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**Comments With Respect to  
Prop. Treas. Reg. §§ 1.401(A)(4)-8(B)(1) And 9(B)(2)(V)  
Governing So-Called “New Comparability Plans”**

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The following Comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

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This report was prepared by individual members of the Employee Benefits Committee of the Section of Taxation. The principal responsibility was exercised by Wm. Scott Magargee, III. Substantive contributions were made by Thomas C. Graves, Kurt L.P. Lawson, and Scott Magargee. The Comments were reviewed by Kyle N. Brown, Committee Vice Chair, and Diane J. Fuchs, Committee Chair. They were also reviewed by Cynthia C. Benson of the Section’s Committee on Government Submissions and by Stuart M. Lewis, Council Director for the Employee Benefits Committee.

Although many members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments, with the exception of Mr. Lewis, whose involvement with these Comments was limited to nonsubstantive, technical and procedural review.

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## **Nondiscrimination and Section 415 Subcommittee**

### **Introduction**

This is in response to the request for comments by the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) to proposed amendments (REG-114697-00) to 26 CFR part 1 under section 401(a)(4) of the Internal Revenue Code of 1986 (“Code”). The proposed regulations, Prop. Treas. Reg. §§ 1.401(a)(4)-8(b)(1) and 9(b)(2)(v), would prescribe conditions under which defined contribution plans, and defined benefit/defined contribution (“DB/DC”) aggregated plans, known as “new comparability” plans, would be permitted to demonstrate compliance with applicable nondiscrimination requirements based on benefits rather than contributions.

These Comments address a number of testing issues, including the definition of compensation to be used, the use of a combination of age and service in determining “broadly available allocation rates,” the “broadly available allocation” rates requirement itself, the applicability of these rules to target benefit plans, and the “primarily defined benefit” test.

### **Background**

Under section 401(a)(4) of the Code, plan sponsors have been able to cross-test new comparability plans by actuarially projecting current contributions to determine an anticipated retirement benefit and then using the anticipated benefit in testing for nondiscrimination. The proposed regulations would retain the cross-testing rules for plans that either have “broadly available allocation rates” or meet a “minimum allocation gateway.”

The regulations would be effective for plan years beginning after 2001.

### **Summary of Issues Addressed and Recommendations:**

These Comments address the following issues and make the recommendations indicated:

#### **I. Definition of Compensation:**

Could a plan use a “reasonable” compensation definition for the broadly available allocation rate test and minimum allocation gateway requirement, rather than being limited to the I.R.C. § 415(c)(3) definition of compensation?

We recommend that a plan be permitted to use a definition of “reasonable” compensation, such as that described in Reg. § 1.414(s)-1, for either the broadly available allocation rate test or the minimum allocation gateway requirement. This would include, but not be not limited to, a rate

of compensation (such as base pay) that satisfies the “reasonable” compensation standard in the regulations.

**II. Use of Combination of Age and Service in Determining “Broadly Available Allocation Rates”:**

Should a defined contribution plan be permitted to disregard age and service conditions in determining whether each allocation rate under the plan is currently available to a nondiscriminatory group of employees, if allocation rates under the plan’s allocation formula are determined using a schedule of rates that is based on a combination of age and service rather than solely on either age or service?

We suggest that allocation rates under a single schedule of rates be allowed to be based on a combination of age and service, rather than solely on age or service.

**III. “Broadly Available Allocation” Rates Requirement:**

Could the goal of the broadly available allocation rates requirement test be met, and still give plan sponsors more flexibility in design, by limiting the banding test to egregious cases of discrimination?

We suggest that plan sponsors be given more flexibility in design of plans by limiting the banding test under the broadly available allocation rates requirement to egregious cases of discrimination, rather than by applying these requirements to all plans.

**IV. Target Benefit Plans:**

Should target benefit plans be deemed to satisfy the broadly available allocation rates requirement?

Yes. We recommend that target benefit plans be deemed to satisfy the broadly available allocation rates requirement.

**V. “Primarily Defined Benefit” Test:**

What changes could be made to the “primarily defined benefit” test to simplify it without destroying its intended purpose?

We suggest that the criteria for determining whether a DB/DC plan is “primarily defined benefit” in character be revised to: (a) provide that a DB/DC plan satisfies the test for the “primarily defined benefit in character” requirement by showing that at least 50% of the NHCEs in the DB/DC plan earn a meaningful benefit under the DB part of the DB/DC plan, (b) disregard I.R.C. § 401(k) deferrals and § 401(m) contributions for this purpose, and (c) clarify that this requirement does not have to be satisfied if DB and DC plans are aggregated solely for the purpose of satisfying I.R.C. § 410(b).

## Analysis

### **I. Allowing Use of a “Reasonable” Compensation Definition**

A plan that uses a definition of compensation other than that required by I.R.C. § 415(c)(3)<sup>1</sup> in testing for nondiscrimination would be required to use the I.R.C. § 415(c)(3) definition in determining whether the plan satisfies either the broadly available allocation rate test or the minimum allocation gateway requirement.

This seems to us to be unduly burdensome on plan sponsors. Sponsors of plans that use a definition of compensation that meets the “reasonable” standard of Treas. Reg. § 1.414(s)-1 would still have to collect pay data based on the section 415(c)(3) definition to meet the broadly available test or the minimum allocation gateway requirement.

From a policy perspective, the differences between nondiscriminatory compensation under Treas. Reg. §§ 1.415-2(d)(2) and (3) and nondiscriminatory reasonable compensation under Treas. Reg. § 1.414(s)-1 would seem to be de minimis. The Treas. Reg. § 1.414(s)-1 reasonable compensation definition is used in other contexts already, such as for other Treas. Reg. § 1.401(a)(4) purposes. (See Treas. Reg. § 1.414(s)-1(a)(2)). Furthermore, IRS Notice 89-23, which provides interim guidance with respect to I.R.C. § 403(b)(12) nondiscrimination testing, also specifically allows the use of an I.R.C. § 414(s) definition of compensation for nondiscrimination testing purposes; this presumably includes a “reasonable” base pay definition.

Therefore, we respectfully submit that any plan definition of compensation that satisfies the Treas. Reg. § 1.414(s)-1 “reasonable compensation” standard should also be permitted to be used for either the broadly available allocation rate test or the minimum allocation gateway requirement under these regulations.

### **II. Combination of Age and Service in Determining Broadly Available Allocation Rates.**

In the preamble to the proposed regulations, the IRS and Treasury explain that they see no need to impose a minimum allocation gateway on plans with broadly available allocation rates, such as age-weighted profit sharing plans, because “these plans provide an opportunity for participants to ‘grow into’ higher allocation rates as they age or accumulate additional service.” Any schedule of rates under which increases in age or service are positively related to increases in allocation rates satisfies this criterion. Therefore we see no compelling reason why allocation rates under a single schedule of rates should not be allowed to be based on a combination of age and service, rather than solely on age or service.

One objection might be that, under some circumstances, it would be more difficult to apply the requirement that each rate band (with certain exceptions) have the same length. However, this

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1. Treas. Reg. § 1.415-2(d)(2) describes items specifically includable as compensation and Treas. Reg. § 1.415-2(d)(3) describes items specifically not includable as compensation.

objection would not apply to a schedule of rates that is based on the arithmetic sum (including the weighted sum) of a participant's age and service, similar to the schedule of rates under a "points" plan. In that case the requirement that each rate band have the same length simply would be applied to the numbers representing the arithmetic sums of participants' ages and years of service rather than the numbers representing participants' ages or years of service.

More importantly, as noted in the next comment, we believe that the requirement that each rate band have the same length, if it is adopted as part of the final regulations, would not further the purposes that the IRS and Treasury have identified for the proposed regulations. Instead, as long as increases between rate bands are regulated, this requirement merely would cause plans to reduce the allocation rates assigned to participants with fewer years of age and/or service within what would otherwise be a single rate band. While this would ensure that a participant would earn higher and higher allocation rates as he or she continued to work, which would create the impression of fairness and equal access to higher rates, it would do so by mandating worse treatment of the participant earlier in his or her career, and in our view would do little to ensure equal access to the highest allocation rates under the plan.

### **III. "Broadly Available Allocation Rates" Requirement:**

Under the broadly available allocation rates requirement, allocation rates for age or service weighted plans must increase smoothly and at regular intervals. A schedule of allocation rates has regular intervals of age or service if each age or service band, other than the band associated with the highest age or years of service, and any band beginning before age 25, is the same length. This test further requires that there be no more than a 5% increase between the bands, the ratio of rates between bands not exceed two and the ratio of rates between bands not exceed the ratio between the two immediately preceding age or service bands.

We suggest that the mathematical exactness of the proposed "smoothly increasing" and "regular intervals" in the broadly available allocation rates requirement is overly restrictive, could add great complexity to plan administration, and could in practice result in lower contributions for many participants at younger ages.

Effect on Younger Employees. The proposed complex set of constraints will allow plans to have significant contribution differences if rates are changed often enough and begin at low contribution levels. In the following examples, a plan can pass these rules and allow the oldest employees to get a contribution more than 15 times that of the youngest employees. But these requirements could cause problems for plans that are less discriminatory in favor of HCEs, even though younger employees receive a more meaningful level of contributions (with fewer contribution rate bands as they age).

PLAN A (hypothetical)		PLAN B (actual)	
Passes		Does Not Pass	
Available Allocation Gateway		Available Allocation Gateway	
<u>Age</u>	<u>Contribution</u>	<u>Age</u>	<u>Contribution</u>
under 25	.75%	under 25	8%
25-29	1.5%	25-30	10%
30-34	3.0%	30-45	15%
35-39	5.0%	45-55	18%
40-44	7.0%	over 55	20%
45-49	9.0%		
50-54	11.0%		
55-59	13.0%		
60 +	15.0%		

The schedule in Plan B (an existing plan) does not meet the broadly available allocation rate test even though it provides a more meaningful benefit to younger (and presumably lower paid) employees than the schedule in Plan A (a hypothetical plan), which would meet the test.<sup>2</sup>

The first problem under the test for Plan B is that the increase in contribution rates at age 30 is 50% (as the contribution rate moves from 10% to 15%), while the increase at age 25 is only 25% (8% to 10%). In order to conform to the requirement that the percentage increase in contribution rates cannot go up at higher ages, the plan could reduce the contribution at ages under 25 to 5% of pay. Clearly this is an undesirable solution that will harm younger employees, who also tend to be NHCEs.

The second problem with the schedule in Plan B arises from the irregular intervals (25-30 vs. 30-45). This could be solved by reducing the contribution rate to the age 30-35 group from 15% to 10%, making the 25-35 interval an even 10 years. Again, those in the age 30-35 group, many of whom will be NHCEs, will receive less than they would under the plan before the change.

Plans with Multiple Formulas. Another way in which the broadly available allocation rates requirement seems overly restrictive is that it makes no accommodation for grandfathered benefits or for different allocation rates for different profit centers or geographic locations. In our experience, it is not uncommon for defined contribution plans to have different allocation formulas for grandfathered groups as a result of plan mergers following acquisitions or similar transactions, or to have the same allocation formula for all participants but base total contributions for groups at different locations or profit centers on that location's or center's profitability (resulting in different allocation rates for each group). Such plans typically pass the general test easily using cross-testing, but in many cases would be unable to satisfy the broadly available allocation rates requirement and therefore could effectively be prohibited from using cross-testing under the proposed regulations.

<sup>2</sup> Plan B would meet the minimum allocation gateway requirement.

We believe that, to address this problem, at a minimum the broadly available allocation rates requirement should be modified to (a) disregard limitations on the availability of allocation rates that result solely from grandfathering restrictions imposed in connection with acquisitions or similar transactions, and (b) disregard differences in actual allocation rates that result solely from differences in contribution levels for groups at different locations or profit centers, e.g., based on the profitability of the location or center.

If the IRS and Treasury decide to keep this structure, we recommend that the broadly available allocation rates scheme provide for more flexibility to recognize the diverse types of designs that currently exist. The focus should be on the upper ranges of age and service and only if a plan design blatantly discriminates in favor of highly paid individuals should it fail to meet the requirement. In our experience, there are no plans that are currently structured as the proposed regulations would require.

#### **IV. Target Benefit Plans.**

The proposed regulations would permit a defined contribution plan to be cross-tested only if the plan either provides broadly available allocation rates or satisfies a minimum allocation gateway (i.e., generally each nonhighly-compensated employee must receive an allocation of at least 5% of compensation). We believe that target benefit plans will find it impossible to satisfy the broadly available allocation rates requirement and difficult in many cases to satisfy the minimum allocation gateway. Thus, the regulations effectively would force target benefit plans to fit within the safe-harbor testing method for target benefit plans in Treas. Reg. § 1.401(a)(4)-8(b)(3).

We see no compelling reason to restrict the testing options available to target benefit plans. In our experience, target benefit plan designs are generally not prone to abuse. Target benefit plans are by their nature age-weighted, and therefore provide an opportunity for participants to “grow into” higher allocation rates as they age or accumulate additional service. Allocation rates are based on amounts actuarially determined to be needed to fund benefits under a defined benefit formula.<sup>3</sup>

The safe harbor for target benefit plans was provided — like all bona fide safe harbors — as a simpler alternative to the rules that otherwise would apply to such plans, namely the general test for nondiscrimination using cross-testing, and not as the only set of rules. In their own practices the drafters of these Comments have encountered numerous target benefit plans that do not fit within the safe harbor, generally, but not always, because of technical violations of the uniformity requirement that the safe harbor imposes on the target benefit formula or differences in the way that allocations are calculated based on the benefit formula. Whether this represents an accurate cross-section of existing target benefit plans is beside the point. We believe that the

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3. If target benefit plans fail to provide such an opportunity, it is worth asking whether traditional defined benefit plans do, either.

nondiscrimination regulations should be made flexible enough, consistent with policy, to permit further evolution in plan designs, including among target benefit plans.

If the IRS and Treasury are concerned about the possibility that plan sponsors will adopt unusual target benefit plan designs to take advantage of the exception that we are proposing, we suggest that it would be enough to require that the same targeted benefit formula apply to all participants.

**V. Simplification of the “Primarily Defined Benefit” Test.**

We recommend that a plan be permitted to demonstrate that a DB/DC plan<sup>4</sup> is primarily defined benefit in character on the basis of a testing methodology that is less complex than the methodology proposed in Prop. Treas. Reg. § 1.401(a)(4) - 9(b)(2)(v)(B). Under the proposed regulation, “A DB/DC plan is primarily defined benefit in character if, for more than 50% of the NHCEs benefitting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under defined benefit plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under defined contribution plans that are part of the DB/DC plan.”

This will require an additional layer of complex testing. We suggest that this could be improved, from a policy perspective, with less of a burden on plan sponsors, with a simple head count/minimum normal accrual rate requirement. For example, the following language could be added to the provision quoted above “. . . or if more than 50% of the NHCEs benefitting under the DB/DC plan receive a normal accrual rate under the DB part of the DB/DC plan that is meaningful; for purposes of this paragraph, an accrued benefit shall be treated as meaningful if the normal accrual rate under the DB part of the DB/DC plan is equal to at least 1% of compensation.” Furthermore, employee deferrals under an I.R.C. § 401(k) plan and employee and employer contributions under an I.R.C. § 401(m) plan should be disregarded for this purpose. Additionally, the regulations should clarify that this requirement does not apply to DB and DC plans that are aggregated solely for the purpose of satisfying the I.R.C. § 410(b) minimum coverage requirements.

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4. A defined contribution plan and a defined benefit plan that are aggregated for purposes of sections 401(a)(4) and 410(b) of the Code are considered a DB/DC plan under Treas. Reg. § 1.401(a)(4)-9(a).