested, a demonstration that a definition of compensation is nondiscriminatory under the test in Regulations section 1.414(s)-1(d) should include the following information:

1. It should state if the demonstration relates to a definition used to determine contributions or benefits, or a definition used in a section 401(k) and/or section 401(m) plan's ADP and/or ACP test.
2. It should state the definition of compensation being tested (and cite the plan provision where applicable), and indicate whether the definition uses rate of compensation or includes prior-employer compensation or imputed compensation.
3. It should identify the period for which compensation data is given.
4. It should state whether the test is based on the compensation of all employees benefiting under the plan or all employees benefiting under all plans of the employer for which the same alternative definition of compensation is used to determine that the plan satisfies section 401(a)(4). It should also state whether all employees with zero total compensation have been excluded from the test. The demonstration should state the numbers of HCEs and NHCEs whose compensation is taken into account in the demonstration.
5. For both the highly compensated and non-highly compensated groups of employees, it should state whether the test uses an aggregate, individual, or other reasonable method to calculate inclusion percentages. If an “other” method is used, this should be described.
6. With regard to the determination of total compensation and compensation included under the definition being tested, the demonstration should:
   - ***a.*** Specify the section 415(c)(3) definition of compensation used in determining total compensation;
   - ***b.*** Indicate if total compensation includes elective contributions and deferred compensation and, if applicable, if and how the adjustment required by Regulations section 1.414(s)-1(d)(3)(ii)(B) has been made; and

c. State if, for purposes of the test, compensation included under the definition being tested is limited to total compensation and if both total compensation and compensation included under the definition being tested are limited to amounts not in excess of the limit in section 401(a)(17).

7. The demonstration should show, for both groups of employees, the respective inclusion percentages, and also describe the manner in which such inclusion percentages are determined.
8. Finally, if the HCEs inclusion percentage is greater than the NHCEs inclusion percentage, the demonstration should set forth any facts relevant to whether the difference is de minimis.

DEMO 10 –EMPLOYER-PROVIDED BENEFIT METHOD

If a determination is being requested attach a demonstration showing that the eligibility requirements of Regulations section 1.401(a)(4)-6(b)(2)(ii) are satisfied. If applicable, also indicate the plan factor.

DEMO 11 –TEST TO SHOW EMPLOYER-PROVIDED BENEFIT IS NONDISCRIMINATORY IN AMOUNT

If a determination is being requested attach a demonstration, if applicable, that the benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided on account of employee contributions at higher levels of compensation, as required by Regulations section 1.401(a)(4)-6(c)(4)(ii)(D).

EXCERPT FROM EMPLOYEE PLAN NEWS, SPECIAL EDITION, FEBRUARY 2002 REGARDING SCHEDULE Q

Frequently Asked Questions Regarding Schedule Q (Form 5300) – Demo 6 .

What information do I need to submit for a ruling under Code section 401(a)(4) using the general test?

What is generally required is a copy of the nondiscrimination test showing that the plan passes the relevant general test and the information listed in the instructions to Schedule Q. The precise amount of data that must be disclosed will vary among plans, but all plan sponsors are required to provide certain information, including, but not limited to: plan year being tested, basis of testing (contributions or benefits), description of the method used to determine allocation or accrual rates, what, if any, special attributes (imputing disparity, grouping of accrual rates, etc.), were used, and, if cross-tested, the interest rate and mortality table used to normalize benefits. (See Schedule Q instructions for complete list).

Can I still provide sample calculations?

Yes, the Service will accept sample calculations, especially for cases with a large number of participants (such as greater than 500). The calculations should show what method was used and how the accrual or allocation rate was calculated for each participant. If the test imputed permitted disparity, we would like the samples to include at least one participant above and one below the covered compensation level (taxable wage base if tested on a contributions basis). The material submitted should also include any additional information described in the instructions to Schedule Q that is applicable to the plan being tested.

.Is there a preferred format for submitting the general test?

No, any format is acceptable as long as the information enables the Service to determine how the test was run and if the allocations or benefits used in the test conform to plan provisions. If this data is present, the Service can follow the methodology used in performing the test and make a final determination as to whether the plan satisfies section 401(a)(4).

For example, The ABC Company could submit the following (in accordance with pages 4 –5 of the instructions for Schedule Q Demo 6 General Test):

1. See attached demo 6
2. Three rate groups – see page 5 of demo 6.
3. Tested on a benefits basis
4. 1999 plan year
5. Method of determining allocation/accrual rates- PV $1 using UP 84 and 8 ½%
6. Not imputing disparity
7. No grouping was done.
8. Demonstration of how benefits are normalized- see attachment.
9. Definition of compensation – W2 compensation with no exclusions and satisfies 1.414(s)-1(c)(2).
10. Period used in determining compensation - plan year 1/1-12/31.

11. Testing age- 65
12. -19. Not applicable (DB only)
20. - 21. Cross testing- see attachment

The above, along with a copy of the general test and any attachments mentioned, would be acceptable.

When can salary deferrals be taken into consideration?

Salary deferral contributions, which are tested separately for nondiscrimination using the actual deferral percentage test of section 401(k), are not included in the determination of allocation or accrual rates used to form rate groups for purposes of a general test for nondiscrimination under section 401(a)(4). However, if the average benefit percentage test is used to demonstrate that rate groups established under a general test satisfy the coverage requirements of section 410(b), the computation of the benefit percentage of each participant must include salary deferral contributions.

Must I use a testing age of 65?

If the plan does not provide for a uniform normal retirement age, the employee's testing age is 65. If the plan defines a uniform normal retirement age, this is the age that should be used. A plan is permitted to use different uniform normal retirement ages for different employees or different groups of employees, and the testing age of an employee who is beyond the plan's testing age is his or her current age. For more information, see Regulations section 1.401(a)(4) –12.

What it is the minimum amount of information needed for a Demo 6?

The items of data that are necessary to perform a general test include plan participants (names need not be disclosed on the actual test), birth date or attained age of each participant (applicable to defined benefit plans or defined contribution plans cross-tested on a benefits basis), allocations or accruals for the plan year being tested, compensation, and relevant plan provisions for allocations or accruals.

DISTINGUISHING BETWEEN THE AVERAGE BENEFITS TEST AND THE MODIFIED AVERAGE BENEFITS TEST FOR NONDISCRIMINATION.

Confusion between Demos 5 and 6-If rate group fails ratio percentage-Introduction

Remember, if the rate group fails ratio percentage, it has to apply the modified average benefits test, which is the following:

Nondiscriminatory classification test: the rate group's ratio percentage has to be at least equal to the plan's ratio percentage or the midpoint between the safe and unsafe harbor and

Average benefits test: which the rate group is deemed to satisfy the average benefits percentage test if the plan satisfies the average benefits test.

If a rate group fails the ratio percentage test, some employers submit Demo 5, the average benefits test demonstration, to show that the rate group satisfies the average benefits test.

If the employer takes this approach, there is a good chance that the employer may be applying the average benefits test for coverage rather than the modified average benefits test as applied to rate groups. An agent can quickly verify this if Form 5300 indicates that the plan has satisfied the ratio percentage test, but Appendix A requests a review of the average benefit test.

Comparison of average benefit test for coverage and modified average benefits test as applied to rate groups for nondiscrimination

	Average benefits test-Coverage	***Modified average benefits for rate groups under section 401(a)(4)***
Nondiscrimination Classification test		
Reasonable classification	Facts and circumstances	Deemed satisfied
Nondiscriminatory classification test	Plan's ratio percentage: ➢ Above safe harbor- **pass** ➢ Between Safe harbor and unsafe harbor-**facts and circumstances** ➢ If below Unsafe harbor-- **fails**	Rate group's ratio percentage **must equal** midpoint of safe and unsafe harbor percentage.
Average benefits percentage test	Average benefits of NHCEs / Average benefits of HCEs	Same as coverage—plan has to satisfy the average benefits percentage test.

	For entire controlled group **has to be ≥ 70%**	

WHAT DEMO 6 SHOULD INCLUDE FOR A RATE GROUP FAILING THE RATIO PERCENTAGE TEST

If a rate group fails the ratio percentage test, the demonstration, element I(a), must show how the rate group satisfies the modified average benefits test.

Information similar to Demo 5 should be provided, such as showing the NHCE concentration percentage, safe and unsafe harbor, and information with respect to how the allocation or normal accrual rates are determined.

Important information from Demo 5 should be included in Demo 6

As stated above with respect to the average benefits percentage test, Demo 5 has a lot of the same information as Demo 6 because the average benefits percentage test and the general test are based on the same rules for determining the allocation or accrual rates. Thus, if the plan is a general test plan, Demo 6 is required. If the rate group fails the ratio percentage test, some of the information from Demo 5 is required. However, most of the information with respect to element 4 of Demo 5 is not be required since this information is submitted with Demo 6.

In addition to the elements of Demo 6, Demo 5 also requires the following additional information to show the modified average benefit test to rate groups:

Element I, special rule for Collectively bargained plans, (if applicable)

Element 2, average benefit percentages for HCEs and NHCEs,

Element 3, Nondiscriminatory classification test

Element 4-showing employee benefit percentages

The employer would not have to describe how the employee benefit percentages were determined since this information is already in element I(d) of Demo 6.

However, the following information would be required:

Testing group, showing all the plans for which the average benefits test was taken into account.

Remember, the testing group includes 401ks and Esops, even though these plans were mandatorily disaggregated.

Average Benefit Percentage-Demo should show how the average benefit percentage of the NHCE and the HCEs

Testing period