

MEMO# 13699

July 3, 2001

IRS ISSUES FINAL REGULATIONS AND REVENUE RULING ON "NEW COMPARABILITY" PLANS

[13699] July 3, 2001 TO: PENSION COMMITTEE No. 44-01 RE: IRS ISSUES FINAL REGULATIONS AND REVENUE RULING ON "NEW COMPARABILITY" PLANS The Internal Revenue Service has issued final regulations providing conditions under which "new comparability" plans may be eligible for "cross-testing" to satisfy the Code's nondiscrimination requirements.¹ In conjunction with the final regulations, the IRS also published Revenue Ruling 2001-30, which sets forth additional guidance on a particular component of the final regulations.² The final regulations generally follow the guidance provided in the proposed regulations issued in October 2000.³ Like the proposed regulations, the final regulations permit application of cross-testing to a plan if it (1) provides for "broadly available allocation rates"⁴; (2) provides for certain age-based allocation rates⁵; or (3) satisfies a "minimum allocation 1 New comparability plans are defined contribution plans that generally provide higher rates of employer contributions to highly compensated employees. Such plans may satisfy the Code's nondiscrimination requirements through testing on a "benefits basis" (i.e., "cross-testing"), under which participant benefits are actuarially projected to normal retirement age. 2 The revenue ruling sets forth "specific conditions" for determining whether an allocation is a "defined benefit replacement allocation" under the "broadly available allocation rate" requirement. The final regulations, which provide "basic conditions" for defined benefit replacement allocations (under the topic of "transition allocations"), explain that guidance separate from the final regulations was issued to provide "ongoing flexibility to the IRS and Treasury to respond to changing circumstances, or additional information relating to defined benefit replacement allocations." 3 See Institute Memorandum to Pension Committee No. 77-00, dated October 12, 2000. The proposed regulations followed Notice 2000-14, which had invited public comments on new comparability plans. See Institute Memorandum to Pension Committee No. 18-00, dated February 28, 2000. 4 To be broadly available, each allocation rate under a plan must be currently available to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test). 5 A plan with an "age-based allocation rate" must have the same schedule of allocation rates available to all employees in the plan, and a schedule that "smoothly" increases at regular intervals of age or service. 2gateway" test that prescribes minimum allocation rates for non-highly compensated employees (NHCEs).6 Notable differences between the final and proposed regulations include the following: • The final regulations expand the circumstances under which a plan is viewed as having "broadly available allocation rates." Specifically, for purposes of determining whether a plan provides broadly available allocation rates, the final regulations (1) permit two allocation rates to be aggregated in a manner similar to the

aggregation of certain benefits, rights or features, thereby permitting “excess NHCEs” with a higher allocation rate to be used to support a lower allocation rate, and (2) provide that differences in allocation rates resulting from any method of permitted disparity provided for under the Code section 401(l) regulations are disregarded. • The final regulations create a separate category of plans that qualify for cross-testing — plans using an “age-based allocation rate.”⁷ The final regulations also expand this group of plans to include those that provide for allocation rates based on a “uniform target benefit allocation.” • The final regulations clarify the scope of “NHCE” for purposes of determining which employees receive a “minimum allocation” under the “gateway” requirement. The application of various “minimum coverage” requirements of Code section 410(b) under the minimum allocation gateway also is clarified. • The final regulations provide that certain “transition allocations” — “defined benefit replacement allocations,”⁸ “pre-existing replacement allocations,” or “pre-existing merger and acquisition allocations” — may be disregarded for purposes of the “broadly available allocation rate” requirement. Each of these transition allocations is described in the final regulations. • As under the proposed regulations, the final regulations permit defined contribution and defined benefit plans that are tested together as a single “combined” plan to be tested under a similar “minimum allocation gateway”; however, for this purpose, the allocation rate for each NHCE need not exceed 7.5 percent of pay. Consistent with the effective date set forth in the proposed regulations, the final regulations apply for plan years beginning on or after January 1, 2002. For further details 6 A plan satisfies the gateway if (i) each NHCE received an allocation of at least 5 percent of the NHCE’s compensation, or (ii) each NHCE in the plan has an allocation rate that is at least one-third of the allocation rate of the highly-compensated employee (HCE) with the highest allocation rate. 7 Under the proposed regulations, plans with qualifying age-based allocation designs had been permitted under the “broadly available allocation rate” prong of the regulation. 8 As noted above, Revenue Ruling 2001-30 provides specific conditions under which an allocation qualifies as a “defined benefit replacement allocation.” 3 regarding the IRS guidance on new comparability plans, please refer to the final regulations and the revenue ruling, which are attached, and the Institute’s memorandum on the proposed regulations cited above. Thomas T. Kim Assistant Counsel Attachments Attachment (in .pdf format)