

## Treasury Finalizes New Comparability Regulations

### Treasury Agrees to 7 1/2% Allocation Rate Cap for DB/DC Combinations Retains 5% Minimum Contribution for DC Plans

Brian H. Graff, Esq. • ASPA Executive Director • Arlington, VA

The Department of Treasury and the Internal Revenue Service made public today final regulations prescribing certain conditions under which new comparability plans may continue to satisfy the nondiscrimination rules using cross-testing. As reported in previous *ASAPs*, since the beginning of last year Treasury and IRS have been reviewing new comparability plans, suggesting that these plans may disproportionately benefit HCEs in an inappropriate manner.

After the proposed regulations were issued last October, we filed extensive comments and were the only organization to testify at the public hearing. ASPA also had countless meetings with Treasury and IRS officials to discuss technical concerns with the proposed regulations. In particular, we focused on the impact of the proposed regulations on combination defined benefit/defined contribution plans. Under the proposed regulations, such combination plans could easily have minimum contribution requirements in excess of 15 percent of compensation and sometimes as high as 20 percent. ASPA appreciates the willingness of Treasury and IRS officials to listen to these concerns, as reflected in the changes made in the final regulations.

A more detailed summary of the proposed regulations is provided below. You can access an electronic version of the complete text of the regulations at <http://www.aspa.org/govpages/ASPAGovt.htm>.

As expected, the final regulations retain the "gateways" in the proposed regulations, which, if satisfied, permit a new comparability plan to continue to cross-test under the current nondiscrimination regulations. In general, this means that a new comparability plan may continue to cross-test if each eligible NHCE receives an allocation rate of at least 5% of compensation, or, if less, one-third of the highest allocation rate provided under the plan. A new comparability plan would not have to satisfy these gateways if it has broadly available allocation rates or certain age-based allocation rates. Further, the final regulations retain the proposed rules applicable to combinations of defined contribution and defined benefit plans that are intended to prevent circumvention of the gateway requirements through such combinations. However, in response to concerns raised by ASPA, the final regulations contain a 7 1/2 percent of compensation cap on any contribution that may be required under the rules applicable to such combination plans. Finally, the final regulations continue to restrict the use of component plans and permitted disparity for purposes of satisfying all of these rules.

As with the proposed regulations the rules contained in the final regulations are effective for plan years beginning on or after January 1, 2002, regardless of when the new comparability plan design was adopted.

Please note that these regulations are somewhat complex and this *ASAP* is only a summary. In the interest of providing you this information quickly, we have foregone a more detailed examination and analysis of the regulations. To the extent this more detailed examination and analysis reveals any significant errors in the summary below, we apologize, and we will certainly inform you immediately.

#### Summary of New Comparability Final Regulations

Under the final regulations, a new comparability plan can continue to satisfy the nondiscrimination rules through cross testing if the plan design satisfies one of two possible gateways. Alternatively, a new comparability plan may continue to cross-test if the plan's allocation rates are considered "broadly available" or if the plan uses age-based allocation rates that satisfy certain requirements. Finally, the proposed regulations contain special rules applicable when combinations of defined contribution plans and defined benefit plans are cross-tested. The final regulations also contain special rules for new comparability plans with grandfathered allocation rates provided to employees who formerly participated in a defined benefit plan or are provided to a group of employees in connection with a merger, acquisition, or other similar transaction. Since these rules appear to have limited application to small plans they are not discussed here.

#### Minimum Contribution Gateway

A new comparability plan will be allowed to continue to satisfy the nondiscrimination rules under the current cross-testing regime provided each eligible NHCE receives an allocation rate of at least 5% of compensation (as defined in Section 415(c)(3)). In response to concerns raised by ASPA, the final regulations allow compensation to be defined for this purpose to only include amounts paid during the period of participation within the plan year. Also, only employees benefiting under the plan within the meaning of the nondiscrimination regulations are entitled to a minimum contribution. So, for example, a plan with a "participation on the last day of the plan year provision" would not have to give a minimum contribution to employees terminated earlier in the year.

#### Alternative Minimum Contribution Gateway

A new comparability plan may provide a minimum allocation rate of less than 5%, provided that the minimum allocation rate is not less than one-third of the highest allocation rate. For example, if the top allocation rate under the plan were 12%, the minimum allocation rate for NHCEs would have to be 4%. (Note that in calculating allocation rates for this gateway or the gateway applicable to DB/DC combinations, a definition of compensation that satisfies section 414(s) may be used.) Like the minimum contribution gate-

way, a new comparability plan that satisfies this gateway could continue to cross-test. Further, the regulations provide that elective deferrals do not count in determining allocation rates. Consequently, if the new comparability plan is combined with a 401(k) plan and HCEs defer under the 401(k) plan, the highest allocation rate for HCEs may be lower than they otherwise would have been, which in turn will reduce the minimum required allocation. Also, any nonelective contributions made under the 401(k) plan will count toward the minimum allocation requirement.

### **Broadly Available Allocation Rates**

Under the final regulations, a new comparability plan will not have to satisfy the minimum contribution gateways if its allocation rates are considered broadly available. A new comparability plan is considered to have broadly available allocation rates if each allocation rate under the plan is currently available to a group of employees that satisfies section 410(b) (without regard to the average benefits test). This is the same current availability test applicable to benefits rights and features under the nondiscrimination regulations. The final regulations permit two allocation rates to be aggregated for this purpose provided the higher allocation rate independently satisfies section 410(b) (without regard to the average benefits test). Also, in determining whether a plan has broadly available allocation rates, differences in allocation rates resulting from any method of permitted disparity are disregarded. Small business retirement plans are generally not expected to be able to take advantage of these rules.

### **Plans with Age-Based Allocations**

New Comparability Plans will also not need to satisfy the minimum contribution gateways under the regulations if the plan's allocation rates are provided pursuant to a "gradual age or service schedule" or a "uniform target benefit allocation."

Under the final regulations, a plan is considered to have a gradual age or service schedule if two requirements are satisfied. First, the plan provides for a single schedule of allocation rates defined as a series of bands based solely on age, years of service, or the number of points representing the sum of age and service, and under which the same allocation rate applies to all employees within each band. Second, the allocation rates under the schedule satisfy a mathematical requirement that demonstrates that the allocation rates "increase smoothly" at "regular intervals."

A schedule of allocation rates is considered to "increase smoothly" if the allocation rate for each band is greater than the immediately preceding allocation rate (i.e., the band with the next lower number of years of age or service), but by no more than five percentage points. However, a schedule of allocation rates will still not be treated as "increasingly smoothly" if the ratio of the allocation rate for any age or service band to the allocation rate for the immediately preceding band is more than 2.0 or if it exceeds the ratio of allocation rates between the two immediately preceding bands.

A schedule of allocation rates is deemed to have "regular intervals" if each band, other than the last band associated with the highest age, service, or age and service points, is the same length. If the schedule is based on age and the first band ends at or before age 25, the first band is deemed to be the same length as the other bands. If the first band ends after age 25, then in determining whether the length of the first band is the same as the length of the other bands, the starting age for first band can be treated as age 25 or any earlier age. For a schedule of allocation rates based on service, the starting service for the first

service band is permitted to be treated as one year of service or any lesser amount of service. Note that there is no requirement in the regulations that at least one participant actually benefit under each band.

In response to comments made by ASPA, the final regulations provide that a plan's schedule of allocation rates does not fail to increase smoothly at regular intervals merely because a specified minimum uniform allocation rate is provided to all employees or the top-heavy minimum is provided to all non-key employees (whether or not the plan is top-heavy), provided that one of two alternative conditions in the regulations designed to prevent abuse are satisfied.

In response to comments made by ASPA, the final regulations clarify that safe harbor target benefit plans are exempted from the minimum contribution gateways. The exception to the minimum contribution gateways also applies to non-safe harbor target benefit plans with a uniform target benefit allocation. Under the final regulations, a plan has a uniform target benefit allocation if it would comply with requirements for a safe harbor target benefit plan, except that the rate for determining the actuarial present value of the stated plan benefit and the theoretical reserve is lower than a standard interest rate, the stated benefit is calculated assuming compensation increases, or the plan computes the current year contribution using the actual account balance instead of the theoretical reserve.

### **Combination Defined Contribution and Defined Benefit Plans**

The regulations contain rules intended to prevent circumvention of gateway requirements through cross testing of a DC/DB plan combination. Under the regulations, a DC/DB combination may satisfy nondiscrimination through cross testing if it meets one of three requirements. The combination must either (1) be "primarily defined benefit in character;" (2) consist of "broadly available separate plans;" or (3) satisfy a gateway requirement.

A combination plan will be treated as primarily defined benefit in character if, for more than 50% of NHCEs benefiting, the normal accrual rate attributable to benefits under the DB plan for NHCEs exceeds the equivalent accrual rate attributable to contributions under the DC plan for the same NHCEs.

A combination plan is generally treated as consisting of broadly available separate plans if the defined contribution plan and the defined benefit plan would each separately satisfy the mathematical nondiscriminatory classification test.

To determine if the gateway for combination plans is satisfied, the allocation rates under the DC plan and the equivalent allocation rate under the DB plan for each employee are aggregated. If the aggregate allocation rate of the HCE with the highest aggregate allocation rate is less than 15%, then the aggregate allocation rate for all NHCEs must be at least one-third of such HCE's aggregate allocation rate. If the aggregate allocation rate of the HCE with the highest aggregate allocation rate is between 15% and 25%, the aggregate allocation rate for NHCEs must be at least 5%. If the HCE rate exceeds 25%, then the allocation rate for NHCEs must be at least 5% plus one percentage point for each five percentage point increment (or portion thereof) by which the HCE rate exceeds 25%. However, as stated earlier, in response to concerns raised by ASPA, in no case will a combination plan be required to provide NHCEs with an aggregate allocation rate that exceeds 7 ½ percent of compensation.