

# Chapter 1

## Nondiscrimination-detailed review of demonstrations

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### Introduction

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**Purpose of chapter**                    Although there have been prior CPE chapters explaining the technical requirements of section 401(a)(4), these chapters did not go into any detail with respect to the demonstrations. This chapter provides practical advice on how to review a demonstration either for your own case or when reviewing the demos for another agent.

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## Focus of chapter

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**Focus of this chapter**

IRC 401(a)(4) requires that a plan not discriminate in favor of Highly Compensated Employees, as defined by IRC414(q), in terms of contributions or benefits under the plan.

This chapter focuses on plans that use a Non-Design Based Safe Harbor or General Test allocation formula or accrual formula in their plan. Schedule Q requires certain demonstrations be submitted to demonstrate compliance with IRC401(a)(4) and IRC410(b).

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## Definition of a plan and aggregation, disaggregation

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**Importance of testing group**

The best way to approach the demonstration is to think of each plan as a sum of parts to determine what "plans" and what benefits are involved in the tests.

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**Definition under the regulations**

Before the reviewer can test a demo 5 or 6, he or she must determine what plans are included in the group considered for testing. For the general test, there is no real reference to testing group, but the concept still applies because you have to determine what plans or portions of plans are considered in the test. Treasury Regulations section 1.401(a)(4)-12 definition of "Plan": a Plan means a plan within the meaning of 1.410(b)-7(a) and (b), after application of the mandatory disaggregation rules of 1.410(b)-7(c) and the permissive aggregation rules of 1.410(b)-7(d).

In addition, Treasury Regulation § 1.410(b)-7(e)(1) "Determination of plans in the Testing Group for the Average Benefits Percentage Test" provides that "all plans in the testing group must be taken into account for the Average Benefit Percentage Test of Treasury Regulation §1.410(b)-5.

The plans in the testing group are the plan being tested and all other plans of the employer that could be permissively aggregated under Treas. Reg. §1.410(b)-7(d).

Section 1.410(b)-7(d)(2) states an employer may not aggregate any portion of a plan that is required to be disaggregated under the rules of 1.410(b)-7(c).

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## Definition of a plan and aggregation, disaggregation, Continued

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**Identifying the separate plans-separate plans for defined contribution**

The following are considered separate plans under Income Tax Regulations the 1.410(b)-7(c) disaggregation rules. The separate plans are the portion of the employer's defined contribution plan that provides:

- employer nonelective contributions.
  - elective contributions under 401(k)
  - matching contributions under 401(m).
  - employee after tax contributions under 401(m).
  - ESOP contributions.
- 

**Disaggregation for DB plans**

A DB plan must be disaggregated with respect to the defined contribution portion of a plan described in section 414(k). In addition, a DB plan must also be disaggregated with employee voluntary contributions under 401(m).

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**Other plans that are disaggregated**

- Plans benefiting Collectively bargained and non-collectively bargained plans
- Plans benefiting employees of one or more than Qualified Separate Lines of Business
- Plans maintained by more than one employer
- Restructured component plans
- If an employer applies section 410(b) separate to the portion o a plan that benefit employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a), Plans that benefit otherwise excludable employees is to be disaggregated from the part of the plan that benefits non-excludable employees.



## **Demonstration 1-qualified separate lines of business**

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### **Introduction— overview of Separate line of business**

In the processing of determination letter applications, an employer can submit a Demonstration 1 in order to receive a ruling on a Qualified Separate Line of Business.

IRC414(r) and the Income Tax Regulations under 1.414(r) define qualified Separate Lines of Business. A Separate Line of Business requires a:

- separate workforce,
- separate management,
- separate accounting, and a
- separate organizational unit.

A Separate Line of Business includes operating units in separate geographic areas, or separate operations for a bona fide business purpose.

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### **Qualified separate lines of business**

IRC414(r) requires that a separate line of business, in order to be a Qualified Separate Line of Business, also:

- employ 50 employees;
  - give Notice to the Secretary, by the filing of Form 5310-A (prior to the beginning of the QSLOB's first plan year), and
  - satisfy Administrative Scrutiny as defined by IRC414(r) and Income Tax Regulations 1.414(r).
- 

### **Administrative scrutiny under section 414(r)**

Under IRC414(r), Administrative Scrutiny is satisfied by the separate line of business having:

- at least 10% of the HCEs of the employer performing services only for the separate line of business, either in the current or prior year; or
  - the percentage of HCEs only performing services for the QSLOB be between 50% and 200% of the percentage of all HCEs employed by the employer as a percentage of the employer's workforce, either in the current or prior plan year.
- 

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**Definition of a plan and aggregation, disaggregation, Continued****Administrative scrutiny under the regulations**

Under the Income Tax Regulations section 1.414(r), administrative scrutiny can be satisfied by the following:

- “Safe-Harbor” for separate lines of business in different industries, (as long as the line of business is in a different industry from any other separate line of business of the employer);
- certain acquisitions through mergers and acquisitions;
- Separate Lines of Business that are reported as industry segments by the Securities and Exchange Commission;
- a Separate Line of Business that provides the same average benefits as other Separate Lines of Business; or
- Separate Lines of Business that provide certain designated minimum or maximum benefits.

**Qualified SLOBs must satisfy two coverage tests—first test is employer wide**

Qualified Separate Lines of Business must satisfy two IRC410(b) tests.

The “employer wide” test under Income Tax Regulations 1.414(r)-8(b)(2) requires that the QSLOB satisfy IRC410(b) on an employer wide basis.

If the ratio percentage test is not satisfied, the employer can use the average benefits test (without regard to the average benefits percentage test of I.T. Reg. 1.410(b)-5).

Therefore, employer-wide, the QSLOB must have a ratio percentage at or above the Non-Safe Harbor found in 1.410(b)-4, based upon the Non-Highly Compensated Employee Concentration Ratio. This would satisfy the IRC410(b) Nondiscriminatory Classification test.

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**Definition of a plan and aggregation, disaggregation, Continued**

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**Second coverage test- each SLOB must satisfy 410(b)**

The second IRC410(b) test requires that IRC410(b) must be passed on a Qualified Separate Line of Business basis. This test can be passed using the ratio percentage test or the average benefits test.

If the average benefits test is used, both 1.410(b)-4 and 1.410(b)-5, using both the Nondiscriminatory Classification Test and the Average Benefits Test, must be satisfied under Treas. Reg. Section 1.414(r)-8(b)(3).

It is also possible to test IRC410(b) and IRC401(a)(4) on an employer wide basis aggregating all Qualified Separate Lines of Businesses of the employer without regard to the disaggregation rules of 1.410(b)-7(c)(4), see 1.414(r)-1(c)(2)(ii).

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**Explanation of chart**

This chart applies to QSLOBs, and identifies which employees must be covered under the plans allocation or accrual formula. If the formula is a general test formula, the employees who work for the Qualified Separate Line of Business would constitute the group considered for section 401(a)(4).

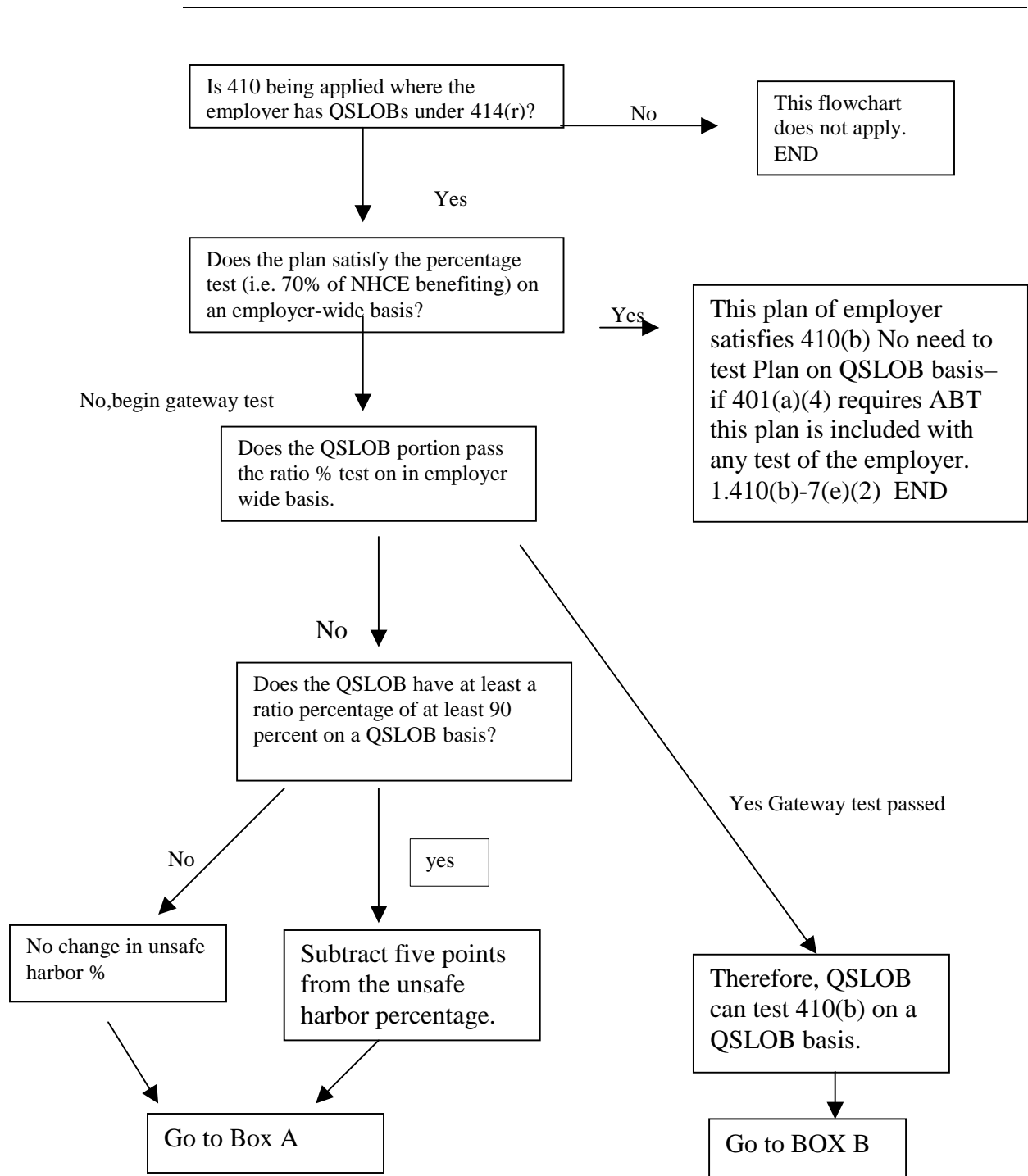
Generally, members of a QSLOB are excluded from the other QSLOBs.

However, under certain circumstances other QSLOBs may be aggregated with the testing group for purposes of satisfying both IRC410(b) and IRC401(a)(4).

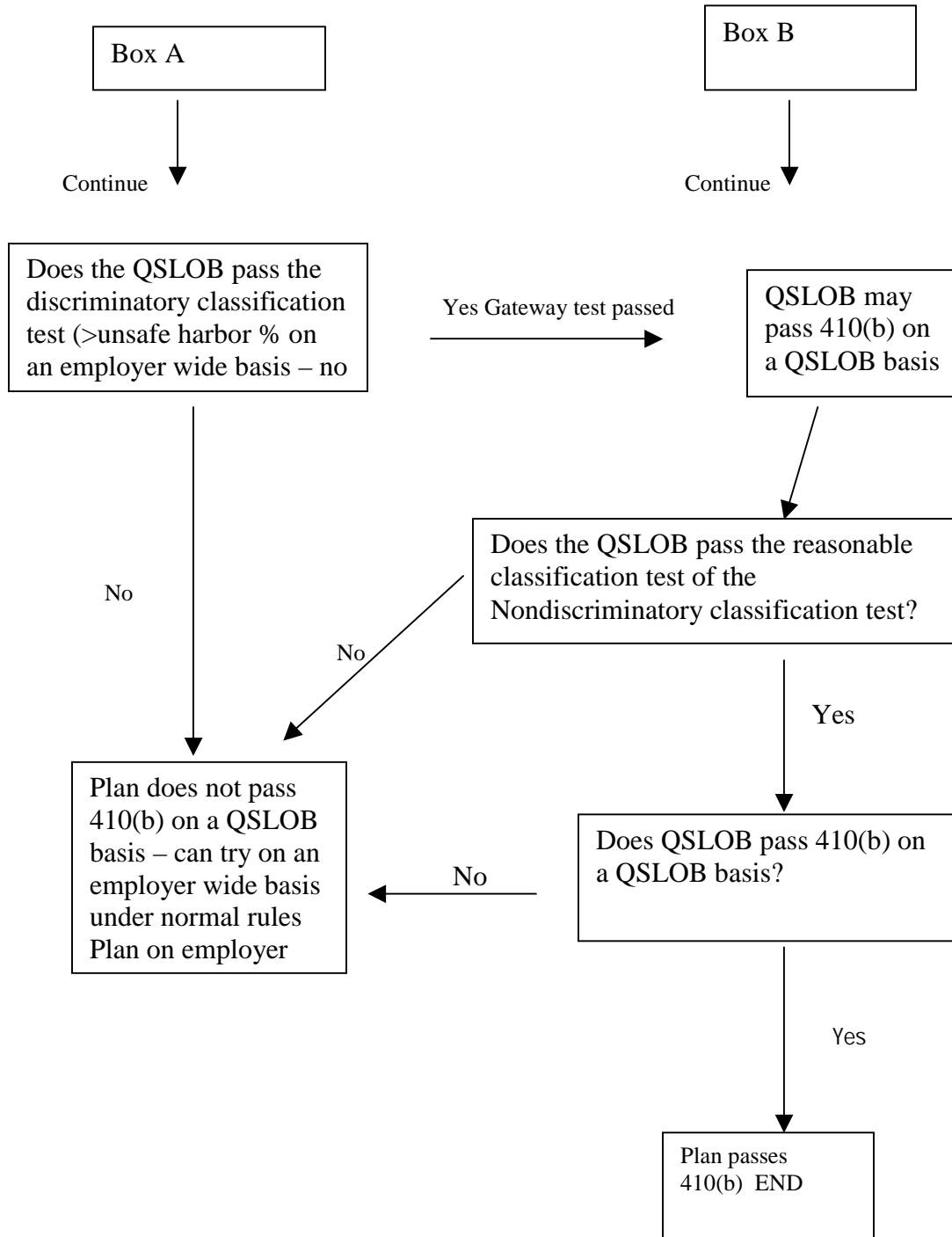
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**Definition of a plan and aggregation, disaggregation, Continued**



**CHAPTER 1 NONDISCRIMINATION-DETAILED REVIEW OF DEMONSTRATIONS**



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**Definition of a plan and aggregation, disaggregation, Continued**

**QSLOB Table**

**Introduction** This table provides the same essential information as the information above, but in table format.

Question	Details	Outcome	Next Action or conclusion
1. Does this employer have QSLOBs?		Yes	If yes, this chart applies.
		No	If No, this chart does not apply.
2. Is this a plan that has QSLOBs but wants to test a plan on an employer-wide basis?	All QSLOBs of the employer are aggregated for purposes of 401(a)(4) and 401(b) such as the rate groups. See 1.414(r)-1(c)(2)(ii) - "Special rule for employer-wide plans"	Yes	The plan must pass a test. See #3 of this chart.
		No	Go to #4 of this chart
3. Does the plan satisfy 410(b)(1)(A) on an employer wide basis?	Ratio of number of NHCEs benefiting under the QSLOB to the number of NHCEs of the employer as a whole	No	The plan is not satisfying 410(b) and IRC401(a)(4) on an employer-wide basis. Go to #4 of the chart
		Yes	For this plan, the tests of both 410(b) and 401(a)(4) can be tested on an employer-wide basis, but remember if you have rates groups under 401(a)(4), each rate group must satisfy the 70% test i.e. no ABT.
4. When running the IRC410(b) test employer wide, is the ratio percentage of the QSLOB equal to or greater than 90%?	The nonhighly compensated employee concentration ratio under I.T. Regs. 1.410(b)-4, is the number of NHCEs divided by all employees of the employer to determine the safe and unsafe harbor under 1.410(b)-4.	Yes	The unsafe harbor can be reduced by 5 percentage points which can help the QSLOB to satisfy the nondiscriminatory classification test, using the ratio percentage that was calculated on an employer wide basis. See 1.414(r)-8(b)(2)(iii)
		No	The unsafe harbor is not adjusted under 1.414(r)-8(b)(2)(iii)
5. Does the QSLOB pass the nondiscriminatory classification test on an employer-wide basis?	That is, does the ratio percentage on a employer wide basis exceed the unsafe harbor percentage?	Yes	Now, IRC410(b) can test the QSLOB on a separate line of business basis. Go to #6.
6. Does the QSLOB pass 410(b) on a separate line of business basis?		Yes	Plan passes 410(b)
		No	Plan fails to satisfy 410(b) for that year.

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**Definition of a plan and aggregation, disaggregation, Continued**

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**Brief  
description of  
determination  
letter process**

In the determination letter process, a ruling can be made on a Qualified Separate Line of Business if a Demonstration One is provided pursuant to Schedule Q.

The Demonstration 1 must demonstrate that :

- the Qualified Separate Line of Business has 50 employees,
- satisfies IRC410(b) both on an employer wide basis,

However, this information is not required if all QSOLBs of the employer are aggregated and tested on an employer wide basis.

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## Demonstration 4

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### Overview of requirements

Under the old Schedule Q instructions, (last revised July 1998) if there is mandatory or permissive aggregation, a demonstration 4 must be provided.

Mandatory disaggregation and permissive aggregation defines the population of employees who are tested for nondiscrimination. A plan using a General Test Formula may aggregate several plans by use of Permissive Aggregation, permitted by I.T. Regs. 1.410(b)-7, to satisfy the general test. Thus, for a determination letter application, the employer can provide both a Demonstration 4, for purposes of a ruling on the permissively aggregated plans under I.T. Regs. 1.410(b)-7, and a Demonstration 6 to show that the aggregated plans satisfy the General Test under I.T. Regs. 1.401(a)(4)-2(c) or 3(c).

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### Requirements for Demo 4

A determination letter application, pursuant to Schedule Q, may request a ruling on either aggregation or disaggregation of plans or benefit structures. This applies where mandatory aggregation is required or permissive aggregation is allowed pursuant to Income Tax Regulations 1.410(b)-7.

Under the new Schedule Q, a demonstration 4 is required if:

- (1) the employer wants reliance on whether the permissive aggregation or mandatory disaggregation is done properly.
- (2) The application is a termination, which requires a demonstration that uses mandatory or permissive aggregation.

Thus a voluntarily provided demonstration 6, for example, does not need to provide a demonstration 4 even if the demonstration 6 indicates that the test is permissively aggregating two plans.

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### Common requests for information from the taxpayer

A demonstration 4 is needed if the taxpayer wants a ruling on permissively aggregated plans. This allows the plans to aggregate for purposes of 410(b) or 401(a)(4) testing.

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## **Demonstration 7**

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**Overview of requirements**

If a plan amendment grants participants pre-participation or imputed service credits pursuant to 1.401(a)(4)-5(a)(3) and 1.401(a)(4)-11(d), for prior periods of service for the employer during which the employee was not a participant, the employer can request a ruling when applying for a determination letter.

Under 1.401(a)(4)-5(a)(3), a “Safe-Harbor” is provided if the grant of prior service credit for past periods does not exceed five years, immediately preceding the year in which the amendment first becomes effective, e.g. for purposes of increasing benefits, etc..

---

**Requirements for demo 7**

Demonstration 7 is submitted for a ruling on whether the pre-participation or imputed service satisfies IRC401(a)(4). However, for purposes of cross-testing a defined contribution plan, only years in which the employee benefited under the plan may be taken into account in determining the equivalent accrual rate.

Demo 7 should include the following information:

- A description of the nature of the grant of past service or pre-participation or imputed service,
  - The location of the various plan provisions that provide for the granting of past service, and
  - In the case of pre-participation or imputed service, state if the service is being taken into account in determining if the plan satisfies the Regulations section 1.401(a)(4)-1(b)(2).
- 

**Common request for information from taxpayer**

The demonstration 7 must be detailed enough to determine whether the pre-participation service granted does not favor the highly compensated employees. What employees received what service and who were they?

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## Demonstration 9

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**safe harbor  
definition of  
compensation**

If the plan uses a “safe harbor” definition of compensation that satisfies I.T.Reg. section 1.414(s)-1(c), Demonstration 9 is not needed.

These “Safe-Harbor” definitions are based on the definition of compensation found in IRC415(c), and I.T.Reg. 1.415-2(d)(1). The definition can elect to include or exclude all of the following items: (Section 1.414(s)-1(c)(4))

- elective employee deferrals under IRC402(e)(3), IRC402(h), IRC403(b),
- IRC 457 contributions,
- IRC125 cafeteria contributions,
- IRC132(f) transportation fringes, and
- contributions made under IRC408(k) and IRC408(p).

In addition, compensation can be reduced by all of the following: (section 1.414(s)-1(c)(3))

- reimbursements or other expense allowances,
  - fringe benefits, (cash and non-cash),
  - moving expenses,
  - deferred compensation, and
  - welfare benefits.
- 

**If compensation  
definition does  
not satisfy the  
safe harbor  
definition and  
demo 9**

The definition of compensation used must be nondiscriminatory, and thus satisfy IRC 414(s).

1.414(s)-1(d)(2) requires that a definition of compensation be reasonable, any compensation outside the normal hours of work such as overtime, premiums for shift differential, call-in premiums, bonuses, etc. may be excluded.

If the definition of compensation does not satisfy 1.414(s)-1(c), then it must be tested under 1.414(s)-1(d)(2) and 1.414(s)-1(d)(3), to ensure that the definition of compensation used is non-discriminatory.

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## **Demonstration 9, Continued**

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**Demo 9  
description**

An employer may submit a demonstration 9, during the determination letter process and request a ruling that the definition of compensation used by the plan is nondiscriminatory.

1.414(s)-1(d)(3) requires that a demonstration 9 compare the plan definition of compensation, as applied to Highly Compensated Employees, to determine percentage of their IRC415(c) compensation. An average inclusion percentage of compensation is determined with respect to the HCEs. The same calculation is performed with respect to non-highly compensated employees.

Demo 9 must show that the average percentage cannot be greater, by more than a de minimis amount, than the average percentage of the Non-Highly Compensated Employees plan compensation.

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## **Average benefits test**

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**When average benefits test is applicable**

If a plan does not satisfy the ratio percentage test, the plan must satisfy the average benefits test. There are two parts to the average benefits test:

- The nondiscriminatory classification test, and
  - The average benefits percentage test.
- 

**Nondiscriminatory classification test**

**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. This involves comparing the plan's ratio percentage to the safe and unsafe harbor percentages. For more details on this topic, please see page chapter 7, page 7-16 of CPE 2002.

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**Average benefits percentage test-overview**

The second part of the average benefits test is the average benefits percentage test. This test requires an average of the "employee benefit percentages" of both the highly compensated employees and the non-highly compensated employees.

The employee benefit percentages are determined by using similar methodology that was used in determining the allocation or accrual rates for the general test. However, there is a major difference in determining the employee benefit percentages, which is the types of plans that are included in calculating the employee benefit percentages.

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**Average benefits test, Continued**

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**Testing group for the average benefits percentage test**

The testing group for purposes of the average benefits percentage test is the group of plans that are included when determining the employee benefit percentages.

Under Treas. Reg. Section 1.410(b)-7(e), the testing group is the plan and all other plans that can be permissively aggregated with that plan. The average benefit test has a very broad definition of which plans are included in the testing group.

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**General rule for permissive aggregation**

Under the general rule for permissive aggregation, the employer may designate two separate plans as a single plan under Treas. Reg. Section 1.410(b)-7(d). However, certain plans cannot be aggregated under section 1.410(b)-7(c). Some of these plans include a 401(k)/(m) plan and an ESOP.

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**Testing group for average benefits percentage test includes plans that are required to be disaggregated**

For purposes of the average benefit percentage test, the testing group includes the plan and all plans that can be permissively aggregated with that plan.

Section 1.410(b)-7(e) also provides that the mandatory disaggregation rules with respect to ESOPs and 401(k)/(m) plans are inapplicable. Thus, allocations under those plans would be included in determining the employee benefit percentages for purposes of the average benefits test.

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**Demos use annual addition when describing the allocations**

Some Demo 5s use the term “annual additions” to describe the allocations included in the rate group test or the average benefits percentage test.

However, this may be an inappropriate designation in some cases.

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## **Overview of general test**

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**Overview-safe harbor vs. general test**

The plan automatically satisfies IRC401(a)(4) if the plan:

- allocates contributions pursuant to a Design Based Safe-Harbor Defined Contribution Plan Formula found in I.T. Regs. 1.401(a)(4)-2(b)(2), or
- accrues benefits pursuant to a Designed Based Safe-Harbor Defined Benefit accrual formula found in I.T. Regs. 1.401(a)(4)-3(b)(2), (3), (4) and (5).

If the plan uses a Non-Design Based Safe-Harbor allocation or accrual formula or as found in I.T. Regs. 1.401(a)(4)-2(b)(3), or 1.401(a)(4)-3(b)(4)(i)(C)(3), or if the plan uses a General Test allocation or accrual formula, as found in I.T.Reg. 1.401(a)(4)-2(c) and 1.401(a)(4)-3(c), then, during an audit, or to receive a ruling with respect to the nondiscrimination requirements, the employer would have to provide a Demonstration 6. Demonstration 6 is used to demonstrate compliance with IRC401(a)(4) for the plan year.

For purposes of a determination letter ruling, for a Non-Design Based Safe-Harbor or a General Test Formula, the employer must submit a Demonstration 6 pursuant to Schedule Q if the employer wants reliance on nondiscrimination.

Thus, Demo 6 is discretionary for ongoing plans but is required for terminating plans that have not received a ruling on a Demonstration 6 in the preceding 3 years.

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*Continued on next page*

**Overview of the general test, Continued**

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**Nondesign based safe harbor**

A non-Design-Based Safe-Harbor utilizes a Demonstration 6 to test the Non-Design Based Safe-Harbor for 401(a)(4). However, a non-design based safe harbor does not utilize Rate Groups.

Instead, for a DC plan, the average of all NHCEs individual allocations, as a percentage of their individual compensation, are compared to the average of all HCEs individual allocations as a percentage of their individual compensation under the plan.

The average allocation percentage of NHCEs cannot be less than the average allocation percentage to the HCEs.

In a DB Non-Design Based Safe-Harbor plan, the average accrual increases for the NHCEs as a percentage of their individual average annual compensation must be at least 70% of the average accrual increases for the HCEs as a percentage of their individual average annual compensation for a plan year.

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## Overview of the general test, Continued

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### Major steps for running general test

There are three steps:

1. The allocation or accrual rates for each participant are determined.
  2. Once the allocation or accrual rates are determined, they are used to form rate groups.
  3. Once the rate groups are determined, each rate group must satisfy the IRC section 410(b) coverage requirements.
- 

### Overview of rate groups

In order to determine whether a plan satisfies the general test, the plan is broken down into rate groups, or “mini plans” in which there is at least 1 HCE and every other participant who have an equal or greater allocation rate or accrual rates. This information is to be provided on a Demonstration 6 for a determination letter application or when the plan is being examined.

In a DC plan, a rate group consists of an HCE and every other participant who has an equal or greater allocation rate.

A DB plan tests both the Normal Accrual Rate and the Most Valuable Accrual Rate, as a percentage of their average annual compensation. In a DB plan the rate group consists of the HCE and every other participant whose Normal Accrual Rate and Most Valuable Accrual Rate are at least as great as the Normal Accrual Rate and Most Valuable Accrual Rate of the HCE forming the rate group.

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### Definitions of Normal and most valuable accrual rate

The Normal Accrual Rate is the participant’s accrual increase for the measurement period based upon the participant’s normal form of benefit, under the plan, as a percentage of average annual compensation.

The Most Valuable Accrual Rate is based upon Optional Forms of Benefit, under the plan that is more valuable than the Normal Form of Benefit. These benefits include subsidized forms of benefits, e.g. certain Early Retirement Benefits that are not reduced or are only partially reduced, a fully subsidized 100% JSA, etc.

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*Continued on next page*



**Overview of general test, Continued**

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**Once the rate groups are determined, each rate group must satisfy coverage**

The rate group is treated as if it were a separate plan that benefits only the employees included in the rate group for the plan year. To satisfy the general test, each rate group must satisfy section 410(b). Whether the rate group satisfies 410(b), take into account all nonexcludable employees regardless of whether they benefit under the plan or the rate group.

Under section 401(a)(4), if the rate group does not satisfy the ratio percentage test of IRC410(b)(1)(B), then the rate group, and the plan, can attempt to satisfy the average benefit test of IRC410(b)(1)(C) under Income Tax Regulations 1.410(b)-4 and 1.410(b)-5. This test is modified under the 401(a)(4) regulations.

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**If the rate group does not satisfy the ratio percentage test**

Under coverage, if the rate group does not satisfy the ratio percentage test, the rate group must satisfy both the nondiscriminatory classification test and the average benefits percentage test.

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**How a rate group satisfies the nondiscriminatory classification test**

Under Section 1.401(a)(4)-2(c)(3)(ii), a rate group satisfies the nondiscriminatory classification test of 1.410(b)-4 (including the reasonable classification requirement of 1.410(b)-4(b)) if and only if the ratio percentage of the rate group is greater than or equal to the lesser of:

- (A) the midpoint between the safe and the unsafe harbor percentages applicable to the plan, and
- (B) The ratio percentage of the plan.

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**How a rate group satisfies the average benefits percentage test**

Remember, a rate group has both HCEs and NHCEs who have an equal or higher allocation/accrual rate of the HCEs. Thus, since the average of all of the allocation or accrual rates of the NHCEs would be equal or higher to the HCEs, a rate group would automatically pass the average benefits percentage test.

Thus, the regulations require that for a rate group to pass the average benefits percentage test, the plan of which it is a part must satisfy the average benefit percentage test of 1.410(b)-5. This is the same test that would be required for coverage if the plan as a whole failed the ratio percentage test.

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*Continued on next page*

## **Overview of general test, Continued**

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**Ensure proper information is submitted for average benefits test**

If the Demo 6 indicates that one rate group fails the ratio percentage test, the determination application must include Demo 5 or sufficient information to show that the plan satisfies the average benefits test.

Although the allocation or normal accrual rates can be used for the employee benefit percentages, the employee benefit percentages must include all allocations or accruals in the testing group.

Thus, as stated above, elective deferrals under 401(k) plans or allocations under ESOPs must be included when applying the average benefits percentage test.

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## **Optional Rules to adjust the accrual rates**

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**Introduction**

There are four optional rules:

- Fresh Start
  - Grouping
  - Imputing permitted disparity
  - Cross testing
-

## **Fresh start**

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**Brief  
explanation**

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.

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 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 additional requirements.

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## **GROUPING**

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### **Introduction**

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. Grouping can be used when the participants have allocation or accrual rates that are fairly close to each other. Grouping enables the employer to “deem” that all allocations/accruals in a narrow range have the same allocation or accrual 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.

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### **Size of the ranges for grouping**

The sizes 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).

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**GROUPING, Continued**

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**Example--  
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**

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**Theory of cross  
testing**

Section 401(a)(4) requires that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q)). This statutory language does not require that a defined contribution plan provide contributions that do not discriminate in favor of highly compensated employees or that a defined benefit plan provides benefits that do not discriminate in favor of highly compensated employees.

Thus, this statutory language permits a defined contribution plan to satisfy section 401(a)(4) on the basis of benefits. Cross testing is the method by which contributions to a defined contribution plan are converted to “equivalent benefits” to determine whether the defined contribution plan satisfies section 401(a)(4).

This optional rule is covered later.

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## Imputing permitted disparity

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### Theory of permitted disparity

Section 401(l) of the Code permits a plan to provide a higher allocation or accrual rate to participants with compensation above a certain level, known as the integration level.

This higher allocation or accrual rate is to take into account the benefit provided under Social Security. Under social security, the benefit provided as a percentage of compensation decreases as compensation increases. Thus, section 401(l) allows employers to take into account this disparity in the rates, by providing a higher percentage of compensation to those participants with higher compensation.

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### Theory of imputing permitted disparity

A plan is allowed to provide for permitted disparity under section 401(l) and still satisfy the safe harbor requirements under section 1.401(a)(4). A plan that does not satisfy the safe harbor requirements is still permitted provide for permitted disparity under Treas. Reg. section 1.401(a)(4)-7.

In determining whether a plan satisfies the general test, the difference in the accrual or allocation rates attributed to section 401(l) must be taken out before the plan is tested under the general test.

For example, imputing permitted disparity for a DB plan is accomplished by adjusting all employees' accrual rate as if they were receiving an accrual rate equal to the excess benefit percentage.

For DB plans, imputing permitted disparity adjusts both the normal and the most valuable accrual rate.

The affect of imputing permitted disparity is that resulting differences (after imputation) in those rates do not reflect permitted disparity. Thus, any **differences** in the accrual or allocation rates will not be due to permitted disparity, even if the plan does not provide for disparity.

Remember, 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.

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## Formulas for imputing permitted disparity

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### DC plans -- Introduction

There are specific formulas for both DC and DB plans. The rules for adjusting the allocation rates for DC plans are in Treas. Reg. Section 1.401(a)(4)-7(b). The rates are adjusted under a hypothetical formula that would yield the allocation actually received by the employee if the plan took into account the full disparity permitted under section 401(l)(2) and used the taxable wage base as the integration level.

The adjusted allocation rate is used to determine whether the amount of contributions under the plan satisfies the general test under section 1.401(a)(4)-2(c) and to apply the average benefit test under section 1.410(b)-5(d).

For DC plans, the formulas are based on whether the employee's plan year compensation exceeds the taxable wage base. The formulas assume that the plan took into account full disparity and used the taxable wage base as the integration level. (Remember, under permitted disparity, the plan would provide for allocation rates above and below an integration level). Thus, there are two separate sets of formulas:

- One set for employees whose plan year compensation does not exceed the taxable wage base,
- The second set for employees whose plan year compensation exceeds the taxable wage base.

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### DC Formulas not exceeding taxable wage base

For employees whose plan year compensation does not exceed the taxable wage base, the employee's adjusted allocation rate is the **lesser of the A and the B rate** determined under the following formulas:

- **A Rate**- 2 x unadjusted allocation rate
- **B Rate** is unadjusted allocation rate plus permitted disparity factor.

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**Formulas for imputing permitted disparity, Continued**

**DC formulas exceeding the taxable wage base**

The employee's adjusted allocation rate is the lesser of the following rates:

**C rate**

$$\frac{\text{Allocation}}{\text{Plan year compensation minus } \frac{1}{2} \text{ taxable wage base}}$$

**D rate**

$$\frac{\text{Allocations plus (permitted disparity x taxable wage base)}}{\text{Plan year compensation}}$$

**Definitions**

**Plan year compensation** means 414(s) compensation for the plan year determined by measuring 414(s) compensation during:

- The plan year,
- 12 month period ending in the plan year
- period of plan participation during the plan year.

**Permitted disparity rate** means the rate in effect as of the beginning of the plan year under section 401(l)(2)(A)(ii), i.e. 5.7%

**Taxable wage base** means the taxable wage base, as defined in section 1.401(l)-(c)(32), in effect as of the beginning of the plan year. Taxable wage base is the contribution and benefit base under section 230 of the Social Security Act (42 U.S.C. Section 430).

**Unadjusted allocation rate** means the employee's allocation rate determined under Treas. Reg. Section 1.401(a)(4)-2(c)(2)(i) for the plan year, expressed as a percentage of plan year compensation, without imputing permitted disparity.

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## **Formulas for imputing permitted disparity, Continued**

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**Example (taken from the regulations)**

Employee M and N participate in a defined contribution plan maintained by Employer X. Employee M has plan year compensation of \$30,000 in 1990 plan year and has a unadjusted allocation rate of 5%.

Employee N has plan year compensation of \$100,000 in the 1990 plan year and has an unadjusted allocation rate of 8%. The taxable wage base in 1990 is \$51,300.

Employee M's plan year compensation does not exceed the taxable wage base. Thus, Employee M's adjusted allocation rate is the lesser of

Twice the allocation rate ( $2 \times 5\%$ ) or 10% or

5% plus 5.7 or 10.7%.

Thus, the adjusted allocation rate is 10%.

Employee N's allocation is \$8,000 or  $8\% \times 100,000$ . N's plan year compensation exceeds the taxable wage base. Employee N's C rate is 10.76%, which is  $8,000 / (100,000 - (1/2 \times \$51,300))$ . N's D rate is 10.92% or  $\$8,000 + (5.7\% \times \$51,300) / 100,000$ . Thus, N's C rate of 10.76 is used.

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**Formula for DB plans**

Similarly, for DB plans, there is one set of formulas for employees whose average annual compensation does not exceed covered compensation and another set of formulas for employees whose average annual compensation exceeds covered compensation.

Covered compensation is the integration level. 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.

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## Formulas for imputing permitted disparity, Continued

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**Definition of covered compensation**

Treas. Reg. section 1.401(l)-1(c)(7) defines covered compensation 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).

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**Example of covered compensation**

Actual calculation of covered compensation in 1997 for a 65 year old individual is completed as follows:

The sum of the taxable wage bases for the years 1963 through 1997 is 1,025,900.  $1,025,900 / (35 \times 12) = 2442.62$

The result of this operation is truncated at the lowest whole dollar amount-

2442.62 is truncated to 2442

$2442 \times 12 = 29,304$

\$29,304 is the covered compensation in 1997 for an individual that is 65 years old.

---

**Formulas if employee's average annual compensation 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:

- **A Rate**-- $2 \times$  accrual rate or
- **B Rate**--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.

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*Continued on next page*

**Formulas for imputing permitted disparity, Continued**

**Formula if employee's average annual compensation exceeds 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:

**C Rate**

$$\frac{\text{Employer provided accrual}}{\text{AAC}-1/2 \text{ covered compensation}}$$

Or **D Rate**

Employer provided accrual +

$$\frac{(\text{permitted disparity factor} \times \text{covered compensation})}{\text{AAC}}$$

**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 .65%, .70% or .75%, depending on the social security retirement age. There is an optional rule for using .65% for all participants. 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).

*Continued on next page*

**Formulas for imputing permitted disparity, Continued**

**Example illustrating DB 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 ( $.0148 \times \$21,000 = \$310.80$ ). 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 nor 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% ( $2 \times 1.48$ ), or **A Rate**
  - 2.23% ( $1.48\% + .75\%$ ). **B rate**
- 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% ( $\$1,802 / \$106,000 - (.5 \times \$25,000)$ ) or **C rate**
  - 1.88% ( $(\$1,802 + .75\% \times \$25,000) / \$106,000$ ) **D rate**
- 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%.

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## **Formulas for imputing permitted disparity, Continued**

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**Points about example**

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 the normal and most valuable 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. This happens because social security retirement benefits decrease as a percentage of income as income rises.

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## Issues with respect to imputing permitted disparity

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### **Introduction**

The following paragraphs contain language that has been sent to taxpayers. These paragraphs highlight issues that have been found in prior determination letter application. Each paragraph requests information from the taxpayer.

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### **Which plans can impute permitted disparity**

Permitted disparity may be reflected in the determination of the rates for the average benefit test only to the extent that the plans for which the rates are being determined are plans for which the permitted disparity of section 401(l) is available.

Section 401(k) plans cannot provide for permitted disparity. Thus, for example, if a section 401(k) plan is included in the testing group and permitted disparity is imputed under 1.401(a)(4)-2(c)(iv), then employee benefit percentages are determined by:

- calculating an adjusted allocation rate (within the meaning of 1.401(a)(4)-7(b)(1)) without regard to the amount of allocations under the section 401(k), and
- adding the adjusted rates to the allocation rate for the section 401(k) plan.

This applies to all plans in the testing group for which permitted disparity is not available.

Please revise your test accordingly. See Treasury Regulation § 1.410(b)-5(d)(6)(ii).

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*Continued on next page*

**Issues with respect to imputing permitted disparity, Continued**

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**Inconsistency in narrative or testing**

- The narrative accompanying the demonstration 6, item 5 indicates that imputed disparity shall be used, yet item 5 indicates that permitted disparity shall not used. Get an explanation and correction.
- Item I(e) indicates that the general test is imputing permitting disparity; however, the test does not use permitted disparity. We need a revised narrative.
- Item 6 of the general test narrative indicates that the "test" is not imputing permitted disparity, however, the test does impute permitted disparity. We need a revised narrative, accordingly.

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**Super integrated plans may impute permitted disparity**

The narrative indicates that "Permitted disparity is NOT allowed in this plan". However, this is not the issue. The issue is whether permitted disparity is used in the demonstration. Please revise the narrative.

Note that a super-integrated plan may use permitted disparity to satisfy the general test, assuming all other restrictions are not applicable.

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**If employer has another plan that provides for permitted disparity**

If an employer maintains another integrated plan which covers any of the same employees, a cross tested plan may not impute permitted disparity, 1.401(a)(4)-7(b)(4)(ii)(B) and 1.401(a)(4)-7(d)(3).

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*Continued on next page*

Issues with respect to imputing permitted disparity, Continued

Miscalculating imputed disparity

- The plan is miscalculating the imputed disparity by using a formula inconsistent with 1.401(a)(4)-7. We need an explanation with several examples of how the Imputed Permitted Disparity was calculated.

If based on your information, a correction is needed, please re-run the test.

- The demonstration 6 improperly uses the **permitted disparity formulas** for adjusting allocation rates in a defined contribution plan in Treasury regulation §1.401(a)(4)-7(b).

This plan is cross-tested in accordance with 1.401(a)(4)-8. Therefore, you must use the permitted disparity formula found in 1.401(a)(4)-7(c) in accordance with §1.401(a)(4)-8(b)(2)(iii). Note the taxable wage base is not used in adjusting accrual rates.

- **Imputed Permitted Disparity:** The plan is miscalculating the imputed disparity by using an **incorrect disparity factor**. We need an explanation with several examples for how the disparity factor was determined. If based on your information, a correction is needed, re-run the test.
- The formula for determining the imputed disparity would not work if the **unadjusted rate were less than .65%**. Therefore, you must use the permitted disparity formula found in 1.401(a)(4)-7(c) in accordance with §1.401(a)(4)-8(b)(2)(iii). Thus, if the unadjusted was .5%, the maximum disparity would be  $.5\% \times 2$ , since you are adding .5% and not .65%.

Using fractional permitted disparity

The samples provided are using fractional Maximum permitted disparity. Get an explanation and authority for using fractional or interpolated.



## Issues with respect to covered compensation

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### Introduction and definition of covered compensation

*Covered compensation* means covered compensation as defined in § 1.401(l)-1(c)(7) which is the average of the taxable wage bases in effect at the beginning of each calendar year during the 35 year period which ends at the time of the employee's attaining social security retirement age.

Covered compensation must be adjusted or re-determined each year for the purpose of imputing permitted disparity. The actual calculation of covered compensation tables includes a truncation function so that covered compensation is a whole dollar amount. However, the test may use a 35-year average if one of the tables is not used.

The following paragraphs highlight issues that have been found in prior determination letter application. Each paragraph requests information from the taxpayer.

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### Incorrect application of covered compensation

The test is apparently using an **incorrect covered compensation table**. We need an explanation for how the covered compensation was determined. Specifically, what table was used? If it is based on an average, provide the formula used including the years that were included in the calculation.

If based on your information, a correction is needed, please re-run the test. For the definition of compensation for the test purposes, see Treasury regulation §§1.401(a)(4)-7(c)(4)(i), 1.401(l)-1(c)(7)(iii), and 1.401(l)-3(d)(2).

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### Covered compensation cannot be based on past year

Covered compensation for imputed disparity cannot be based on a **past year**. You cannot use the 5-year look-back option for imputing disparity. See 1.401(a)(4)-7(b)(4)(i).

For the definition of compensation for the test purposes see Treasury regulation §§1.401(a)(4)-7(c)(4)(i) and 1.401(l)-1(c)(7)(iii).

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*Continued on next page*

**Issues with respect to covered compensation, Continued**

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**Covered compensation incorrect**

The test reports a **covered compensation that is incorrect**. It is not certain whether the reported covered Compensation is used in the actual calculation but the test should show the correct covered compensation.

We need an explanation for how the covered compensation was determined. Specifically what table. If it is based on an average, provide the formula used including the years that were included in the calculation. Also provide the code or regulation section for which you think the formula is authorized. This may be corrected by changing the reported covered compensation without changing the results. It depends on what was used in the test. For the definition of compensation for the test purposes see Treasury regulation §§1.401(a)(4)-7(c)(4)(i) and 1.401(l)-1(c)(7)(iii).

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**Other points**

Section 1.401(l)-1(c)(7)(ii) provides that, for purposes of determining the amount of an employee's covered compensation under §1.401(l)-1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years (dates) of birth.

1. The regulations do not authorize other rounded tables.
2. The demonstration should identify what covered compensation table is used.
3. The demonstration should use the covered compensation table i.e. it must be based on the table in effect at the beginning of the plan year.

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**Finding the proper covered compensation tables**

The following published guidance provide the covered compensation for each year.

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*Continued on next page*

**Issues with respect to covered compensation, Continued**

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**Covered Compensation Table**

<b>Year</b>	<b>Pronouncement</b>	<b>Date Published</b>
2003	Revenue Ruling 2002-63	10/18/02
2002	Revenue Ruling 2001-55	11/20/01
2001	Revenue Ruling 2000-53	11/29/00
2000	Revenue Ruling 1999-47	11/16/99
1999	Revenue Ruling 1998-53	11/29/98
1998	Revenue Ruling 1997-45	
1997	Revenue Ruling 1996-53	
1996	Revenue Ruling 1995-75	
1994 and 1995	Revenue Ruling 1995-30	
1990, 1991, 1992 and 1993	Revenue Ruling 1993-20	
1989	Revenue Ruling 1989-70	6/19/89
Re-affirm 71-446	Revenue Ruling 81-202	
1988 and before	Revenue Ruling 71-446	

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*Continued on next page*

## Issues with respect to covered compensation, Continued

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**Example  
illustrating  
covered  
compensation  
calculation**

Actual calculation of covered compensation in 1997 for a 65 year old individual is completed as follows:

If the individual is 65 in 1997 he was born in 1932.  
The SSRA for an individual born in 1932, is 65.  
The sum of the taxable wage bases for the years 1963 through 1997 is 1,025,900.

$$1,025,900 / (35 \times 12) = 2442.62$$

The result of this operation is truncated at the lowest whole dollar amount- 2442.62 is truncated to 2442.

$$2442 \times 12 = 29,304$$

\$29,304 is the covered compensation in 1997 (Table II) for an individual that is 65 years old.

A straight 35 year average is  $1,025,900 / 35 = \$29,311$

For Table I rounded to the nearest 3000 is 30,000 ( i.e. \$29,304 is closer to \$30,000 than to \$27,000)

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*Continued on next page*

**Issues with respect to covered compensation, Continued**

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**Example illustrating covered compensation calculation**

Suppose that a person is 47 in 1997.

Therefore, the individual was born in 1950 (i.e. 1997-47). Thus, the SSRA for this individual is 66. The year in which the individual turns 66 is 2016.

Therefore the 35 year average includes the 2016 ( end of 35 year period) and adds all the years from 1982 (2016-34) through 2016.

The determination year is 1997 and the regulations say that we assume no increase in the TWB after the determination year. Therefore, from the years 1997 through 2016 the TWB is the TWB for 1997.

The sum of the taxable wage bases for the years 1982 through 2016 is 2,034,600

$$2,034,600 / (35 \times 12) = 4,844.29$$

The result of this operation is truncated at the lowest whole dollar amount-

4,844.29 is truncated to 4,844

$4,844 \times 12 = 58,128$  (the dividing the average by 12, truncating and multiplying effective rounds down to the \$12.)

\$58,128 is the covered compensation in 1997 (Table II) for an individual that is 47 years old in 1997.

A straight 35 year average is  $\$2,034,600 / 35 = \$58,131$

For Table I rounded to the nearest 3000 is 57,000 ( i.e. \$58,128 is closer to \$57,000 than to \$60,000

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**Covered compensation tables can be used**

Section 1.401(l)-1(c)(7)(ii) provides that, for purposes of determining the amount of an employee's covered compensation under §1.401(l)-1(c)(7)(i), a plan may use tables provided by the Commissioner. These tables are developed by rounding the actual amounts of covered compensation for different years of birth.

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## **Safety Valve—DB plans**

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### **Overview**

A plan is deemed to satisfy the general test if the plan would satisfy the test by excluding (treat as not benefiting), no more than five percent of the HCEs in the plan. To use this exception the Commissioner must determine that, on the basis of all the relevant facts and circumstances, the plan does not discriminate with respect to the amount of employer provided benefits. The Commissioner may consider in making the determination,

- (i) the extent to which the plan has failed general test;
- (ii) The extent to which the failure is for reasons other than the design of the plan;
- (iii) Whether the HCEs causing the failure are five percent owners or are among the highest paid nonexcludable employees;
- (iv) Whether the failure is attributable to an event that is not expected to recur (plant closing), and
- (v) The extent to which the failure is attributable to benefits accrued under a prior benefit structure or to benefits accrued when a participant was not an HCE.

## **Allocations included in the general test**

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**What allocations are included in the general test**

The following chart describes the allocations that are used to calculate the allocation rate, as a percentage of compensation, for purposes of forming rate groups.

Note that if one of the rate groups fail the ratio percentage test, then the rate group must satisfy nondiscriminatory classification test and the plan must satisfy the average benefits test.

Demo 6 may state that annual additions are included in determining the allocation or accrual rates. However, this term is inconclusive as to whether the proper allocations/accrual rates are being included for purposes of determining the allocation/accrual rates.

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*Continued on next page*

**Allocations included in the general test, Continued**

<b>Type of allocation included for purposes of the general test</b>	
<b>Counted</b>	<b>Not Counted</b>
<p>"The amounts taken into account in determining allocation rates for a plan year include all employer contributions ... that are allocated or treated as allocated to the account of an employee under the plan for the plan year, other than amounts described in 1.401(a)(4)-2(c)(2)(iii).</p> <p>"Employer contributions include annual additions described in 1.415-6(b)(1) and 1.415-6(b)(2)(i) (regarding amounts arising from certain transactions between the plan and the employer)." See §1.401(a)(4)-2(c)(2)(ii). Section 1.415-6(b)(2)(i)</p>	<p>Excludes the Portion of the plan that is an ESOP or is not included in the general test because of Mandatory Disaggregation, See Treasury Regulation 1.401(a)(4)-1(c)(4)(i) and 1.410(b)-7(c).</p>
<p>Includes QNECs as described in Treasury Regulation §1.401(k)-1(b)(5). See Treasury Regulation §1.401(a)(4)-1(b)(2)(ii)(B).</p>	<p>Excludes allocations of income gains and expenses. §1.401(a)(4)-2(c)(2)(iii).</p>
<p>Includes QMACS as described in Treasury Regulation §1.401(m)-1(b)(5). See Treasury Regulation §1.401(a)(4)-1(b)(2)(ii)(B).</p>	<p>Excludes Employee contributions §1.401(a)(4)-1(c)(7).</p>
<p>Includes Employer nonelective contributions See Treasury Regulation §1.401(a)(4)-1(b)(1)(ii)(A) and §1.401(a)(4)-2(c)(2)(ii).</p>	<p>Excludes contribution to a qualified CODA, See Treasury Regulation §§1.401(a)(4)-1(b)(2)(ii)(B), 1.401(a)(4)-1(c)(4)(i) and 1.410(b)-7(c) (Mandatory Disaggregation).</p>
<p>Includes Forfeitures allocated see Treasury Regulation §1.401(a)(4)-1(b)(1)(ii)(A) and §1.401(a)(4)-2(c)(2)(ii) For the rate group test, "The amounts taken into account in determining allocation rates for a plan year include forfeitures that are allocated or treated as allocated to the account of an employee under the plan for the plan year, other than amounts described in 1.401(a)(4)-2(c)(2)(iii)." See §1.401(a)(4)-2(c)(2)(ii). Section 1.415-6(b)(2)(i) includes Forfeitures allocated see Treasury Regulation §1.401(a)(4)-1(b)(1)(ii)(A) and §1.401(a)(4)-2(c)(2)(ii).</p>	<p>Excludes allocations of matching contributions. See Treasury Regulation §§1.401(a)(4)-1(b)(2)(ii)(B). , 1.401(a)(4)-1(c)(4)(i) and 1.410(b)-7(c) (Mandatory Disaggregation)</p>
<p>Includes contributions to a nonqualified CODA, See Treasury Regulation §§1.401(a)(4)-1(b)(2)(ii)(B).</p>	
<p>Includes allocations of Elective contributions described in Treasury Regulation §1.401(k)-1(b)(4)(iv) that <u>fail</u> to satisfy the allocation and compensation requirements of §1.401(k)-1(b)(4)(i). See §§1.401(a)(4)-1(b)(2)(ii)(B).</p>	
<p>Includes allocations of matching contributions that <u>fail</u> to satisfy Treasury Regulation §1.401(m)-1(b)(4)(ii)(A). See Treasury Regulation §§1.401(a)(4)-1(b)(2)(ii)(B).</p>	



## **Issues with respect to allocations/accruals**

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**Sample requests for information-introduction**

The following paragraphs have been used in requesting information from the taxpayer. These paragraphs raise issues or deficiencies that have been found on previous Demo 5 and 6s.

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**Provide a summary of plan allocation formula**

The narrative for the demonstration 6 should at least provide a summary of plan allocation formula along with the plan sections applicable.

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**Allocation schedule**

We need an allocation schedule with complete detail to show how the non-elective allocations were made.

---

**Test should indicate which contributions included**

The general test (401(a)(4)) and the average benefits percentage test (410(b)) should indicate what contributions will be included in allocations including what plans they belong to and what type of contribution it is.

For example " the rate group test includes the profit sharing allocation from this plan, the QNECS provided in this plan and forfeitures this plans, and normalized benefits from the permissibly aggregated defined benefit plan". The average benefits percentage test includes those amounts included in the rate group test plus deferrals under the 401(k) portion of the plan, the matching under §401(m) and after tax employee contributions under 401(m).

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*Continued on next page*

**Issues with respect to allocations/accruals, Continued**

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**Provide a detailed allocation schedule**

Please provide an allocation schedule with complete detail to show how the non-elective allocations were made. The general test (401(a)(4)) and the average benefits percentage test (410(b)) should indicate what contributions will be included in allocations including what plans and the type of contribution it is.

For example, the following language would be appropriate:

“ the general test includes the profit sharing allocation of this plan, where applicable QNECs, provided in this plan, and forfeitures from this plans, as well as the normalized benefits from a permissibly aggregated defined benefit plan”.

---

**Schedule of contributions and forfeitures and projected data**

We need an explanation for what the "allocation base", "contributions" and "accrual rates" are in the exhibit called Schedule of Contributions and Forfeitures". Find out, what assumptions are used to generate this schedule.

If this plan is using projected data, the projection data and sample calculations must be provided.

If you are providing theoretical or projected data for a plan that has possible 401(k) deferrals and or matching contributions, the projected should also have these contributions to show how they are handled. It is not reasonable to assume that a 401(k) plan would not have any deferrals.

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## **Cross tested plans**

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**Theory of cross testing**    Section 401(a)(4) requires that the contributions **or** benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q)).

This statutory language do not require that a defined contribution plan provide contributions that do not discriminate in favor of highly compensated employees or that a defined benefit plan provide benefits that does not discriminate in favor of highly compensated employees.

Thus, this statutory language permits a defined contribution plan to satisfy section 401(a)(4) on the basis of benefits.

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**New comparability requirements--background**    For years beginning on or after January 1 2002, cross tested plans must satisfy the requirements in the next section, entitled new comparability.

Certain plans solely rely on the cross-testing method to demonstrate compliance with the nondiscrimination rules. These plan designs were viewed as defeating the purpose of the nondiscrimination regulations because these designs 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.

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).

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**Allocation rate defined**    Contributions tested on a contributions-basis (not cross-tested) are tested based on the current plan year contribution to the participant, as a percentage of their plan year compensation.

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## Cross tested plans, Continued

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### Defining cross testing

Cross testing is the method by which contributions to a defined contribution plan are converted to “equivalent benefits” to determine whether the defined contribution plan satisfies section 401(a)(4). 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.

It is assumed that contributions whenever made will earn interest or other earnings over the years until the amount is distributed to the participant at retirement age. In order to compare amounts at the same time, first determine the date the amounts will be compared. For cross testing, the amounts will be compared the testing age (usually the normal retirement age).

To illustrate this point, a contribution at the age of 21 of \$1000 at 8.5% interest would grow to \$36,216.67 at age 65. By the same token, a \$22,198.83 at age 59 will grow to \$36,216.67 at age 65 (testing age for this plan).

Supposedly, each could purchase the same annuity at age 65 if the contributions were made at the attained age and each participant stayed until NRA. Therefore, a contribution to a person age 21 of \$1,000 is equal to a contribution to a person age 59 of \$22,198.83 both of which contributions were made the same year.

The final step in normalization is to make a theoretical purchase of annuity. This is done by dividing the theoretical lump sum by the annuity purchase rate. The Annuity Purchase Rate is an assumed price of the annuity per dollar. Once the contribution is normalized the amount is divided by the applicable compensation to produce the EBAR (i.e. Equivalent Benefit Accrual Rate).

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### Normalizing or converting the allocations to equivalent benefits

Once the allocations are determined, they must be normalized. This is accomplished in two steps:

1. Calculate the future value or the **amount available to purchase** an annuity
2. Then annuitize this future value or calculate how much an annuity can be purchased with the future value

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*Continued on next page*

**Cross tested plans, Continued**

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**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%.

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**Example**    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  $(\$30,000 \times 1.085^{15})$  or \$101,992.22 when HCE 1 reaches age 65.

---

**Annuitizing the future benefit**    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 benefit accrual rate.

If the HCE's compensation is \$150,000, the equivalent accrual rate is 8.55% ( $\$12,832/\$150,000$ ).

---

**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 rate and straight life annuity table 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 the alert guidelines, and CPE 1993, 4213-013, chapter 6, Cross Testing.

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**Cross tested plans, Continued**

**Example 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.

**Table of Employees**

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%

**If employer tested on an allocation basis**

Note, that if tested on the basis of contributions, the rate group for the HCE has only one employee, the HCE, because the HCE has an allocation rate of 20%.

Thus, the plan cannot pass the ratio test of IRC section 410(b) as its ratio would be zero (which is also below the midpoint of the safe and unsafe harbor percentage for the plan for purposes of passing the nondiscriminatory classification test).

**If employer tested on a benefits basis**

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).

As you can see from the table below, the rate group for the HCE has all 3 EEs in it since both NHCEs are an equal or higher equivalent benefit as the HCE. Since it has 100% of the NHCEs and 100% of the HCEs, it passes the ratio test of IRC section 410(b). Therefore, the plan satisfies 401(a)(4). Of course, there is no need to pass the modified average benefits test.

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**Cross tested plans, Continued**

**Results from Cross Testing**

<b>Employee</b>	<b>Increase-projected to Age 65</b>	<b>Equivalent Annuity Benefit</b>	<b>Equivalent Accrual Rate</b>
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%

**Cross tested plans may not use projected date**

A cross-tested plan may not use projected data i.e. data based on future years but it may use estimated data based on the current year of the test only. In other words, when we see tests for plan year 2003 - this can be estimated. However, they can not base the test on projected average allocations for plan year 2004.

**Tips to review a determination application—review demonstrations**

The following items are suggestions for reviewing determination letter applications:

1. Look at case chronology (use this step only if you are reviewing a demo for another agent)
2. Look at F5621 see if any other issue pending (use this step only if you are reviewing a demo for another agent)
3. Look on the application form for other plans. The F5310 will not indicate if there are other plans.
4. Look at the schedule Q for demonstration review requests.
5. Look at all demonstrations in the case file
6. If there is Demonstration 6, look for spreadsheet calculations of Equivalent Benefit Accrual Rate (“EBARs”), if cross-tested.
7. Read narrative and note:
  - the testing basis,
  - the testing year,
  - permitted disparity,
  - the interest rate used to project the calculations to the plan’s testing age,
  - the APRs used to convert those amounts into EBARs , and
  - the compensation definition to ensure they do not need demo 9

*Continued on next page*

## **Cross tested plans, Continued**

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**Check certain issues**

8. Check testing age and Normal Retirement Age in the plan.
  9. Look at the calculation of the EBARs, for rate group testing and for the average benefit test.
  10. Check for use of appropriate APR ,
  11. Check the allocation formula and determine whether the allocation formula is an age weighted or points allocation formula.
  12. If the demonstrations satisfy IRC401(a)(4) and IRC410(b), note in the case chronology that the demonstrations satisfy section 401(a)(4) and 410(b).
  13. Note on 5621 whether the demo was good or not.
  14. Note on the F5621 whether the demonstrations are good or not, and summarize issues provide a note to see your memo for details. (use this step only if you are reviewing a demo for another agent)
  15. Note on the memorandum requesting demonstration review, the issues, and date this when it is forwarded. (use this step only if you are reviewing a demo for another agent)
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## **New Comparability**

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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.

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**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.

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**New Comparability, Continued****Technical background**

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As discussed under the cross testing section above, 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.

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**New Comparability and other plans rely on cross testing to satisfy nondiscrimination**

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.

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**New Comparability, Continued**

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**New regulations published to address these plans**

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).

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**Plans must satisfy minimum gateway**

The final regulations remedy this situation by requiring these plans to pass a minimum allocation gateway requirement.

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**Plans that provide broadly available or age based allocation rates are exempt**

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 allocation 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.

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## **New Comparability, Continued**

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**Structure of new regulations**

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:

3. **the plan has broadly available allocation** rates (within the meaning of – 8(b)(1)(iii) for the plan year;
4. 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
5. the plan satisfies the **minimum allocation gateway** of –8(b)(1)(vi).

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**Rules for DB/DC plans**

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.

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**Refer to last year's CPE text for a detailed explanation**

Please refer to Chapter 7, section IX, page 155 through 175 for a detailed explanation of these new regulations.

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**New Comparability, Continued**

**Explanation of following table** The table immediately below provides a list of the allocations that are included for purposes of the new comparability regulations.

TYPE OF ALLOCATION	
COUNTED	NOT COUNTED
Employer non-elective contributions	Elective contributions to a 401(k). See 1.401(k)-1(e)(7)
Safe Harbor Matching contributions to a Safe Harbor 401(k) plan as per Section 613 of EGTRRA.	Employee After tax contributions under 401(m)
QMACs as per 1.401(k)-1(e)(7) and 1.416-1 Q M-18, M-19	Social Security i.e. permitted disparity as per 416(e) and Regulations §1.416-1 Q M-11
Safe Harbor nonelective contributions to a safe harbor 401(k) plan as per notice 98-52	
Forfeiture allocation	
QNECs as per 1.401(k)-1(e)(7)	

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## **New Comparability, Continued**

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**Sample requests for information-introduction**

The following paragraphs have been used in requesting information from taxpayers. These paragraphs raise issues or deficiencies that have been found on previous Demo 5 and 6s.

**Potential issues and tips in reviewing demos**

- Make sure that if the testing year begins in 2002 or later that a cross-tested plan satisfies broadly available or minimum allocation gateway. (New comparability only applies to cross-tested plans).
  - The plan appears to fail the broadly available or minimum allocation gateway, so the plan is not permitted to cross test. Please provide detailed information to show that the plan satisfies the new comparability requirements set out in in the final 1.401(a)(4)-8(b) Income Tax Regulations, Published June 29, 2001, (Treasury Decision 8954) and Revenue Ruling 2001-30.
  - If the 5% deemed safe-harbor (for the minimum allocation gateway) is used, the plan compensation used for the allocation must be a definition that satisfies IRC415(c)(3). However, the 1/3 test can use the plan's IRC414(s) definition of compensation (since it is compared to the HCE - i.e. the 5% test is not compared to the HCEs benefit in any way).
  - Age weighted plans satisfy the broadly available but check to see that the formula for the benefit uses 65 or current age if later. If not "current age if later" the plan could fail the demo 6 because it must use 65 or current age if later.
  - For the gateway test, matching contributions are not taken into account either to satisfy or test.
-

## Non-design based safe harbor

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### Introduction- DC safe harbor

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).
- 

### Uniform allocation formula

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).
- 

### Uniform Points allocation formula- introduction

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 (not to exceed \$200), years of service or age (or in any combination). Points have to be assigned for either age or service. The points are totaled for each employee and an allocation is made based on the ratio:

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

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*Continued on next page*

**Non-design based safe harbor, Continued**

**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), as a percentage of 414(s) compensation, cannot exceed the average allocation rate for non-highly compensated employees (NHCEs).

The plan cannot impute permitted disparity or use grouping to pass. (I.T.Reg. 1.401(a)(4)-2(b)(3)).

A Demonstration 6 is required to demonstrate compliance with this average allocation percentage test.

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**Sample  
requests for  
information-  
introduction**

The following paragraphs have been used in requesting information from the taxpayer. These paragraphs raise issues or deficiencies that have been found on previous Demo 5 and 6s.

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**Plan is  
inconsistent  
with Form 5307**

Items 5(1) and 12 on the form 5307 indicate that the plan is a designed based safe harbor. Yet section 3.01 of the plan is using new comparability rate groups. Item 12 should be revised to indicate the initial question is No and adjust the remainder of the item 12 accordingly.

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*Continued on next page*



**Non-design based safe harbor, Continued**

**Whether a plan is actually a non-designed based safe harbor**

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Item 9C of the Schedule Q to Form 5307 indicates that the plan is a non-design based safe harbor. This plan does not appear to be a non-design-based safe harbor.

The Demonstration 6 indicates that it is a general tested plan. Generally a points allocation Profit Sharing plan can qualify as a non-design based safe harbor.

This appears to be an age-weighted plan and is not eligible for non-design based safe harbor status. The formula uses the word "points" but is not based on age or service. A uniform-points allocation formula (which would be a non-design-based safe harbor) provides that "each employee must receive the same points for each year of age. However, this allocation formula appears to be an age-weighted plan, See Treasury Regulation §1.401(a)(4)-2(b)(3). Please revise the schedule Q to indicate a general test, accordingly.

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*Continued on next page*

**Non-design based safe harbor, Continued**

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**Item 9(c) of schedule Q**      Item 9C of the Schedule Q to Form 5307 indicates that the plan is a non-design based safe harbor. This plan does not appear to be a non-design-based safe harbor. The Demonstration 6 indicates that it is a general tested plan. Generally a points allocation Profit Sharing plan can qualify for a non-design based safe harbor.

**Demo 6 must be included for a non-designed based safe harbor**      If this is a non-design based safe-harbor, the average of allocation rates for the HCEs must not exceed the average allocation rates for the NHCEs.  
  
Secure a demonstration 6 that supplies numerical data. See Treasury Regulation §1.401(a)(4)-2(i)(B).

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**If the plan is an age weighted profit sharing plan**      Schedule Q indicates that you are requesting a ruling on a non-design based safe harbor, since this is an age weighted plan you must either request a ruling on the general test or revise the schedule Q to request no ruling.  
  
If you request a general test, you must submit the applicable user fee, an additional \$550, along with a revised Form 8717 (User Fee for Employee Plan Determination letter Request).

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## **Sample Demo 6**

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**Specific responses to certain items of Demo 6- introduction**

The following exhibit lists the questions and appropriate responses to the questions on Schedule Q Demo 6 instructions that could be sent to the taxpayers or compared to the taxpayers' demonstrations as an example to show what kinds of responses are expected or are ideal - the responses have to be customized for the particular demonstration facts but some language is universal. The appropriate sample responses are in *italics and bold*.

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### **Demo 6 - 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) and 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 DBP's 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.

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.

*See the attached schedule*

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*Continued on next page*

**Sample Demo 6, Continued**

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.

*Each non-excludable Highly Compensated Employee forms his or her own rate group. The members of a particular rate group are that Highly Compensated non-excludable Employee and each other non-excludable employee having an Equivalent benefit accrual rate (EBAR) equal to or greater than that of the particular highly Compensated Non-excludable employee.*

*If each rate group passes that ratio percentage test under Treasury regulation § 1.410(b)-2(b)(2), testing is completed and the plan satisfies IRC section 401(a)(4). If any rate group failed the ratio percentages, those rate groups that failed the ratio percentage test satisfied the average benefit test under Treasury regulation §1.410(b)-2(b)(3) for the plan as a whole.*

*If the plans or plans require that an employee complete any age or service requirement, any employee who has not met the most liberal requirement will be excluded from the test.*

*Any employee who has attained the required minimum age and completed the required year(s) of service to be eligible to become a participant during the plan year, but who subsequently terminates employment before his plan entry date and thus never becomes a participant in the plan, is treated as an excludable employee in accordance with 1.410(b)-6(b)(1).*

*If the plan requires that an employee complete 1,000 hours of service during the plan year to be eligible to share in the allocation of the employer contribution and forfeitures for the plan year, any participant who:*

- *terminates employment during the plan year,*
- *is not employed on the last day of the plan year, and*
- *does not complete more than 500 hours of service during the plan year,*

*is treated as an excludable employee in accordance with regulation section 1.401(b)-6(f)(1).*

*If the plan requires a participant to still be employed on the last day of the plan year to be eligible to share in the allocation of the employer contribution and forfeitures for the plan year, any participant who*

- *terminated employment during the plan year ,*
- *is not employed on the last day of the plan year, and*
- *does not complete more than 500 hours of service during the plan year,*

*is treated as an excludible in accordance with 1.410(b)-6(f)(1).*

*If the plan requires a participant to still be employed on the last day of the plan year or complete more than 500 hours of service during the plan year to be eligible to share in the allocation of the employer contribution and forfeitures for the plan year, any participant who*

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*Continued on next page*

## **Sample Demo 6, Continued**

- *terminated employment during the plan year ,*
- *is not employed on the last day of the plan year, and*
- *does not complete more than 500 hours of service during the plan year*

*is treated as an excludible in accordance with 1.410(b)-6(f)(1).*

3. State whether the plan is being tested on a contributions or benefits basis.

*The Plan is tested on a benefits basis.*

4. Provide the plan year being tested.

*The testing year is the Plan Year ended 12/31/01*

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).

*The method for determining the allocation or accrual rates is the annual method.*

*First, the plan contributions and forfeitures allocated are determined. These amounts include any QNECs and QMACs allocated during the measurement period under this plan or any plan permissibly aggregated. This profit sharing 401(k) plan is permissibly aggregated with the money purchase plan. However, we are not asking for a separate demonstration 4 at this time. These are the 401(a) allocations.*

*Second, Under this Annual method, the normalized benefit (determined under item 8 ) is divided by the average annual compensation (described in item 10 ). The benefit that is normalized is the contribution allocated during the plan year. Allocations are determined in accordance with section 6.5 of the profit sharing plan and 6.8 of the money purchase plan. See the sample calculation attached. The measurement period is the Plan Year.*

*Testing service is each Plan Year, excluding pre-participation service.*

For the average benefits test , marked demonstration 5):

*If the test requires the average benefits test, for the average benefit percentage only, employer –provided benefits, employer non-elective contributions, employee 401(k) salary deferral contributions, employee after-tax contributions, employer matching contributions, employer 401(m) matching contributions, employer safe harbor matching contributions, and employer safe harbor non-elective contribution for each non-excludible employee under this plan and any other qualified plans maintained by the employer were taken into account and normalized. However, only one imputed permitted disparity benefit (if applicable) was used to each non-excludible employee and such imputed permitted disparity benefit (if any) was determined without regard to any employee 401(k) salary deferral contributions, employee after-tax contributions, employer 401(m) matching contributions, employer safe harbor matching contributions, and employer safe harbor non-elective contributions for the non-excludible employee.*

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*Continued on next page*

## **Sample Demo 6, Continued**

6. State whether the test is imputing permitted disparity under Regulations section 1.401(a)(4)-7.

*The test does impute permitted disparity. The plan does not assume a maximum disparity factor of .65 percent for all participants. The test uses the 2002 Table II covered compensation table. No plans of the employer use permitted disparity to determine benefits. See the sample calculations attached.*

*If the modified average benefits test is used to satisfy the nondiscrimination test, only one imputed permitted disparity benefit (if applicable) was used for each non-excludable employee. Such imputed disparity benefit (if any) was determined without regard to any employee 401(k) salary deferral contributions, employee after-tax contribution, employer 401(m) matching contributions, employer safe harbor matching contributions, and employer safe harbor non-elective contributions for the non-excludable employee.*

7. Provide an explanation of how allocation or accrual rates are grouped.  
*EBARs are not grouped.*
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).

*For the general, first the 401(a) allocation rate is determined. Since this plan is cross-tested the 401(a) allocations are determined under item 20. Lastly, this amount is divided by a straight life monthly annuity (payable annually) factor at the Testing Age (derived from the post retirement interest rate and mortality assumption identified below).*

*The straight life annuity factor is based on:*

*A pre-retirement interest factor of \_\_\_\_\_,  
A post retirement interest factor of \_\_\_\_\_, the post retirement mortality factor is \_\_\_\_\_.*

*See the sample calculation attached.*

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 Demo 9 Instructions pertaining to nondiscriminatory compensation for guidance pertaining to this demonstration.

*414(s) Compensation is defined in Section 1.10 of the profit sharing Plan and and section 1.10 of the money purchase plan. This definition of 414(s) compensation would satisfy 1.414(s)-1(c)(2), were it not for the fact that it excludes compensation paid during that portion of the Plan Year that an employee is not an Eligible Participant for the portion of the Plan Year being tested. This exclusion will not cause the definition to be discriminatory due to the operation of Regulation Section 1.401(a)(4)-12 (the definition of Plan year Compensation) and the "period of plan participation" provided.*  
*or*

*Total W-2 wages including elective deferrals (subject to the limits of 401(a)(17) were used as plan year compensation, which satisfies 1.414(s)-1(c)(2).*

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*Continued on next page*

## **Sample Demo 6, Continued**

10. Provide the method of determining average annual compensation used in testing the plan for nondiscrimination as defined in Regulations section

*Compensation is as defined in Section 1.10 of the Plan for each Plan Year and is not averaged over a period of more than one year. 1.401(a)(4)-3(e)(2).*

*Current Plan Year compensation was used in determining the EBARs.*

11. Provide the testing age of employees; include fractions of year if test is based on fractional age (not applicable to DCPs testing on a contributions basis).

*Testing age is attainment of normal retirement age under the plan (which is the later of age 65 or the fifth anniversary of plan participation in accordance with section 1.25 of the profit sharing and section 1.27 of the money purchase plan) or actual age, if later.*

*Fractional Years do not apply.*

*Testing age is age attained at testing year-end.*

### **Defined Benefit Plans Only**

**All DBP's must also provide the following information if applicable.**

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.

*N/A - this is a defined contribution plan.*

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.

*N/A - this is a defined contribution plan.*

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.

*N/A - this is a defined contribution plan.*

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).

*N/A - this is a defined contribution plan.*

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*Continued on next page*

## Sample Demo 6, Continued

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.

*N/A - this is a defined contribution plan.*

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 preretirement survivor annuity charges as provided in Regulations section 1.401(a)(4)-3(f)(8).

*N/A - this is a defined contribution plan.*

18. Plans with employee contribution 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.

*N/A - this is a defined contribution plan.*

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.

*N/A - this is a defined contribution plan.*

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*Continued on next page*



## **Sample Demo 6, Continued**

Cross- Tested Plans Only

20. Provide a description of the method used to determine equivalent allocations and benefits.

*The plan allocations satisfy the minimum allocation gateway by providing at least 5% of annual Compensation for the current testing year without regard to the measurement period. The compensation satisfies a definition of compensation under section 415(c)(3). Therefore, this plan may cross-test.*

*To determine the equivalent benefits accrual, the test uses the assumed interest rate identified in item 8. This interest rate is used to convert the 401(a) allocations to a lump sum value at the Participant's Testing Age by multiplying the 401(a) allocations by the quantity 1 plus the interest rate to the an exponent determined by subtracting the Attained Age from the Testing Age.*

*Such amount is converted to an annual straight life annuity by dividing the lump sum value by the annuity purchase rate determined by using the post retirement interest rate and mortality table identified in item 8. This is the "Equivalent Benefit Accrual Rate" or if the plan is imputing disparity the "unadjusted Equivalent Benefit Accrual Rate". The Attained Age is the age attained by the participant by the end of the Testing Year.*

21. 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.

*See the numerical portion of the test.*

## **Defined benefit plans—General test**

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**Major steps for general test**

There are three steps:

1. The allocation or accrual rates for each participant are determined.
  2. Once the allocation or accrual rates are determined, they are used to form rate groups.
  3. Once the rate groups are determined, each rate group must satisfy the IRC section 410(b) coverage requirements.
- 

**Two accrual rates when general testing DB plans**

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:

$$\frac{\text{Accrued benefit}}{\text{Testing service}} \quad \frac{\text{Most valuable optional benefit}}{\text{Testing service}}$$

The accrued benefit, most valuable optional form of benefit and testing service are measured during the measurement period.

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**Definitions**

- 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:
    1. Current plan year method
    2. Accrued to date method
    3. Projected method
  - 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.
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*Continued on next page*

**Defined benefit plans—General test, Continued**

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**Definitions**  
(continued)

- 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.
- 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).

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**Normal accrual rate defined**

The normal accrual rate for an employee for the plan year is the **increase** in the employee's accrued benefit (within the meaning of section 411(a)(7)(A)(i) during the measurement period.

This increase is divided by the employee's testing service during the measurement period.

The normal accrual rate is expressed as either a dollar amount or as a percentage of the employee's average annual compensation.

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**Determining normal accrual rate—current plan year 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. The testing service 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.

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*Continued on next page*

**Defined benefit plans—General test, Continued****Example illustrating current year method**

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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 applying the formula  $1.5\% \times 1 \text{ year of service} \times 50,000$  or \$750 per year divided by "1" (the testing service) or \$750 per year. This benefit can be expressed as either a dollar amount (\$750) or as percentage of average annual compensation, which would be 1.5% ( $\$750/\$50,000$ ), assuming \$50,000 satisfies the requirements for average annual compensation.

**Accrued to date method-defined**

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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.

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*Continued on next page*

## Defined benefit plans—General test, Continued

**Example illustrating accrued to date**

Same facts as previous example, 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:

$$\frac{\text{Accr. ben.} - 2\% \times 10 \text{ years} \times \$50,000 \text{ plus } 1.5\% \times 5 \text{ years} \times \$50,000}{\text{Testing service} - 15 \text{ years}}$$

or a benefit of \$917 per year, which can be expressed as either a dollar amount or a percentage of average annual compensation. The percentage would be 1.83% ( $\$917/\$50,000$ ), assuming \$50,000 satisfies the requirements for average annual compensation.

**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 illustrating projected method**

Same facts as previous example 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:

$$\frac{\text{accr. ben.} - (2\% \times 10 \text{ yrs}) + (1.5\% \times 10 \text{ yrs}) + (1\% \times 20 \text{ yrs}) \times \$50,000}{\text{Testing service} - 40 \text{ years}}$$

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.

*Continued on next page*

**Defined benefit plans—General test, Continued**

**Most valuable accrual rate defined**

Treas. Reg. Section 1.401(a)(4)-3(d) defines the most valuable accrual rate as the increase in the employee’s most valuable optional form of payment of the accrued benefit during the measurement period. This benefit is divided by the employee’s testing service during the measurement period, and expressed either as a dollar amount or as a percentage of the employee’s average annual compensation.

The employee’s most valuable optional form of payment of the accrued benefit is determined by calculating for the employee the normalized QJSA associated with the accrued benefit that is potentially payable in the current or any future plan year at any age under the plan and selecting the largest (per year of testing service).

The most valuable accrual rate reflects the value of all the benefits accrued or treated as accrued under section 411(d)(6) that are payable in any form and at any time under the plan, including:

- early retirement benefits,
- retirement-type subsidies,
- early retirement window benefits, and
- QSUPPs.

**Determining whether there are most valuable benefit calculations**

Generally, if the plan provides an early retirement benefit, there is probably a most valuable benefit calculations. If an early retirement benefit is the actuarial equivalent normal retirement benefit then a most valuable benefit may not be needed.

The following table indicates whether a plan has a most valuable benefit calculation.

PROBABLY MOST VALUABLE BENEFIT	PROBABLY NO MOST VALUABLE BENEFIT
Early retirement benefit based on a schedule	Only early retirement benefit is one that is the actuarial equivalent of normal form
Early retirement benefit based on decimal fraction e.g. Early retirement for those attained age 55 and 10 year of service in amount of 50 percent of normal retirement benefit.	The plan provides no early retirement benefit.

## Sample Demo 6,

**Specific responses to certain items of Demo 6- introduction**

The following exhibit lists the questions and appropriate responses to the questions on Schedule Q Demo 6 instructions that could be sent to the taxpayers or compared to the taxpayers' demonstrations as an example to show what kinds of responses are expected or are ideal - the responses have to be customized for the particular demonstration facts but some language is universal. The appropriate sample responses are in *italics and bold*.

### Demo 6 - 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) and 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 DBP's 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.

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.

*See attached for necessary data that demonstrates the plan satisfied section 401(a)(4).*

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."

*Each non-excludable Highly Compensated Employee forms his or her own rate group. The members of a particular rate group are Highly Compensated non-excludable Employee and each other non-excludable employee having a Normal Accrual Rate and Most Valuable Accrual Rate equal to or greater than that of the particular highly Compensated Non-excludable employee.*

*If each rate group passes the ratio percentage test under Treasury regulation § 1.410(b)-2(b)(2), testing is completed and the plan satisfies IRC section 401(a)(4). Any rate group that fails the ratio percentage test must satisfy the nondiscriminatory classification for the rate group and the average benefit percentage test under Treasury regulation §1.410(b)-2(b)(3) for the plan as a whole.*

3. "State whether the plan is being tested on a contributions or benefits basis."

*The Plan is being tested on a benefits basis.*

*Continued on next page*

**Sample Demo 6,, Continued**

4. "Provide the plan year being tested."

*The testing year is the Plan Year ended August 31, 2000*

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).

*The method for determining the allocation or accrual rates is the accrued-to-date method. This method takes into account service from date of hire as testing service and the measurement period. (See Examples 1 and 2 attached)*

6. State whether the test is imputing permitted disparity under Regulations section 1.401(a)(4)-7.

*The test imputes permitted disparity. The plan does not assume a maximum disparity factor of .65 percent for all participants. The permissible factor used in the calculation is .65 for SSRA 65, 70 for SSRA 66 and 75 for SSRA 67. The test uses the 2000 Table II covered compensation tables. See items 12,13,22 and 23 of Examples 1 and 2, attached.*

7. Provide an explanation of how allocation or accrual rates are grouped.

***EBARs are grouped***

*Accrual rate ranges were developed as follows:*

- ***Normal Accrual Rates***  
*<1.0% - range is .05% above and below midpoint*  
*= or >1.0% - range is 95% to 105% of the midpoint*
- ***Most Valuable Accrual Rates***  
*< .3% - range is .05% above and below midpoint*  
*= Or >.3% - range is 95% to 105% of the midpoint*

Note: The range subject to the .05% above and below cannot exceed 5%. In this case it is 1% and .3%.

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).

*Actuarial assumptions used to normalize benefits are the UP-84 Mortality Table and 8.5% interest. The normal form of accrued benefit was calculated as of 08/31/2000 end of the testing year. Unadjusted accrual rates equal the accrued benefits were divided by the testing Service and then divided by the testing compensation. Disparity is then imputed in accordance with question 6 above.*

*Most valuable accrual rate started with the accrued benefit as calculated above:*

- *multiplied by the plan early retirement reduction factor,*
- *multiplied by the plan's QJSA conversion factor at the most valuable retirement (early retirement age).*
- *multiplied by 1.085% raised to the exponent of the Testing age minus the most valuable retirement age).*

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*Continued on next page*



## **Sample Demo 6,, Continued**

- *multiplied by the Testing QJSA test factor at the most valuable retirement age.*
- *divided by the testing life only annuity factor at the Testing Age.*
- *divided by Testing Compensation and then testing service.*

*Disparity is then imputed in accordance with question 6 above.*

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 Demo 9 Instructions pertaining to nondiscriminatory compensation for guidance pertaining to this demonstration.

*414(s) Compensation is defined in Section 4.1(x) of the Plan. This definition of 414(s) compensation would satisfy 1.414(s)-1(c)(2), except that it excludes compensation paid during that portion of the Plan Year that an employee is not an Eligible Participant for the portion of the Plan Year being tested. This exclusion will not cause the definition to be discriminatory due to Regulation Section 1.401(a)(4)-12 (the definition of Plan year Compensation) and the "period of plan participation" provided. Therefore demonstration 9 is not needed.*

*or*

*Total W-2 wages including elective deferrals (subject to the limits of 401(a)(17) were used as plan year compensation, which satisfies 1.414(s)-1(c)(2). Therefore demonstration 9 is not needed.*

10. Provide the method of determining average annual compensation used in testing the plan for nondiscrimination as defined in Regulations section

*Compensation is as defined in Section 1.2(L) of the Plan for each Plan Year and is not averaged over a period of more than one year.*

*Current Plan Year compensation was used in determining the equivalent benefit accrual rates. (EBARs)*

11. Provide the testing age of employees; include fractions of year if test is based on fractional age (not applicable to DCPs testing on a contributions basis).

*Fractional Years do not apply.*

*Factional Years do apply*

*Testing age is nearest age at testing year-end.*

*Testing age is age attained at testing year-end.*

*Testing age is attainment of age 65 or actual age, if later.*

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*Continued on next page*

## **Sample Demo 6,, Continued**

### **Defined Benefit Plans Only**

All DBP's must also provide the following information if applicable.

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.

*Accruals after normal retirement age are taken into account.*

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.

*No early retirement window benefits were taken into account.*

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.

*No unpredictable contingent event benefits are available and so none were 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).”

*The Plan has not offsets as described in Treasury Regulation §1.401(a)(4)-3(f)(9) and so none were taken into account.*

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.”

*No disability benefits are taken into account in determining an employee's accrued benefits.*

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). “

*No special rules in Treasury Regulation §1.401(a)(4)-3(f) are applied in testing the Plan for nondiscrimination amount.*

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*Continued on next page*

## **Sample Demo 6,, Continued**

18. “Plans with employee contribution 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. “

*The plan does not permit employee contributions and so none were taken into account.*

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.

*The plan satisfies the general test so other determination is being sought.*

### **Cross- Tested Plans Only**

20. “Provide a description of the method used to determine equivalent allocations and benefits.”

*N/A – This plan in a defined benefit plans so was not cross-tested.*

21. “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. “

*N/A*

## **Defined benefit issues**

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**Sample requests for information-introduction**

The following paragraphs have been used in requesting information from the taxpayer. These paragraphs raise issues or deficiencies that have been found on previous Demo 5 and 6s.

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**Incorrect assumptions identified**

The Exhibit marked Defined Benefit Testing Assumptions and the test incorrectly identifies the plan assumptions. Section 2.1 of the plans states that actuarial equivalence will be determined using the applicable mortality table not the 71 IAM mortality.

The Exhibit marked Defined Benefit Testing Assumptions incorrectly identifies what the plan assumptions are. It should identify whether the male or female table, if applicable. The reviewer should not have to guess what table is being used.

---

**Whether J&S with 50% is most valuable benefit**

Why is a Joint and 50% survivor annuity the most valuable benefit when:

- (1) the QJSA is an actuarial equivalent of the normal form and
  - (2) there is a 100% survivor option. It seems that the most valuable benefit is identical to the normal accrued benefit.
- 

**How most valuable is calculated**

We need details (including the assumptions and APRs used) on how the Early retirement benefit was calculated. It appears that the normal retirement benefit in the form of a 10 certain and life (as per section 5.1 page 13) would be reduced using the early retirement factor stated in section 5.3 page 14 of the plan. Then the benefit at the ERD will be converted to a 50% QJSA. It appears that the QJSA at 60 for Sample 1 participant would be approximately \$1345 not 1328.23.

For purposes of calculating the early retirement benefit for the most valuable benefit rate, if a 10 year certain and life is not the normal form used, find out in what form the benefit is at Normal Retirement Date (“NRD”). (i.e. the benefit accrual at NRD is \$2091.00 - what is the form of benefit). The normal form of benefit stated in section 8.1(a) page 16 is not the proper normal form of benefit - it is the normal form of distribution.

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*Continued on next page*

## **Defined benefit issues, Continued**

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**Request for information**

We made a request for certain details for adjustment to the most valuable accrual rate, but have not yet received this information. We need to have complete details including age used for each factor, how the factor was derived, what actuarial assumptions were used including the mortality factors used.

If the GATT rate was used, specify what month factor is being used. We should be provided with an explanation of how the most valuable benefit was chosen, including why one form was chosen over another.

The information and or example should allow a reviewer to duplicate the numbers used in the test without having to guess the details. You must demonstrate the proper methodology for running the test.

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**Issue-need details as to the following information**

- For the demonstration 6, we need details with respect to the Normal Accrual Rates and Most Valuable Accrual Rates including:
    - (1) age used for each factor,
    - (2) how the factor was derived,
    - (3) what actuarial assumptions were used including the mortality factors used.
  - If the GATT rate was used, the test must specify what monthly factor is being used.
  - Please provide an explanation of how the normal and most valuable benefit was chosen, including why one form was chosen over another.
- 

*Continued on next page*

**Defined benefit issues, Continued**

**Issue-need details as to the following information**  
(continued)

- 
- The normal and most valuable form of benefit should be identified. If the NAR and MVAR are the same, an explanation should be provided.
  - The information and/or example should allow a reviewer to duplicate the numbers used in the test. If permitted disparity is used, a detailed example showing an employee that had compensation below and above the covered compensation should be provided.
  - Calculations for the Average benefits test should also be provided including what allocations are included.
  - We need details on how the early retirement benefit (ERB) was determined. Please use the example, “Life 10” to explain and show how the ERB was calculated including the annuity purchase rates used to convert the single life annuity to a QJSA.

The plan seems to say that the 50% Qualified Joint and Survivor Annuity (QJSA) is the actuarial equivalent of the normal form of benefit (Straight life Annuity).

- It appears that the ERB at age 65 would be the greater of the ERB and the NRB for calculation of the most valuable benefit. We need an explanation of why the ERB at age 65 (testing age) it is not equal to the NRB.

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*Continued on next page*

**Defined benefit issues, Continued**

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**Issue-need details as to the following information**  
(continued)

- We need an explanation of how the "testing Age IAF", the Plan Joint and 50% Survivor Conversion Factor" and Testing Joint and 50% Survivor Conversion Factor" is determined.
  
- Please provide an excerpt of the mortality tables used for each factor. We could not duplicate the EBAR based on the explanation. The APRs for each age is needed.

---

**Suggested review procedures for Defined Benefit Plan Demo 6 review**

1. Look at application form to determine if there are other plans. The 5310 will not tell you if there are other plans.
2. Look at schedule Q for demonstration review requested
3. Gather up demos, Pull from case
4. If Demo 6, you will need to consider actuarial equivalence, the early retirement benefits, the normal form of benefit, normal retirement benefits and definition of the qualified joint and survivor benefits.
5. Read narrative if supplied. Note the
  - testing basis, testing year,
  - method of determining accrual,
  - permitted disparity,
  - assumptions (look up Annuity purchase rates at 65),
  - definition of compensation to ensure that they do not need demo 9

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*Continued on next page*

**Defined benefit issues, Continued**

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**Suggested  
review  
procedures for  
Defined Benefit  
Plan Demo 6  
review  
(continued)**

6. Look for sample calculations of the most valuable and normal accrual rate.
  7. Duplicate the normal form of benefit.
  8. Duplicate the normal accrual rates.
  9. Using the testing assumptions, duplicate the imputed disparity for the normal accrual rates.
  10. Using the plan document and plan assumptions, duplicate some early retirement benefits that are reported in the sample calculations.
  11. Using the plan document and testing assumptions, duplicate the early retirement age lump sum.
  12. Using the testing assumptions, duplicate the testing age lump sum
  13. Using the plan document and testing age assumptions, duplicate the most valuable benefit is the form of the normal form of benefit.
  14. Using the testing assumptions, duplicate the imputed disparity for the most valuable accrual rates.
  15. check testing age
  16. Check normal retirement age in plan if not obvious or not 65 or use of 5<sup>th</sup> anniversary
-



## Other issues that may arise

**Sample requests for information-introduction**

The following paragraphs have been used in requesting information from the taxpayer. These paragraphs raise issues or deficiencies that have been found on previous Demo 5 and 6s.

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**DC and DB plans**

- We need information on other plans maintained by the employer to determine whether benefits or allocations should be included in the tests.
- 

**Schedule Q-plan may opt out of Demo 5 or 6**

An on going plan may opt out of Demonstration 5 or Demonstration 6. Terminating plans cannot opt out of either. See Revenue Procedure 2002-6 sections 6.07 and 12.04.

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**Changes to user fee**

- Schedule Q item 5(l) indicates that the plan passes the ratio percentage test yet it requests a review of demonstration 5.
  - The Schedule Q must be revised to change the fill-in for 5(o) to "A". We will not rule on the average benefit test for a plan that passes the ratio percentage test.
  - Schedule Q item 9 indicates that the taxpayer is requesting a review of demonstration 6. However, there were no nonelective employer contributions that would require such a demonstration. The only employer contributions are matching which are subject to testing under 401(m)(3).
  - The taxpayer may change 9 to blank as per directions on item 6. A user fee refund would be in order. If not, the employer needs to provide a revised demonstration 6 to show theoretical contributions including theoretical deferrals to a 401(k) and matching.
- 

*Continued on next page*

**Other issues that may arise, Continued**

**Annuity  
purchase rate  
issues**

- The APR must not have setback because is its considered a nonstandard table. §1.401(a)(4)-8(b)(2)(ii)(B).
- For defined contribution plans, the APR must be based on one of the standard tables listed in Treasury Regulation §1.401(a)(4)-8(b)(2)(ii)(B) under the definition of "Standard mortality table" and other pronouncements by the Service.

These tables include UP84, 83GAM(f), 83GAM(m), 83IAM(f), 83IAM(m), 71GAM(f), 71GAM(m), 71IAM(f), 71IAM(m), GAM83(u) and GAR. See 1.401(a)(4)-12 (definitions) under "standard mortality table".

- The APRs for those with current ages past the testing age must be different than those with current ages at or before the testing age. Thus, the incorrect APR is used if such APR is used for someone is age 69 and age 65.
- Check the current age of the participants because it appears that they are using different APRs for some. This can be different if

- (1) the participant is past the testing age or
- (2) the normal retirement date for that individual is influenced by a 5th anniversary rule.

If corrected, secure a revised test.

- The mortality table and interest rate used to generate the APR indicated on the numerical portion of the test is not used to determine the allocation rates, accrual rates or EBAR (equivalent benefit annual rate).
- The narrative portion of the test improperly identifies the APR used in the test. Either change the test or correct the narrative. The narrative indicates that the APR is based on \_\_\_\_\_ assumptions and that the pre-retirement interest rate is \_\_\_\_\_, however, the test uses a \_\_\_\_\_ to determined the APR and a pre-retirement interest rate of \_\_\_\_\_.

*Continued on next page*

**Other issues that may arise, Continued**

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**Average Benefit  
Test issues**

- A separate narrative (explanation that follows the instructions to Demonstration 5) is needed for the Demonstration 5. However, if a demonstration 6 is used to describe the average benefit test, all the information to determine the average benefit test must be provided.
- Explain why the average benefit test and general test are using different amounts for compensation.
- The 5307 item 9a indicates that the sponsor maintains another plan. However, the remainder of the questions indicate there are no more plans. Please verify the proper answer and revise the 5307 or note the change accordingly. If there is another plan, the benefits under the other plan must be included in the ABT.
- The demonstration 6 shows that the plan fails the average benefits test. Since this is a projected contribution, the projected contributions must be revised re-run and resubmitted.
- The mathematical portion of the average benefit percentage test does not identify where the benefit percentage comes from. The narrative could also explain where it came from.
- I can not tell what APRs are used for the rate group test or the average benefit percentage test. A reviewer should not have to figure it out by trial and error. Please provide a revised mathematical portion or narrative.
- Based on the proper ratio percentage of the rate groups i.e. 33.333% (see the discussion on the rate group test) and the midpoint of the safe and unsafe harbor i.e. 33.75, the rate groups fail the nondiscriminatory classification test. Thus, the rate group fails the average benefit test of 1.410(b)-2(b)(3). Thus, the plan fails the general test.

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*Continued on next page*

**Other issues that may arise, Continued**

- 
- Compensation**
- Item \_\_\_\_\_ of narrative of the demonstration 6 needs to identify how the compensation is calculated - is it plan year compensation or an average? It must identify the definition used in the plan and what section of the regulations the definition satisfies.
  - The compensation used for the demonstration 6 is apparently not a 414(s) safe harbor. Demonstration 9 is needed to show that compensation used for the demonstration 6 (and 5) is nondiscriminatory. Regulation section §1.414(s)-1(c)(2) or (3)
  - The instructions to the Demonstration 6 General test item 8 provides "State the definition of section 414(s) compensation used in determining plan year compensation or average annual compensation and a demonstration (sic demonstration 9) showing the definition as nondiscriminatory. The demonstration is not needed if plan year compensation or average annual compensation is determined using a definition of compensation that satisfies Regulation section 1.414(s)-1(c)(2) or (3)." Accordingly, the demonstration 6 narrative must state what definition is used in the test and what 414(s) definition it satisfies or provide a demonstration 9.
  - The narrative item i indicates that current compensation is used for testing purposes; however, the test indicates that compensation is an average of 3 years. Please reconcile and correct either the narrative or test.

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**Inconsistent interest rate**      The narrative of Demo 6 indicates that the interest rate is 8.5% but apparently the test uses 8%. The narrative should be corrected.

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*Continued on next page*

Other issues that may arise, Continued

General test issues

- Since the mathematical portion seems to use **all the methods** (i.e. annual/accrued -to-date, with and without permitted disparity) for testing, we are going to need a narrative that follows the instructions for the Schedule Q or the instruction to demonstration 5 and 6. Only one method can be used to show that the plan passes the general test. The narrative must identify that method.
- The **narrative** portion of Demo 6 needs to be included or completed. See the instructions to the Schedule Q and demonstration 6. All the items in the instructions must be addressed (and not cross-referenced to other demonstrations in the narrative). See the instructions to the Schedule Q (revised August 2001) - page 2 - under the title "Guidelines For Certain Demonstrations"
- Mathematical portion of the Demo 6 improperly determines **the ratio percentage test for the rate groups**. For example, language that is similar to the following is needed: "Each highly compensated employee forms his or her own rate group. The members of a particular rate group are each highly compensated employee and each other employee having an EBAR equal to or greater than that of the particular highly compensated employee. " The test states that the rate groups pass the ratio Percentage test. However, all the rate groups do not pass the ratio percentage test. The test needs to be corrected.
- Item \_\_\_\_\_ of narrative improperly uses **projected years** of service - this should be removed.
- Item \_\_\_\_\_ of narrative of Demo 6 needs a mathematical demonstration **on how the benefits are normalized**. Show the calculation and data for one of the participants whose compensation is above his covered compensation level and one participant whose compensation is below his covered compensation level would be sufficient. This should properly identify the covered compensation used. This analysis is needed for both the rate group test and average benefits test (four illustrations may be needed).
- The test should be labeled or a separate schedule added to **show the EBARs for the HCE** for the rate group test.
- The narrative needs to **show the ages** used in the example including date of birth and what age is used for the test.

*Continued on next page*

Other issues that may arise, Continued

General test issues  
(continued)

- The example cross-testing calculations appear to be **missing the second page** or so. I would expect an example of a participant that has testing compensation above the covered compensation.
- The **illustration**
  - (1) uses an incorrect testing year,
  - (2) uses an incorrect testing age,
  - (3) needs an example for an individual with Compensation above the covered compensation,
  - (4) incorrectly calculates imputed disparity,
  - (5) does not mention the average benefit test differences and
  - (6) may be using the same maximum disparity for all employees. If it is using the same maximum disparity factor for all employees, the narrative should say so. The illustration cannot be used to relieve the test of details on the rate group test or average benefit test. Please revise the illustration accordingly.
- The mathematical portion of the rate group test indicates that it using a 77% threshold rather than 70%.
- The narrative of the demonstration 6 indicates that **allocation rates were grouped**,but the test indicates that it was not. Secure a revised narrative accordingly.
- The narrative of the demonstration 6 indicates that **allocation rates were grouped**, but the reason is not correct. Grouping refers to a procedure where the number of EBARs are reduced to simplify the testing. No need to revise the narrative.
- A proper demonstration 6 determines whether the rate groups pass the ratio percentage test by using accrual rates **excluding deferrals to a CODA**. The ratio percentage test must not include the deferrals in determining the EBAR in determining the rate groups and testing the ratio percentage test. The deferrals are considered in the modified average benefits test (the demonstration 5 for 401(a)(4) and the demonstration 5 for 410 purposes. Please correct and re-run test accordingly.
- The mathematical portion of the test incorrectly determines how the rate groups are determined. The program appears to be at fault. The program should include the current HCE in the rate group, but appears to include HCEs in other rate groups, but not the current HCE in the group. A correction and re-run of the test is needed.
- Item \_\_\_\_\_ of the narrative incorrectly calculates the ratio percentage test.

*Continued on next page*

## Other issues that may arise, Continued

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**General test issues**  
(continued)

- Calculation of the **lump-sum at the testing age**: I was unable to reproduce the lump-sum amounts reported in the demonstration 6. We need details on how the lump sum was calculated. Review the demonstration to make sure the explanation is consistent from employee to employee and agrees with the narrative provided with the demonstration. Make any necessary changes and re-run test is the numbers are changed.
- **Calculation of the EBAR**: I was unable to reproduce the EBARs reported in the demonstration 6. We need details on how the EBAR was calculated. Review the demonstration to make sure the explanation is consistent from employee to employee and agrees with the narrative provided with the demonstration. Make any necessary changes and re-run test is the numbers are changed.
- The **mathematical portion** of the demonstration 6 is missing. The Allocation schedule provided is not a demonstration 6. The demonstration 6 should follow the narrative. This includes but is not limited to details of the allocations, compensation, accrual rates or EBARs (for cross-tested plans), attained age, testing age, lump sum at testing age, annuity purchase rate, allocations (detailed), covered Compensation, maximum permitted disparity, etc. The narrative should explain how the covered compensation was determined. We should be able to duplicate the results based on the data provided.
- The narrative item 10 incorrectly describes how the allocations are normalized. The accrual rate is determined by dividing the projected accrued benefit by the compensation - not the other way around.
- The rate groups are determined incorrectly. Re-determine the rate groups based on the EBARs (for cross-tested plans). The program apparently made an error determining the 5<sup>th</sup> rate group. The Ratio Percentage should be about 56% not 71%. Therefore, the rate group must satisfy the average benefit test under §1.401(b)-2(b)(3). The Average benefits percentage test under §1.410(b)-5 must be run.

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## **Other issues that may arise, Continued**

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**General test issues**  
(continued)

- Mathematical portion of the test needs to be **labeled** or data added to understand what is going on. I cannot tell if the plan passes the test. This includes but is not limited to details of the allocations, compensation, allocation rates or EBAR, attained age, testing age, lump sum at testing age, annuity purchase rate, etc. The narrative should explain how the covered compensation was determined. We should be able to duplicate the results based on the data provided. See the instructions.
- **Contributions** for Rate Group Test: I cannot tell from the demonstration 6 what contributions are included in the allocations. The narrative or mathematical test should be revised to provide these details.
- If the individual is at the testing age, the factor to convert the allocation to a lump sum at the testing age is 1.0. Please revise the test to use an accumulation factor of 1.00 for those at the testing age.
- The demonstration six indicates that the plan fails the nondiscrimination classification test. The Allocation and demonstration must be revised to show how the plan passes including revised allocations or additional allocations.
- The submission is missing or is deficient in providing the numerical portion of test. This test should include, but is not limited to show how each equivalent benefit accrual rate was calculated including contributions included in each test, attained age, testing age, lump sum at testing age, the equivalent annual benefit. In lieu of some of these items, a sample calculation may be used to show how the allocation rates or EBARS were calculated. See the special rule for imputing permitted disparity. The narrative should be used to explain the item used but is not in place of the numerical test. A reviewer should be able to reproduce the numbers used in the test.

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**Other issues that may arise, Continued**

**General test issues**  
(continued)

- The demonstration 6 rate group test may be **permissively aggregating** the profit sharing plan and the money purchase plan contributions. If this is the case, there must be a demonstration 4 for permissive aggregation or a statement in the narrative. If this is not the case, the rate group test must be adjusted.
- Since the employer has or apparently has other plans, the benefits and allocations counted for the general test should be different from the average benefits test.

The general test excludes deferrals and contributions under 401(k) and (m), but includes employer annual additions under this plan including contributions, forfeitures allocated and any QNECs and QMACs to the plan being tested.

However, demo 5 (average benefits percentage test) includes deferrals and matching in all plans and includes benefits or allocations under all plans of a controlled group. 1.401(a)(4)-8(b)(2)(iii), 1.410(b)-7(c) and (e), 1.401(a)(4)-1(b)(2)(ii)(B).

Your demonstration package does not show that this is being done. Revise and rerun the test accordingly.

- Since the plan or another plan of the employer is a 401(k), the demo 5 average benefit test is different from the Demo six group rate test (ratio percentage test). In other words, there should be two sets of EBARs (equivalent benefit accrual rates). One set for the ratio percentage test for the rate groups and one for the modified average benefits test.

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*Continued on next page*

Other issues that may arise, Continued

General test issues (continued)

- The demonstration 5 (average benefits test) should identify what allocations are included in the mathematical test such as deferrals from 401K, matching contributions from a 401(m) plan, after tax employee contribution under 401(m), and allocations under other plans that are not already permissively aggregate (details included).
- A demonstration 5 is needed for the modified average benefits test since this plan or another plan of the employer has either deferrals to a 401(k), 401(m) matching or employee after tax contributions, or other plans for which have not been permissibly aggregated for the rate group test.

The narrative does not provide enough information to determine how the average benefit percentage test was determined. Also, provide all the information for Demo 5 as per the instructions to the schedule Q regarding demonstration 5. This includes but is not limited to details of: the type of allocations included, compensation, EBAR, attained age, testing age, lump sum at testing age, annuity purchase rate, etc.

The narrative should explain how the covered compensation was determined including each formula used to determine imputed disparity. We should be able to duplicate the results based on the data provided.

- Item \_\_\_\_\_ of narrative and the test portions of Demo 6 improperly **identifies the rate groups**. For example, language that is similar to the following is needed: "Each highly compensated employee forms his or her own rate group. The members of a particular rate group are each highly compensated employee and each other employee having an EBAR equal to or greater than that of the particular highly compensated employee. "

*Continued on next page*

**Other issues that may arise, Continued**

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**Excludable and non-excludable employees**

- Any employee who has attained the required minimum age and completed the required year(s) of service to be eligible to become a participant during the plan year, but who subsequently terminated before his plan entry date and thus never becomes a participant, is treated as excludable. 1.401(b)-6(b)(1).
- Generally, any participant (i.e. someone who has met the minimum participant requirement in the past) who completes more than 500 hours during the testing years **cannot** be excluded from the test. Generally, if no allocation is provided to them (i.e. last day rule or less than the 1000 hours required for an allocation), their allocation for the test is zero. 1.410(b)-6(f)(1).

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**Inconsistency with narrative and numerical calculation**

Identification of the APR used in the numerical portion of Demonstration 5 or 6. The Demo six numerical-portion is not using the APR identified in the narrative. The narrative says \_\_\_\_\_ while the numerical portion indicates \_\_\_\_\_. The narrative should be revised accordingly.

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*Continued on next page*

**Other issues that may arise, Continued****Nondiscriminatory classification test of ABT**

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- The maximum midpoint is 45% since the maximum unsafe harbor is 40% and the maximum safe harbor is 50%. See §1.410(b)(4)-4(c)(4)(iv).
  - The highly compensated employee concentration percentage must be rounded down. See Treasury Regulation §1.410(b)(4)-4(c)(4)(ii).
  - A ratio percentage test of a rate group of 45% or greater does not need to concern itself with the midpoint or NHCE concentration percentage. See §1.410(b)(4)-4(c)(4)(iv).
  - The demonstration 6 appears to have left out the HCE Employee in the NHCE concentration percentage. There is no explanation such as top-paid group, new hire or other explanation.
  - The mathematical portion of the demonstration test contradicts itself on the number of non-highly compensated employees.
  - I don't understand what the percentages under Safe-harbor stand for. Why is there a percentage for each employee?
  - The accrual rates are 1/12 the rates that they should be. Revise the test and re-run.
  - The test does not show how the rate groups are tested or what rate groups each employee belongs to.
  - The nonhighly compensated employee concentration percentage must include all nonexcludable employees not just those benefiting. See §1.410(b)-4(c)(4)(iii).
  - The attained age used for the example shows the incorrect age used for the remainder of the illustration and that used for the actual test; however, no change is needed in the test.

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*Continued on next page*

**Other issues that may arise, Continued**

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**Testing age**

- Testing Age: The testing age generally must be "65" (or such other normal retirement age under the plan) or "current age, if later". Therefore, if an individual is past the NRA the current age is the testing age - the test must use the participant's current age - not his NRA. See 1.401(a)(4)-12 Definition of testing age paragraph 4. A plan can use SSRA only if all participants have the same SSRA. E.G. if all participants are born after 1954 they can use SSRA as the testing age. See Treasury Regulation §§1.401(a)(4)-12 Definitions of testing age paragraph (1) which states

"If the plan provides for a uniform normal retirement age for all employees, the employee's testing age is the employees normal retirement age under the plan." and (4) which provides that "If an employee is beyond the testing age ... under paragraph (1) ..., the employee's testing age is the employee's current age."

The narrative must be revised and/or test must be adjusted accordingly.

- If the individual is at the testing age, the factor to convert the allocation to a lump sum at the testing age is 1.0. Please revise the test to use an accumulation factor of 1.00 for those at the testing age.
- Although the narrative states that the testing age is 65 or current age, if greater; however, the test uses a testing age of \_\_\_\_\_. Please revise the narrative or test and example to reflect the proper testing age. Section 1 item Z page 6 of the Plan indicates that the normal retirement age is the later of age 60 or 5th anniversary of participation. Also, make sure that the APR is determined at the testing age not necessarily at age 65.
- Get an explanation for item J of narrative for Demo 6, which indicates that the testing age is "For plan years beginning after 1996, the Social Security Retirement Age may be used."

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**Other issues that may arise, Continued**

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**Testing Plan  
Year**

- The demonstration confuses the testing year in the explanation and test. Its okay to use the plan year 2000 data but the testing year is 2002. The narrative and test must use the 2002 rules, and limits etc.
- The demonstration 6 and its narrative indicate that the testing year is 2002 and 2001. It should be clear either in the narrative or mathematical portion what year is being tested. If the testing year is 2002 we have to consider the new comparability gateway test in order to cross test. The mathematical portion should be labeled. The narrative should state how the numbers are derived estimate or other wise. Please correct
- The test incorrectly defined the testing year. Please revise the narrative.

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**Highly  
compensated  
employee**

Please explain why \_\_\_\_\_ is not a highly compensated employee. If the employee is indeed not a highly compensated employee, the test or narrative should have indicated why the employee is not a highly compensated employee. Top-paid group, recent hire, non-owner, not a wife or lineal descendant.

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## **Other issues that may arise, Continued**

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**Other  
nondiscriminati  
on issues**

- Check for 401(a)(17): 1998-1999 is \$160,000, 2000 is \$170,000, 2001 is \$170,000, 2002 is \$200,000.
- Check for Highly Compensated Employee - 414(q) look-back period  
Compensation: 1996 - 1999 is \$80,000, 2000 and 2001 is \$85,000 , 2002 is \$
- **For DC plans only**-Demonstration 4 indicates that the plan is aggregating a 401(k) plan with a defined benefit plan. This is not allowed. Secure a revised demonstration 4 or have the demonstration 4 withdrawn. If the request for demo 4 is withdrawn, return the demonstration 4 to the taxpayer.
- **For Cross tested plans** An ESOP may not cross test. See Treasury Regulation §1.401(a)(4)-8(b).
- Check for 415: 1999-2000, 2000 through 2001 is 35,000(25% comp), 2002 is 40,000 (100% comp).
- If forfeitures are allocated, check for forfeiture allocations i.e. check allocation formula. Forfeitures allocated must be added to employer 401(a) allocations. (I.e. included in demo 5 & 6 allocations).
- The allocations, reported on the Demonstration 6, do not match the allocations reported on the employee census in many cases. We need an explanation.
- Basis on which the plan is being tested: Item 2 of the narrative (explanation to demonstration 6) indicates that the plan is tested on a contributions basis. However, the test indicates it is cross-tested. In addition, the plan would fail on a contribution basis based on the facts presented.

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**Other issues that may arise, Continued**

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**Uniform Points allocation**    Under a uniform points allocation formula, each employee must receive the same number of points for each year of age, the same number of points for each year of service, and the same number of points for each unit of plan year compensation. Therefore, if you limit years of service counted to "continuous" years of service, not all employees will get the same number of point for each year of service. (Note the limit on the number of years counted is an acceptable limit allowed by the regulations). The formula should be revised to remove the requirement for continuous years of service or the schedule Q should be revised to request a general test. See Treasury Regulation §1.401(a)(4)-2(i)(A).

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**Procedure if taxpayer withdraws request**    Form 5300 item 14 indicates that the plan is a design based safe harbor. However, Treasury Regulation §1.401(a)(4)-3(e)(1) provides that a designed based safe harbor must provide a definition of Compensation for purposes of determination plan benefits that satisfies §414(s). The demonstration 9 submitted shows that the definition does not satisfy §414(s).

The demonstration 6 provided should not be reviewed until the taxpayer provides the additional user fee. Since this is not a termination the employer may choose not to have the demonstration 6 reviewed. If that is the case, the Demonstration six provided should be returned to the taxpayer along with the demonstration 9.

However, either way, the 5300 should be revised to show that the plan is not a design based safe harbor. In addition, since the plan fails demonstration 9 the employer should revise the schedule Q to withdraw the request to have a demonstration 9 reviewed. The taxpayer can still have both the demos 9 and 6 reviewed if the proper user fee is provided to the Service.

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**Other issues that may arise, Continued**

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**Use judgement  
when reviewing  
demos**

Just as in determination work and screening you must use judgment. Obviously the more problems with the demonstrations, the more likely you should get significant corrections.

In many cases, the taxpayer prepares the narrative while another firm prepares the tests or the test is generated by a software program that the taxpayer inputs.

- More times than not, the narrative preparer does not understand the demonstration fully and is doing its best to prepare the narrative.
  - If you can tell that the plan passes, even though there is confusion, determine the level of confusion. If you can tell the taxpayer passes this year, but confusion may lead to failure in a future, it would be best to get correction or provide clarification now.
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## Helpful Pronouncements and tables

### List of Cost-of-Living Pronouncements

YEAR	PRONOUNCEMENT	DATE PUBLISHED
2003	News Release IR-2002-111 and Notice 2002-71	10/18/02
2002	Notice 2001-84	11/20/01
2001	Notice 2000-66	11/29/00
2000	Notice 99-55	11/16/99
1999	Revenue Ruling 1998-53	11/29/98
1998	Notice 97-58	
1997	Notice 96-55	
1996	Notice 95-55	
1995	Notice 95-4	

### Key limits and thresholds

	1999	2000	2001	2002	2003
Defined Benefit Plans annual Benefits 415(b)(1)(A)	\$130,000	\$135,000	\$140,000	160000	160000
Annual Comp for SEP Participation 408(k)(2)	\$ 400	\$450	\$450	\$450	\$450
SIMPLE plan election deferral limit <408(p)(2)(A)>	\$6,000	\$6,000	\$6,500	\$ 7,000	\$8,000
HCE Any Employee <414(q)(1)(B)>	\$80,000	\$ 85,000	\$ 85,000	\$90,000	\$ 90,000
HCE Top-paid <414(q)(1)(C)>	n/a	n/a	n/a	n/a	n/a
HCE Officer <414(q)>	n/a	n/a	n/a	n/a	n/a
Key EE Officer <416(i)(1)(A)(i)>				\$ 130,000	\$ 130,000
Key EE 10 largest Owner <416(i)(1)(A)(ii)>				REPEALED	
Key EE 5% Owner <416(i)(1)(A)(iii)>	no min	no min	no min	no min	no min
Key EE 1% Owner <416(i)(1)(A)(iv)>	\$150,000	\$150,000	\$150,000	\$ 150,000	\$ 150,000
TWB	\$72,600	\$ 76,200	\$ 80,400	\$ 84,900	\$87,000
Annual Compensation for Determining Maximum Benefits and Contributions <401(a)(17)>	\$ 160,000	\$170,000	\$170,000	\$ 200,000	\$ 200,000
Max Employee deferral <402(g)(1)>	\$10,000	\$10,500	\$ 10,500	\$ 11,000	\$12,000
DC 415 \$limit <415(c)(1)(A)>	\$30,000	\$ 30,000	\$ 35,000	\$ 40,000	\$40,000
DC 415 Compensaiton limit	25%	25%	25%	100%	100%
PSP Deduction limit DC plans 404(a)(3)(A)	15%	15%	15%	25%	25%
Catch up contributions 414(v)	\$-	\$ -	\$ -	\$ 500	\$ 1,500
414(v)(2)(B)(i) Catch-up non 401(k)(11)	n/a	n/a	n/a	\$ 1,000	\$ 2,000
414(v)(2)(B)(i) Catch-up 401(k)(11)	n/a	n/a	n/a	\$500	\$1,000

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**Helpful Pronouncements and tables, Continued**

**Sample of APRs**

MONTHLY LIFE ANNUITY @ 65 FACTORS PAYABLE ANNUALLY (MALE)							
Interest Rate	83 IAM(m)	71 GAM(m)	U.P. '84	83 GAM(m)	GATT	GAR	71 IAM(m)
7.5%	9.459	8.399	8.457	8.935	9.524	9.695	9.056
8.0%	9.134	8.143	8.196	8.647	9.196	9.354	8.757
8.5%	8.828	7.900	7.949	8.375	8.889	9.035	8.476

MONTHLY LIFE ANNUITY @ 65 FACTORS PAYABLE MONTHLY (MALE)							
Interest Rate	83 IAM(m)	71 GAM(m)	U.P. '84	83 GAM(m)	GATT	GAR	71 IAM(m)
7.5%	113.508	100.788	101.484	107.22	114.288	116.34	108.672
8.0%	109.608	97.716	98.352	103.764	110.352	112.248	105.084
8.5%	105.936	94.800	95.388	100.500	106.668	108.420	101.712

MONTHLY LIFE ANNUITY @ 65 FACTORS PAYABLE ANNUALLY (FEMALE)							
Interest Rate	83 IAM(F)	71 GAM(F)	U.P. '84	83 GAM(F)	GATT	GAR	71 IAM(F)
7.5%	10.369	9.716	8.458	10.219	9.524	9.695	9.969
8.0%	9.980	9.377	8.196	9.843	9.196	9.354	9.614
8.5%	9.616	9.059	7.949	9.491	8.889	9.035	9.280

MONTHLY LIFE ANNUITY @ 65 FACTORS PAYABLE MONTHLY (FEMALE)							
Interest Rate	83 IAM(F)	71 GAM(F)	U.P. '84	83 GAM(F)	GATT	GAR	71 IAM(F)
7.5%	124.428	116.592	101.496	122.628	114.288	116.34	119.628
8.0%	119.76	112.524	98.352	118.116	110.352	112.248	115.368
8.5%	115.392	108.708	95.388	113.892	106.668	108.420	111.36