ASPPA Files Comments on Proposed New Comparability Regulations

January 5, 2001

CC:M&SP:RU(REG-114697-00)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

We are writing to comment on regulations proposed regarding the nondiscrimination requirements for certain defined contribution plans that appeared in the Federal Register on October 6, 2001. In general, the proposed regulations would detail conditions under which certain defined contribution plans – often called "new comparability plans" – may satisfy the nondiscrimination requirements based on benefits rather than plan contributions. In addition to submitting these written comments, we respectfully request an opportunity to speak at the public hearing on these proposed regulations currently scheduled to occur on January 25, 2001.

The American Society of Pension Actuaries (ASPPA) is a national organization of over 4,000 benefits professionals who provide actuarial, consulting, and plan administrative services to over one-third of the qualified retirement plans. The vast majority of these plans are maintained by small businesses and many of these plans would be directly affected by the regulations being proposed. Accordingly, we believe ASPPA's members are uniquely qualified to comment on the policy and technical implications of the proposed regulations.

During the preparation of these proposed regulations we submitted, to the Department of Treasury Office of Benefits Tax Counsel, the results of a survey of new comparability plans. This survey of over 10,000 new comparability plans demonstrated that these plans not only provide valuable retirement coverage for small business employees but also expand access to those who previously had no coverage. In fact, 58% of the plans surveyed were adopted by small businesses with no previous retirement plan coverage. Clearly, new comparability plans are an effective method for providing retirement plan coverage to a sector of the workforce that is generally lacking in coverage. Accordingly, we believe it is critical for the health of the private pension system to retain a viable new comparability plan option for small business.

We would like to begin our comments by thanking those staff members of the Department of Treasury Office of Benefits Tax Counsel and the Internal Revenue Service who met with us as well as representatives of other interested organizations several times to discuss issues surrounding this regulation project. We believe these productive discussions afforded an opportunity to uncover important and varying points of view on the subject that hopefully contributed to your internal deliberations while preparing the proposed regulations. In the future, we would encourage you to continue the practice of conducting these informal discussions prior to proposing other new regulations.

It should be no surprise, then, that our most significant comments and concerns focus on the one area of the proposed regulations where there was no discussion prior to their issuance. Specifically, we are talking about the provisions in the proposed regulations relating to combination defined contribution/defined benefit plans.

The preamble to the proposed regulations states that the rules applicable to combination plans are intended to prevent circumvention of the 5% minimum contribution gateway through a combination plan approach. We recognize and agree on the importance of creating rules to restrict such circumvention of the minimum contribution gateway. However, the rules applicable to combination plans actually proposed go well beyond the stated intent in the preamble. Ultimately, we believe these rules, if finalized in their current state, would cause businesses to abandon their defined contribution plans to the ultimate detriment of rank-and-file small business workers.

Typically, small businesses adopt defined benefit plans because such plans are an effective way to permit longer service employees to catch-up with respect to their retirement savings. These longer service employees have previously not been covered by a retirement plan because the small business has been devoting its resources to

developing the business. Younger workers, on the other hand, prefer retirement benefits through a defined contribution plan because of their portability. A combination defined benefit/defined contribution plan approach allows the small business to catch-up the retirement savings of longer service workers while providing retirement benefits to younger workers that they appreciate.

Unfortunately, if the proposed rules applicable to combination plans are allowed to be made final, it is extremely unlikely that any small business would ever adopt a combination plan approach. Instead, as will be demonstrated, the small business will adopt a stand-alone defined benefit plan that, although satisfying the needs of the longer service workers, does not address the needs of younger workers. This is particularly problematic given today's tough labor market and the need for small businesses to attract younger workers.

The reason small businesses will abandon their defined contribution plans is quite clear. Under the proposed regulations, if a small business adopts a combination plan approach, it would not be unusual for the small business to be required to make defined contribution plan allocations between 15 to 20 percent of pay, and sometimes more. This would often triple or quadruple the cost of maintaining the defined contribution plan, and would be an unsupportable expense for most small businesses. Exhibit A of this letter details a series of examples on how this could happen.

It is important to emphasize that the examples provided in Exhibit A would **not** be unusual. Rather their occurrence would be expected and, given their likelihood, consultants would advise their clients to avoid a combination plan approach given its potential excessive cost. Instead, as also demonstrated in Exhibit A, consultants will advise their clients to adopt stand-alone defined benefit plans of varying designs where the costs are significantly less and the benefits are often less valuable to the younger rank-and-file workers.

Simply put, although the objective of avoiding circumvention of the 5% minimum contribution gateway as stated in the preamble is appropriate, the proposed rules go significantly beyond that. Instead of protecting participants, they will lead to the abandonment of defined contribution plans that provided valuable benefits to small business employees. As a matter of retirement policy, encouraging this change in behavior makes no sense and produces effects that we presume were not intended.

Exhibit B to this letter details a proposal for combination plans that will effectively avoid circumvention of the 5% minimum contribution gateway, but will not result in the abandonment of defined contribution plans to the detriment of younger small business employees. In general, the proposal suggests a gateway for the defined benefit plan similar to the proposed gateway for a stand-alone defined contribution plan. Employees covered only by the defined benefit plan would have to receive a minimum accrual equal to the lesser of (a) one-third of the highest accrual rate provided under the plan or (b) a 2% accrual rate. Employees covered only by the defined contribution plan would generally receive the same minimum contribution as if they were covered by a stand-alone defined contribution plan. However, in no case would these employees receive less than a 5% minimum contribution.

Exhibit C to this letter contains a series of technical comments applicable to the proposed regulations overall. Given their technical nature and their importance, in addition to discussing these items at the public hearing, we would appreciate the opportunity to meet with you to discuss them in person at your earliest convenience. Please contact Brian Graff at the ASPPA office (703/516-9300) to arrange a meeting time.

Thank you for your consideration of these comments.

Sincerely,

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Exhibit A

Examples Demonstrating Why Small Businesses Will Abandon Their Defined Contribution Plans Under the Proposed Regulations**

1) Consider a plan with a benefit formula of 5% of average pay per year, where average pay is the average of the highest 3 consecutive year's compensation. Consider a key employee on 12/31/2005 whose service began on 1/1/1986. Assume that the employee was born on 12/31/1940, so the employee is 65 on 12/31/2005. Assume that the employee compensation has increased each year, and most recently the compensation history looks as follows:

2002 - 95,000

2003 - 100,000

2004 - 105,000

2005 - 110,000

Under these circumstances the accrued benefit as of 12/31/2004 would be based upon the service and average compensation as of that date. As of 12/31/2004 the employee would have 19 years of service and 3 year average compensation 100,000. The accrued benefit would be 5% X 19 years X 100,000 or 95,000.

Similarly the accrued benefit as of 12/31/2005 would be based on 20 years of service and 3 year average compensation of 105,000 or an accrued benefit of 105,000.

The increase during the plan year would be 105,000 – 95,000 or 10,000. Using the lowest allowable APR, this would produce an equivalent contribution of 10,000 X $8.41 or $84,100. Expressed as a percentage of pay this would be 84,100 / 110,000 or 76%.

This would require a minimum aggregate allocation gateway of 5% increased by one percentage point for each 5-percentage-point increment (or portion thereof) that the 76% exceeds 25%. Because 76% exceeds 25% by 51%, the minimum aggregate allocation gateway would be **16%.**

Consider approaches that the employer might take to alternatively satisfy the regulations. Assuming 5 non-highly compensated employees, a comparison of a 5% Defined Contribution plan to the new 16 % required allocation level would look as follows:

Age	Comp	5% Allocation	EBAR	New DC Allocation	EBAR
20	20,000.00	1,000.00	23.36	3,200.00	74.76
25	25,000.00	1,250.00	15.54	4,000.00	49.72
30	30,000.00	1,500.00	10.33	4,800.00	33.06
35	35,000.00	1,750.00	6.87	5,600.00	21.99
40	40,000.00	2,000.00	4.57	6,400.00	14.62
Totals		7,500.00		24,000.00	

Thus, the proposed regulations more than triple the cost of maintaining both a defined contribution and a defined

benefit plan. Note that EBARs were calculated using 8.5% interest and 71GAM.

Alternatively, the key employee could receive the same level of benefits through a stand-alone defined benefit plan covering all employees. Some potential stand-alone defined benefit plan designs that would satisfy the regulations are as follows:

Age	Comp	5% DB Ben	EBAR	Value	Flat Dollar	EBAR	Value	Cash Balance	EBAR	Value
20	20,000	1,000.00	5.00	773	1,250.00	6.25	967	1,344.65	6.72	1,040
25	25,000	1,250.00	5.00	1,294	1,250.00	5.00	1294	1,256.01	5.02	1,300
30	30,000	1,500.00	5.00	2,078	1,250.00	4.17	1731	1,126.27	3.75	1,560
35	35,000	1,750.00	5.00	3,244	1,250.00	3.57	2317	981.89	2.81	1,820
40	40,000	2,000.00	5.00	4,961	1,250.00	3.13	3101	838.54	2.10	2,080
	Totals			12,350			9410			7,800

Notice that if the ratio of Non-Highly Compensated Employees to Highly Compensated Employees was 5 to 1, that the Concentration Percentage would be 83%. This would produce a Safe Harbor Percentage of 32.75%, an Unsafe Harbor Percentage of 22.75% and a midpoint of 27.75%. The lowest Average Benefit Percentage of the above plan designs is 80%, and the lowest ratio percentage for this Highly Compensated Employee would be 40% (Note that the Highly Compensated Employee would have an EBAR of 5% testing on an accrued-to-date basis).

The Present Value column indicates the lump sum the participant would receive if paid out using 417(e) rates, and assuming an interest rate of 6%. The Cash Balance plan is based upon a hypothetical contribution of 5.2% of pay, projected to retirement and converted to an annuity using 417(e) rates.

Most of the employees in a case like this would prefer to be in a 5% defined contribution plan. However, the cost of the required defined contribution plan (16%) would be so large in comparison to any of the defined benefit only arrangements, it is most likely that the employer would choose to use a defined benefit only approach.

2) Consider a similar plan to the one above. Assume that the plan requires 1,000 hours in order to receive credit for a year of service. Assume that the employee works full time until 7/1/2005, and then retires on that date. Assume that because of this the 2005 compensation is only 55,000.

As in the prior example the 12/31/2004 accrued benefit would still be 95,000, but the 12/31/2005 average compensation would remain at the 12/31/2004 level of 100,000, so the 12/31/2004 accrued benefit would only be 100,000.

While the increase in accrued benefit during the plan year would fall to only 5,000, the equivalent contribution rate would be based on plan year compensation of only 55,000, producing an equivalent contribution rate of 5,000 X $8.41 / 55,000 or 76.45%. Because 76% exceeds 25% by 51%, the minimum aggregate allocation gateway would remain at **16%** of pay.

As in example 1) above, the employer would have the same options as shown above.

3) Consider a plan in which an employee accrues the 415 maximum dollar benefit each year. The employee first becomes a participant on 1/1/1996. The employee turns 65 on 12/31/2005. If the 415 dollar limit for a person born in 1940 is 140,000 in 2004 and 145,000 in 2005 then this employee's accrued benefit on 12/31/2004 would be 140,000 X 9 / 10 (due to the reduction for less than 10 years of participation), or 126,000. The accrued benefit on 12/31/2005 would be 145,000. If the employee earned 170,000 during 2005 the equivalent accrual rate would be (145,000 – 126,000) X 8.41 / 170,000 or 94%. Because 94% exceeds 25% by 69%, the minimum aggregate allocation gateway would be **19%**.

Like in example 1), the employer could consider a number of designs, but unlike example 1), the Highly Compensated Employee would have an EBAR of approximately 8.5%. Consider approaches that the employer might take to satisfy the regulations. A comparison of a 5% Defined Contribution plan to the new required 19% allocation level would look as follows:

Age	Comp	5% Allocation	EBAR	New DC Allocation	EBAR
20	20,000.00	1,000.00	23.36	3,800.00	88.78
25	25,000.00	1,250.00	15.54	4,750.00	59.04
30	30,000.00	1,500.00	10.33	5,700.00	39.26
35	35,000.00	1,750.00	6.87	6,650.00	26.11
40	40,000.00	2,000.00	4.57	7,600.00	17.37
Totals		7,500.00		28,500.00	

Thus, in this case the proposed regulations would nearly quadruple the cost of maintaining both a defined contribution and a defined benefit plan. Note again that EBARs were calculated using 8.5% interest and 71GAM.

Some potential alternative stand-alone defined benefit plan designs that would satisfy the regulations are as follows:

Age	Comp	8.5% DB Ben	EBAR	Value	Flat Dollar	EBAR	Value	Cash Balance	EBAR	Value
20	20,000	1,700.00	8.50	1,315	2,125.00	10.63	1644	2,275.57	11.38	1,760
25	25,000	2,125.00	8.50	2,199	2,125.00	8.50	2199	2,125.55	8.50	2,200
30	30,000	2,550.00	8.50	3,532	2,125.00	7.08	2943	1,906.00	6.35	2,640
35	35,000	2,975.00	8.50	5,514	2,125.00	6.07	3939	1,661.65	4.75	3,080
40	40,000	3,400.00	8.50	8,434	2,125.00	5.31	5271	1,419.07	3.55	3,520
	Total			20,994			15996			13,200

The Cash Balance plan is based upon a hypothetical contribution of 8.8% of pay, projected to retirement and converted to an annuity using 417(e) rates.

As in example one, most employees would prefer the 5% defined contribution approach. However, the cost of the defined benefit only approach would be so much less than the 19% required allocation, that the employer would most likely opt for one of those choices.

4) Consider a plan that previously had a benefit formula of 1% of average pay per year of service. If the plan formula is now increased to 1.5% of average pay per year of service the impact could be significant. Assume an employee who has always earned 100,000. Assume that the employee was born 12/31/1940 and receives service credit from 1/1/1986. On 12/31/2004 the accrued benefit (under the old formula) would be 19 years X 1% X 100,000 or 19,000. On 12/31/2005 the accrued benefit (under the new formula) would be 20 years X 1.5% X 100,000 or 30,000. The equivalent accrual rate would be (30,000 – 19,000) X 8.41 / 100,000 or 93%. Because 93% exceeds 25% by 68%, the minimum aggregate allocation gateway would be **19%**.

In this case the Highly Compensated Employee would have an EBAR of 1.5% using the accrued-to-date method. Consider approaches that the employer might take to satisfy the regulations. A comparison of a 5% Defined Contribution plan to the new 19% required allocation level would look as follows:

Age	Comp	5% Allocation	EBAR	New DC Allocation	EBAR
20	20,000.00	1,000.00	23.36	3,800.00	88.78
25	25,000.00	1,250.00	15.54	4,750.00	59.04
30	30,000.00	1,500.00	10.33	5,700.00	39.26
35	35,000.00	1,750.00	6.87	6,650.00	26.11
40	40,000.00	2,000.00	4.57	7,600.00	17.37
Totals		7,500.00		28,500.00	

Again, in this case the proposed regulations would nearly quadruple the cost of maintaining both a defined contribution and a defined benefit plan. EBARs were calculated using 8.5% interest and 71GAM.

Because the EBAR for the Highly Compensated Employee is less than the Top Heavy minimum, a plan providing the Top Heavy minimum only would satisfy testing and would look as follows:

20	20,000	400.00	2.00	309
25	25,000	500.00	2.00	518
30	30,000	600.00	2.00	831
35	35,000	700.00	2.00	1,298
40	40,000	800.00	2.00	1,984
	Total			4,940

Again, the stand-alone defined benefit plan is significantly less costly than the 19% required allocation defined contribution plan.

5) Consider the same plan as the one above. Assume that the employee had terminated on 2/1/2005, after earning 10,000, but without getting credit for the 2005 plan year. As above the 12/31/2004 accrued benefit would be 19,000, but now the 12/31/2005 accrued benefit would only reflect the increase in the formula, or 19 years X 1.5% X 100,000 or 28,500. The equivalent accrual rate would be (28,500 – 19,000) X 8.41 / 10,000 or 799%. Because 799% exceeds 25% by 774%, the minimum aggregate allocation gateway would be **160%**.

In this situation it would not be possible for the employer to satisfy the requirements of the minimum aggregate allocation gateway because they are so high and would violate the Code section 415(c) limits.

Consider this same plan, but instead assume that this employee had only 5 years of past service and was only age 50. In that case the accrued benefit on 12/31/2004 (under the old formula) would be 4 years X 1% X 100,000 or 4,000. On 12/31/2005 the accrued benefit (under the new formula) would be 5 years X 1.5% X 100,000 or 7,500. The equivalent accrual rate would be (7,500 – 4,000) X 8.41 / 10,000 discounted for 15 years at a discount rate of 8.5% or 86%. Because 86% exceeds 25% by 61%, the minimum aggregate allocation gateway would be **18%**.

The employer's options would be similar to those in example 4), and it is highly unlikely that the employer would elect to choose the Defined Contribution plan option.

6) Consider a Top Heavy plan. An employee is hired and enters the plan on 7/1/2000. The employee has the following salary history:

2000 20,000 (note a partial years' compensation)

2001 90,000

2002 110,000

2003 130,000

2004 150,000

2005 120,000

On 12/31/2004, average compensation would be 100,000. On 12/31/2005, average compensation would be 120,000. The 12/31/2004 accrued benefit would be 2% X 5 years X 100,000 or 10,000. The 12/31/2005 accrued benefit would be 2% X 6 years X 120,000 or 14,400. Assuming that the employee is 65 on 12/31/2005, the equivalent accrual rate would be (14,400 – 10,000) X 8.41 / 120,000 or 31%. Because 31% exceeds 25% by 6%, the minimum aggregate allocation gateway would be **7%**.

Because this plan is only providing Top Heavy minimums, it is most likely that the employer would be comparing benefits at only the Top Heavy minimum. A comparison of a 3% Defined Contribution plan (the Top Heavy minimum) to the new required allocation level would look as follows:

Age	Comp	3% Allocation	EBAR	New DC Allocation	EBAR
20	20,000.00	600.00	14.02	1,400.00	32.71
25	25,000.00	750.00	9.32	1,750.00	21.75
30	30,000.00	900.00	6.20	2,100.00	14.47
35	35,000.00	1,050.00	4.12	2,450.00	9.62
40	40,000.00	1,200.00	2.74	2,800.00	6.40
Totals		4,500.00		10,500.00	

Here, the proposed regulations would more than double the cost of maintaining the defined contribution plan. EBARs were calculated using 8.5% interest and 71GAM.

A Defined Benefit Top Heavy minimum would look as follows:

Age	Comp	Top Heavy	EBAR	Value
20	20,000	400.00	2.00	309
25	25,000	500.00	2.00	518
30	30,000	600.00	2.00	831
35	35,000	700.00	2.00	1,298
40	40,000	800.00	2.00	1,984
	Total			4,940

Most Non-Highly compensated employees would prefer the 3% Defined Contribution plan over the Defined Benefit plan. However, while the employer likely would choose a 3% Defined Contribution plan, it is highly unlikely that the employer would select the 7% Defined Contribution plan over the 2% Defined Benefit plan.

**The above examples were generated pursuant to the following rules:

1) An equivalent allocation rate is defined at Treasury regulation section 1.401(a)(4)-8(c)(2) as "the actuarial present value of the increase over the plan year in the benefit that would be taken into account in determining the employee's normal or most valuable accrual rates for the plan year, expressed as a dollar amount or as a percentage of the employee's plan year compensation."

2) The rules for determining the present value are in the next paragraph, at Treasury regulation section 1.401(a)(4)-8(c)(2)(i). This rule requires the use of a standard interest rate and mortality for determination of the conversion of an annuity into a single sum (which we will call the Annuity Purchase Rate or APR). In addition the rule requires the use of a standard interest rate (with no mortality) for adjustment from one point in time to another (which we will call the discount rate). Standard interest rates and standard mortality rates are defined in 1.401(a)(4)-12. This would mean that the highest APR allowed would be determined using 7.5% interest and the 1983 Individual Annuity Mortality Table (1983 IAM) (Female). This produces a cost of $10.37 per dollar per year payable monthly. The lowest APR allowed would be determined using 8.5% interest and 1971 Group Annuity Mortality Table (1971 GAM) (Male). This produces a cost of $8.41 per dollar per year payable monthly. The highest discount rate allowed would be 8.5% and the lowest 7.5%

3) The benefit taken into account for determining the employee's normal or most valuable accrual rate is indicated at 1.401(a)(4)-3(d)(1)(i) and (ii) in particular with reference to the accrued benefit "within the meaning of IRC section 411(a)(7)(A)(i). 1.401(a)(4)-(3)(d)(2) indicates that "If plan benefits are not expressed as straight life annuities beginning at employees' testing ages, they must be normalized." For simplicity we will assume that all benefits to be discussed are expressed in the form of a straight life annuity beginning at the employees' testing age, and that the testing age is age 65 (testing age is defined in 1.401(a)(4)-12).

4) Plan year compensation is defined in regulation 1.401(a)(4)-12 as section 414(s) compensation during a) the plan year, b) during a 12-month period ending during the plan year, or c) during the period of the plan year that the employee was a plan participant.

Exhibit B

Proposed Rules Relating to DB/DC Combinations

A. DB/DC Combinations

1) As under the proposed regulations, a DB/DC combination that is primarily defined benefit in character or that provides broadly available separate plans is not required to provide gateways.

B. Gateways

1) For Employees Participating in Only the Defined Benefit Plan

a) Except as described at Subsection 2 of this section, the DB gateway is expressed in terms of an accrual for each year of service.

i The analog to the DC 1/3 rule is a (career pay) accrual equal to 1/3 the highest HCE accrual rate, with a normal form, a normal retirement age, and a limit on accrual service identical to the rules applicable to the highest HCE accrual rate.

(a) This 1/3 relationship is determined at the date a plan or amendment is established, and need not be revisited each year.

ii The analog to the DC 5% rule is a (career pay) accrual equal to 2% (without limit on accrual service) payable as a life annuity at the later of age 65 and the fifth anniversary of participation.

(a) A plan providing the top-heavy minimum is deemed to satisfy this 2% minimum.

b) If the DB component is entirely cash balance, the DB gateway may be expressed in cash balance terminology, following the format of the DC gateway.

2) For Employees Participating in Only the Defined Contribution Plan

a) The gateway rules for employees participating in only the defined contribution plan are generally the same as the rules where defined contribution plans are not part of a DB/DC combination. However, in no case would a participant receive less than a 5% minimum contribution.

3) For Employees Participating in Both Plans

a) The proposed rules where an employee participates in both plans is analogous to current top-heavy rules applicable where participants are covered under both defined benefit and defined contribution plans and both are top-heavy.

i These rules are articulated at Regs. Sec. 1.416-1 Q&A M-12. For convenience, we quote from M-12, adding numbering simply to facilitate analysis:

“There are four safe harbor rules a plan may use in determining which

minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans.

(a) “Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top-heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied.

(b) “Another approach that may be used is a floor offset approach (see Rev. Rul. 76-259, 1976-2 C.B. 111) under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan.

(c) “Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis (see Rev. Rul. 81-202, 1981-2 C.B. 93) that the plans are providing benefits at least equal to the defined benefit minimum.

(d) “Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the section 416 minimums.”

ii Analogizing, the proposed gateway would offer the sponsor three options, where an employee is a participant in both plans. Any one of these options would be deemed to satisfy, completely, the sponsor’s gateway obligation:

(a) Provide the defined benefit gateway described at Section A,

(b) Provide the defined contribution gateway described at Section B, or

(c) Use a defined contribution allocation to provide part of the gateway and a defined benefit accrual to provide the remainder, demonstrating that the total is comparable to either the defined benefit or the defined contribution gateway.

iii It will be observed that the defined contribution gateway already reflects the enhancement integral to the 5% top-heavy safe harbor option.

(a) This means the floor offset arrangement offered by the top heavy regulations is unnecessary in the context of gateways. A sponsor willing to provide the “offset” (the DC gateway) will already have satisfied the safe harbor option. The “floor” (the DB gateway) becomes irrelevant.

(b) Consider the comparability option. The DC gateway has already been enhanced to a level where it can be deemed equivalent to the DB gateway. Hence, the sponsor wishing to use the comparability option may use either the DC gateway or the DB gateway as the standard to which the program’s combination of benefits and allocations must

adhere.

Exhibit C

Proposed New Comparability Regulations
Technical Comments

A. DB/DC Combinations

1) The provisions regarding DB/DC combinations are much more severe than those applicable solely to defined contribution plans.

a) The rules appear to cast a much wider net than one intended to apply solely to "new comparability" plans.

b) The required gateways are potentially onerous.

i Especially with younger NHCEs, they could lead the small business to eliminate their defined contribution plan.

(a) For example, it would not be unusual for a combination plan to necessitate a gateway minimum contribution in excess of 10% of pay.

c) There is no assurance that a gateway workable in a current year will be adequate in future years. This is true even when the potential inadequacy is due entirely to the manner in which defined benefit plans traditionally work.

i Exhibit A illustrates the manner in which equivalent allocations for an HCE can be subject to unexpected "spikes," resulting in very high (larger than 10%) minimum contribution requirements.

2) One possible approach to rewriting the rules on gateways for DB/DC combinations is set forth in Exhibit B.

3) It should be clarified that in determining benefit equivalencies it is acceptable to use accrued-to-date and fresh start techniques.

4) Sometimes, in demonstrating that a plan or combination satisfies nondiscrimination rules, it is necessary to examine an entirely separate plan merely to show that the 70% average benefit percentage rule is satisfied. It should be clarified that this reason alone will not cause the unrelated plan to become part of a DB/DC combination.

a) Suppose, for example, that Plans A and B constitute a DB/DC combination being aggregated and general-tested. Suppose certain rate groups in the combination satisfy the safe harbor coverage ratio but fail to satisfy a 70% ratio test under IRC section 410 (b).

b) It becomes necessary to demonstrate satisfaction of the 70% average benefit percentage rule.

c) Suppose the sponsor also maintains Plan C, a CODA that satisfies coverage requirements independently. Existing regulations require that the sponsor include Plans A, B, and C in the 70% average benefits percentage test.

d) However, it would be inappropriate to consider Plan C as part of the DB/DC combination.

5) It should be optionally permissible to use contributions rather than benefits in demonstrating that a DB/DC combination is primarily defined benefit in character.

6) It is hoped that rules similar to the proposals in Exhibit B will replace the approach outlined in the proposed regulations. If not, benefits under a defined benefit plan will need to be converted to equivalent contributions. Under current general testing rules, this process involves inherent discrepancies between techniques with defined benefit plans and those with defined contribution plans. Ways should be established to eliminate these discrepancies.

a) One discrepancy involves the treatment of investment results.

i Consider a cash balance plan with floating investment credits. A substantial increase in investment credits will increase the annual accrual. In turn, this will lead to a higher equivalent contribution.

ii This problem can be eliminated if it is deemed permissible to recast the prior year-end accrued benefit using the current year's investment credit.

iii Alternatively, the problem could be eliminated if it were permissible to use the equivalent of an accrued-to-date approach in performing contributions testing.

b) Another discrepancy involves the impact of amendments increasing past service benefits.

i This problem can be eliminated if it is deemed permissible to recast the prior year-end accrued benefit as if the amendment had previously been in place.

ii Here, too, an alternative solution would involve permitting contributions testing to be performed using the equivalent of an accrued-to-date approach.

c) Still another discrepancy involves the impact of a significant pay increase in a final pay plan.

i This problem could be eliminated if it were deemed permissible to recast the prior year-end balance as if the higher pay level had already been in place.

ii Alternatively, an accrued-to-date approach would solve the problem here, too.

B. Defined Contribution Plans

1) It should be clarified that gateway allocations in a year are necessary only for employees benefiting in that year. It should be clarified that for this purpose employees who would not benefit in the absence of special top-heavy rules are deemed not benefiting.

2) It should be clarified that a broadly available formula can be one in which permitted disparity is imputed.

a) Where this is done, the percentages derived in the imputation process are the ones

tested against the smoothly increasing criteria.

b) In plans providing step-rate formulas, the permitted disparity breakpoint should not have to be the FICA base. Instead, if the plan provides a lower breakpoint, the formula should nevertheless qualify as broadly available.

3) The 5% gateway should not have to be based on §415(c) compensation. Instead, a definition calling for the inclusion of all forms of taxable compensation should be acceptable provided it satisfies §414(s). For example, allocations for mid-year entrants should not have to be based on compensation for the entire limitation year.

4) The regulations should clarify the parameters for defining intervals based on service.

a) We propose that the intervals may be based on whole years of service only or include fractional years of service.

b) The regulations should use section 411(a) as the standard, allowing a plan to exclude any years of service that could be excluded under section 411(a)(4), so long as the definition was applied consistently to all employees benefiting under the plan.

c) If the service intervals are based on fractional years, the regulations could require that service be determined under an elapsed time method or under a prorated hours requirement based on 1,000 hours equaling an full year.

5) It should be clarified that a plan may provide an across the board minimum allocation percentage without destroying the broadly available nature of the formula.

6) It should be permissible for the lowest band in a broadly available formula to cover as broad an age group or as many years of service as desired.

7) After defining a broadly available formula, it should be permissible to specify that allocations for certain HCEs will be pegged at levels lower than the level specified by the formula.

8) Intervals defined by a combination of service points and age points should be acceptable bases for a broadly available defined contribution formula.

a) Comments were solicited on this subject. There appears to be no social purpose served in excluding these “points formulas” from the definition of a broadly available formula.

9) It should be clarified that:

a) A safe harbor target benefit plan provides a broadly available defined contribution formula.

b) A safe harbor floor-offset plan provides a broadly available formula and is not subject to DB/DC combination rules.

10) It should be permissible to fashion a broadly available formula under which allocations are expressed as dollar amounts rather than percentages of pay.

11) It should be clarified that a plan need not use a fixed contribution formula in order to satisfy the broadly available test (including the smoothly increasing, regular age or service intervals approach).

a) This will recognize two basic principles:

i Nondiscrimination testing under section 401(a)(4) is operational and a plan document is not required, as a matter of qualification, to specify how it will satisfy that section, and

ii Profit sharing plans are entitled to provide for discretionary contributions.

b) In designing a discretionary profit sharing plan, the simplest way to deal with the broadly available test option is to structure the plan into separate, defined, allocation groups and allow the employer to make a separate discretionary contribution for each group.

i Each year for which cross-testing of the plan is desired in order to pass section 401(a)(4), the employer would either:

(a) make contributions for each group that would ensure that all NHCEs who are benefiting for the year satisfy the gateway, or

(b) ensure that each resulting allocation rate could satisfy the broadly available test.

ii For an employer who wishes to employ the smoothly-increasing, regular intervals approach, a sample plan design would be as follows.

(a) For each plan year, the eligible participants would be divided into the following allocation groups:

Group A: Eligible participants who have 3 or fewer years of service.

Group B: Eligible participants who have 4, 5 or 6 years of service.

Group C: Eligible participants who have 7, 8, or 9 years of service.

Group D: Eligible participants who have 10 or more years of service.

(b) The employer would make discretionary contributions for the participants in each group. The discretionary contribution made for a particular group would be allocated pro rata, based on a definition of compensation satisfying IRC §414(s), so that within each allocation group, the allocation is a uniform percentage of section 414(s) compensation.

(i) For one year the employer might allocate 2% of pay to Group A, 4% of pay to Group B, 8% of pay to Group C, and 13% of pay to Group D. This would satisfy the smoothly-increasing test.

(ii) In another year, the percentages might be 3%, 5%, 8%, 12%, which also passes the smoothly-increasing test.

(iii) In yet another year, the employer might allocate percentages that do not pass the smoothly-increasing test, but no allocation group that covers at least one NHCE would receive an allocation less than what the gateway requires.

iii This would preserve the discretionary nature of the profit sharing plan without compromising the meaningful NHCE contribution requirements sought through the regulations.

iv The above approach also avoids the potential problem of having a fixed service-based allocation formula along with a discretionary contribution formula that, depending on the size of the employer's contribution, could cause the smoothly-increasing test to be violated.

(a) For example, suppose the plan is set up with 4 service bands, as shown in the prior example, except the plan assigns points to each allocation group based on compensation. The points are assigned so that the result would be a percentage of compensation that satisfies the smoothly increasing test. However, if the employer's discretionary contribution is large enough, the spread in contribution percentages between certain intervals, although maintaining the same proportion, might exceed the 5 percentage point limit under the regulations.

(b) To illustrate, suppose the plan assigns points for each of the 4 service bands as follows:

(i) Group A (3 or fewer years of service): 2 points per $100 of compensation.

(ii) Group B (4, 5, or 6 years of service): 4 points per $100 of compensation.

(iii) Group C (7, 8, or 9 years of service): 8 points per $100 of compensation.

(iv) Group D (10 or more years of service): 13 points per $100 of compensation.

(c) Suppose there is one employee in each group.

Employee	Compensation	Points
Group A Employee	$20,000	400 (200 increments of $100 x 2)
Group B Employee	$40,000	1,600 (400 increments of $100 x 4)
Group C Employee	$80,000	6,400 (800 increments of $100 x 8
Group D Employee	$100,000	13,000 (1,000 increments of $100 x 13)
Total	$240,000	21,400

(d) Assume the employer contributes $21,400, and the plan allocates pro rata based on points.

(i) The Group A employee receives $400 (i.e., 400/21,400 x $21,400),

(ii) The Group B employee receives $1,600 (i.e., 1,600/21,400 x $21,400),

(iii) The Group C employee receives $6,400 (i.e., 6,400/21,400 x $21,400), and

(iv) The Group D employee receives $13,000 (i.e., 13,000/21,400 x $21,400).

(e) This translates into the following contribution percentages:

(i) 2% for the Group A employee,

(ii) 4% for the Group B employee,

(iii) 8% for the Group C employee and

(iv) 13% for the Group D employee,

(f) The smoothly-increasing test is satisfied.

(g) But suppose the next year the employer contribution $36,000 (assume the compensation levels are the same). Now the contribution is allocated as follows:

(i) The Group A employee receives $673 (i.e., 400/21,400 x $36,000),

(ii) The Group B employee receives $2,692 (i.e., 1,600/21,400 x $36,000),

(iii) The Group C employee receives $10,766 (i.e., 6,400/21,400 x $36,000), and

(iv) The Group D employee receives $21,869 (i.e., 13,000/21,400 x $36,000).

(h) This translates into the following contribution percentages:

(i) 3.37% for the Group A employee,

(ii) 6.73% for the Group B employee,

(iii) 13.46% for the Group C employee and

(iv) 21.87% for the Group D employee,

(i) The smoothly-increasing test is not satisfied because the difference in the contribution rate between Group D and Group C exceeds 5 percentage points.

(j) With the separate discretionary contribution approach described earlier, the employer would simply limit its contribution for Group D so it is not more than 5 percentage points higher than Group C's contribution rate (i.e., not more than 18.46%).

12) It should be clarified that the sponsor need not make an advance commitment as to which gateway rule will apply in a given year – the 5% rule or the 1/3 rule.

C. Both Defined Contribution Plans and DB/DC Combinations

1) Current provisions permitting component plan analysis should be extended to the new rules. A plan should not have to be formally split into separate plans to accomplish what could otherwise be accomplished through component plan analysis.

a) In fact, the component plan approach under the new rules should be more relaxed than the one currently applicable to general testing.

i. It should be permissible to include part of a participant's benefit in one component plan and part in another.

ii. To do otherwise could prompt a sponsor to reduce benefits for certain NHCEs.

2) It should be clarified that the assumptions used in determining benefit and contribution equivalencies under the new rules need not be the same as those used in general testing.