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# SPECIAL SUPPLEMENT

**FILE** this Special Supplement behind Special Supplement Vol. 18, No. 22 in Reference File binder.

## IRS FINAL REGULATION PACKAGE ON NON-DISCRIMINATION REQUIREMENTS FOR QUALIFIED PLANS

**Sept. 12, 1991**

- Non-Discrimination Requirements under Section 401(a)(4) (Treasury Decision 8360)
- Permitted Disparity with respect to Benefits and Contributions under Section 401(1) (TD 8359)
- Definition of Compensation under Section 414(s) (TD 8361)
- Limitation on Annual Compensation under Section 401(a)(17) (TD 8362)
- Minimum Coverage Requirements under Section 410 (b)

**Editor's Note**: All five final regulations are scheduled to be published in the *Federal Register* of Sept. 19, 1991.)



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[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

T.D. 8360

RIN 1545-AM95

Nondiscrimination Requirements for Qualified Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 401(a)(4) of the Internal Revenue Code of 1986. They interpret the section 401(a)(4) requirement that contributions or benefits provided under a tax-qualified retirement plan not discriminate in favor of highly compensated employees. This section and the minimum coverage requirements of section 410(b) form a coordinated nondiscrimination rule that prohibits a tax-qualified retirement plan from being designed or operated to favor highly compensated employees.

These final regulations reflect changes made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988. The regulations provide the guidance necessary to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans. These final regulations are issued in conjunction with other sets of final



regulations under sections 401(a)(17), 401(*l*), 410(b), and 414(s), and were developed in conjunction with final regulations under section 401(a)(26) that will be published in the near future.

EFFECTIVE DATES: These regulations are effective for plan years beginning after December 31, 1991, and applied to those plan years except as set forth in the transition rules of §1.401(a)(4)-13.

FOR FURTHER INFORMATION CONTACT: The attorney listed below for the particular section at 202-377-9372 (not a toll-free number).

| | |
|---|---|
| §1.401-4 | Rebecca Wilson or David Munroe |
| §1.401(a)-4 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-1 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-2 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-3 | Marjorie Hoffman or David Munroe |
| §1.401(a)(4)-4 | Suzanne Tank or David Munroe |
| §1.401(a)(4)-5 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-6 | David Munroe |
| §1.401(a)(4)-7 | Patricia McDermott |
| §1.401(a)(4)-8 | Marjorie Hoffman or David Munroe |
| §1.401(a)(4)-9 | David Munroe |
| §1.401(a)(4)-10 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-11 | Rebecca Wilson or David Munroe |
| §1.401(a)(4)-12 | Rebecca Wilson or David Munroe |



| | |
|---|---|
| §1.401(a)(4)-13 | Patricia McDermott or David Munroe |
| §1.411(d)-4 | Patricia McDermott or David Munroe |

SUPPLEMENTARY INFORMATION:

On May 14, 1990, the Internal Revenue Service published in the **Federal Register** proposed amendments to the Income Tax Regulations (26 CFR part 1) under section



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401(a)(4) of the Internal Revenue Code of 1986 (Code) (55 FR 19897). These regulations were proposed in conjunction with regulations under related Internal Revenue Code sections including sections 401(a)(17), 401(a)(26), 410(b), and 414(s) and amendments to regulations under section 401(*l*). The May 1990 proposed regulations were supplemented and modified by proposed regulations published in the **Federal Register** on September 14, 1990 (55 FR 37888), and December 3, 1990 (55 FR 49906).

Written comments were received from the public on the proposed regulations. In addition, a public hearing on the May 14, 1990 regulations was announced on May 14, 1990, (55 FR 19897) and a public hearing on the September 14, 1990, regulations was announced on September 14, 1990, (55 FR 37888). These public hearings were held on September 26, 27, and 28, 1990. After consideration of all of the written comments received and the statements made at the public hearing, the proposed regulations under section 401(a)(4) are adopted as modified by this Treasury Decision.



Explanation of provisions:

Development of Final Regulations

Coordination with other regulations

These regulations were developed in conjunction with regulations under the various related statutory nondiscrimination provisions governing tax-qualified retirement plans. Together, these regulations provide comprehensive guidance on those provisions. These related sections are principally sections 401(a)(17), 401(a)(26), 401(*l*), 410(b), and 414(s). This coordinated approach was initially adopted in developing the proposed regulations and is intended to provide taxpayers with an integrated framework for applying the nondiscrimination provisions of the Code. In addition, this approach made it possible to simplify many of the related nondiscrimination rules. For example, the May 1990 proposed regulations on the minimum participation rules of section 401(a)(26) substantially simplified the regulations previously proposed under that section. Similarly, the May 1990 proposed regulations simplified the early termination restrictions contained in existing final regulations under section 401(a)(4) and simplified previously published proposed regulations under the permitted disparity rules of section 401(*l*), the minimum coverage rules of section 410(b), and the definition of compensation under section 414(s). Retention of this coordinated approach in these final regulations has made possible both the retention and some expansion of these previously proposed simplifications.

Summary of significant modifications

The proposed regulations provided the first comprehensive guidance for determining whether a plan meets the nondiscrimination requirements of section 401(a)(4). Because the



proposed regulations contained comprehensive and objective standards, they generated a significant number of comments. Among other requests, commentators asked for revisions to the testing rules, additional testing alternatives, and clarification of ambiguities. In addition, comments suggested areas in which the regulations under other Code sections might be better coordinated with the requirements of section 401(a)(4).

In general, these final regulations retain the structure of the proposed regulations. In response to comments, however, the final regulations make a number of revisions to the proposed regulations. Substantive changes have been made in response to comments about specific aspects of the testing process. Other changes simplify and clarify the proposed regulations.

The following is a brief summary of the more significant substantive modifications in the final regulations.

- New safe harbors are provided for cash balance plans and section 412(i) insurance contract plans.
- Provisions have been added to accommodate common plan designs in situations where employees transfer between plans of the same employer or transfer from one employer to another in connection with a merger or acquisition. In particular, these provisions include expanded access to safe harbors for plans that offset benefits with benefits provided under another plan of the employer or former employer.
- The general test for determining whether a plan discriminates with respect to the amount of contributions or benefits has been simplified by automatically incorporating a substantially more flexible rate segment restructuring methods; and the requirement that the employee groups that are the basis for restructuring have some common attributes other than accrual or allocation rates has been eliminated.
- A retroactive correction mechanism is provided, permitting employers to make certain retroactive amendments in order to insure compliance with the nondiscrimination rules at any point up to the 15th day of the 10th month after the end of the plan year.

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- Provisions on taking compensation into account for purposes of nondiscriminatory amounts testing in both the safe harbors and the general test are clarified. In addition, for purposes of the safe harbors, options are provided under which an employer can disregard compensation earned by employees in years of termination and years in which employees work under 1000 hours in determining average annual compensation.

- The general test has been revised to permit employers to take certain social security supplements into account for purposes of nondiscrimination testing under section 401(a)(4) and for purposes of satisfying the section 401(*l*) permitted disparity rules.

- The provisions permitting satisfaction of the general test solely on the basis of the most valuable accrual rates have been revised to eliminate the requirement for uniformity in the normal retirement benefit but to require general uniformity in the conversion to subsidized benefits.

- The annual method for determining accrual rates has been revised to take into account all accruals during the plan year, including accruals reflecting increases in prior benefits due to current increases in compensation and increases resulting from grants of past service credit. Under the transition rules, increases in benefits due the effect of increases in compensation on benefit formulas in effect prior to the first plan year beginning on or after January 1, 1992, with respect to accruals prior to that date, are generally disregarded.

- New transition rules for safe harbors and the option to apply the accrued-to-date and projected method to benefits after a date selected by the employer have been clarified and the existing rules have been expanded. The fresh-start and transition rules have been extended to apply to years after the effective date as well as TRA '86 transition years. In addition, a single set of fresh-start rules now cover transitions to the safe harbors and the option to apply the accrued-to-date and projected methods to benefits accrued after a date selected by the employer. Special fresh-start options are provided for plans with employees with compensation limited by section 401(a)(17) under both the accrued-to-date and projected methods.

- The nondiscrimination rules applicable to plan amendments and grants of past service have been consolidated, the relevant facts-and-circumstances test has been clarified, and the more flexible significant discrimination standard, previously applicable only to grants of past service has been broadened to cover plan amendments as well.

- The special merger and acquisition rule for benefits, rights, and features has been expanded to cover employees hired during the transition period in section 410(b)(6)(C), and a new permissive aggregation rule has been provided for purposes of satisfying the current and effective availability requirements applicable to benefits, rights, and features under a plan.



- Step-by-step guidance has been provided for the actuarial calculations needed to determine accrual rates for those employers applying the general test.

- Additional examples have been provided throughout the regulations.

The specific amendments to the proposed regulations are discussed in detail below as part of the discussion of the section to which they relate.

Overview of the Section 401(a)(4) Nondiscrimination Rules

Section 401(a)(4) provides generally that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of highly compensated employees. The rules provided in the final regulations are the exclusive rules for determining whether this requirement is met. A plan, therefore, will satisfy section 401(a)(4) only if it complies both in form and in operation with the rules in these regulations.

Section 1.401(a)(4)-1 of the regulations sets forth the three requirements a plan must meet to satisfy section 401(a)(4) and provides rules on how these requirements are applied. As in the proposed regulations, the final regulations contain a rule in §1.401(a)(4)-1(c)(6) which provides that most collectively bargained plans (including governmental collectively bargained plans) automatically satisfy the requirements of section 401(a)(4).

The first general requirement under section 401(a)(4) is that either the contributions or the benefits provided under a plan must be nondiscriminatory in amount. As provided in the proposed regulations, a plan generally is permitted under the final regulations to satisfy this requirement on the basis of either contributions or benefits, regardless of whether the plan is a defined contribution plan or a defined benefit plan. Thus, a plan is not required to establish nondiscrimination in amount with respect to both the contributions and the benefits provided.



The second general requirement is that the benefits, rights, and features provided under the plan must be made available to employees in the plan in a nondiscriminatory manner. The benefits, rights, and features subject to this requirement are the optional forms of benefit (such as retirement annuities and single sum payments), ancillary benefits (such as disability benefits), and other rights and features (such as plan loans and investment options) available to employees under the plan.

The third general requirement is that the effect of plan amendments (including grants of past service credit) and plan terminations must be nondiscriminatory.

1. Nondiscrimination in Amount of Contributions or Benefits.

Overview

The final regulations, like the proposed regulations, provide several testing





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alternatives for demonstrating compliance with the requirement that either the contributions or the benefits provided under a plan be nondiscriminatory in amount. Specifically, the regulations provide a number of design-based and simplified testing safe harbors. The regulations also provide general testing rules for plans that do not satisfy the safe harbor requirements.

In general, commentators approved strongly of the existence of the safe harbors. Commentators also requested additional safe harbors, expansion and clarification of existing safe harbors, and broader transition rules to facilitate amending non-safe harbor plans to comply with the safe harbor requirements. With respect to the general testing rule, many commentators suggested revisions intended to clarify and simplify the testing process, and requested additional guidance as to the manner in which certain aspects of the test were to be

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performed. As discussed in more detail below, these final regulations reflect amendments addressing these comments on both the safe harbor and general testing issues.

The general approach to nondiscriminatory amounts testing in the final regulations is the same as under the proposed regulations. A defined contribution plan generally will satisfy the nondiscriminatory amount requirement by showing that the contributions provided under the plan are nondiscriminatory in amount under §1.401(a)(4)-2. Except in the case of an employee stock ownership plan (ESOP), or a section 401(k) plan, or a section 401(m) plan, a defined contribution plan also is permitted to satisfy the nondiscriminatory amount requirement by showing that the equivalent benefits provided under the plan are nondiscriminatory in amount under the cross-testing rules in §1.401(a)(4)-8.

A defined benefit plan generally will satisfy the nondiscriminatory amount requirement by showing that the employer-provided benefits under the plan are nondiscriminatory in amount under §1.401(a)(4)-3. A defined benefit plan also is permitted to satisfy the nondiscriminatory amount requirement by showing that the equivalent contributions provided under the plan are nondiscriminatory in amount under the cross-testing rules in §1.401(a)(4)-8.

In addition, plans may use certain alternative methods to demonstrate that contributions or benefits are nondiscriminatory in amount. For example, plans may satisfy the nondiscriminatory amounts requirements of §1.401(a)(4)-2 or 1.401(a)(4)-3 on a restructured basis. The regulations also permit plans with multiple formulas to satisfy the nondiscriminatory amounts test on the basis of each separate formula, provided each formula separately satisfies the safe harbor requirements in §§1.401(a)(4)-2 and 1.401(a)(4)-3.

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Finally, optional safe harbor testing methods for target benefit plans, cash balance plans, and defined benefit plans that are part of a floor-offset arrangement are provided under the cross-testing rules in §1.401(a)(4)-8.

General safe harbor requirements

As in the proposed regulations, all of the safe harbors in the final regulations require that the plan have a uniform benefit formula for allocations or accruals, that any subsidized early retirement or joint and survivor benefits in a defined benefit plan be provided on the same terms to substantially all covered employees, that the plan formula base allocations or benefits on a nondiscriminatory definition of compensation, and that the plan have a uniform normal retirement age for all employees. Most of the comments on these safe harbor uniformity requirements focused on the requirement of a uniform benefit formula and a uniform normal retirement age for defined benefit plans. The September 1990 proposed regulations enumerated certain plan provisions that would not cause a safe harbor plan to fail to satisfy the uniformity requirements. The final regulations retain these provisions and provide further modifications and clarifications.

The final regulations provide that, while uniform vesting and service-crediting rules are required under the safe harbors, safe harbor plans may use different methods of calculating service for different purposes, provided they are uniform within each application. The final regulations also provide guidance on methods for making actuarial adjustments to post-normal retirement age benefits under a defined benefit plan that are consistent with a uniform benefit formula.

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Under the proposed regulations, a defined benefit plan that provided for offsets for benefits under another defined benefit plan of the employer generally failed to satisfy the uniform benefit formula requirement and, therefore, could not use the safe harbors.



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Similarly, where a merger or acquisition had occurred, the uniformity requirement was not satisfied if the plan of the acquiring employer provided offsets for benefits under a plan of the former employer. Commentators stated that these offset provisions are a common plan design and requested that the regulations permit a plan with these offset provisions to remain in the safe harbors. In response to these comments, the final regulations permit a plan providing offsets for benefits under another plan of the employer or a former employer to satisfy the safe harbors if certain requirements are met. The provision for offset plans contained in the final regulations reflects the plan design most frequently referred to in comments, that of freezing the benefits under the old plan and providing all prospective accruals under the new plan, a so-called "wrap-around" approach. Recently, additional comments have been received on situations involving employees transferred from one plan to another where the employer does not offset benefits under the new plan with benefits under the old plan, but does continue to provide accruals under the prior plan to reflect compensation increases. This approach raises a number of technical issues, particularly for section 401(*l*) plans. In addition, the appropriate requirements for future accruals under section 401(a)(4) and for taking transferred employees into account for purposes of section 410(b) raise more complex issues than in the "wrap-around" approach for which safe harbor treatment is provided in the final regulations. Comments are welcomed on appropriate testing methods for addressing this alternative plan design in a safe harbor context.

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Several commentators asked that the uniform-normal-retirement-age requirement for safe harbor plans under the proposed regulations be revised to permit use of social security retirement age, presently ranging from age 65 through age 67 depending on the individual's year of birth. The final regulations do not adopt this suggestion. Although sections 401(*l*) and 415 were amended to incorporate the revision to social security retirement age in the Social Security Amendments of 1983 (Pub. L. No. 98-21, 97 Stat. 122), corresponding changes to sections 411(a)(8) (defining normal retirement age) and 401(a)(14) (requiring distribution upon attainment of normal retirement age) were not made. Absent statutory amendments linking the concept of normal retirement age under those sections to the social security retirement age, the Treasury and the Service believe it is inappropriate in the context of safe harbor plans to use social security retirement age as a uniform normal retirement age.

The September 1990 proposed regulations contained a set of transition rules for defined benefit plans that are amended to meet the safe harbor requirements. Many commentators requested clarification of these transition rules. They also suggested the development of ongoing transition rules to facilitate the transition of plans into the safe harbors plans. The final regulations contain provisions responsive to both of these requests in §1.401(a)(4)-13. These provisions are addressed in greater detail in the discussion of that section.

Defined contribution safe harbors

The final regulations, like the proposed regulations, provide two safe harbor tests for defined contribution plans in §1.401(a)(4)-2(b). The first safe harbor is design-based and permits a defined contribution plan with a uniform allocation formula to satisfy the

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nondiscriminatory amounts test without calculating allocation rates for individual employees. The second safe harbor permits a defined contribution plan with a uniform allocation formula weighted for age or service to satisfy the nondiscriminatory amounts test if the average rate of allocations for highly compensated employees under the plan does not exceed the average rate of allocations for nonhighly compensated employees under the plan. As in the proposed regulations published in September 1990, plans using the second safe harbor must provide the same number of points for each unit of compensation, and each unit of compensation must not exceed $200.

Written and oral comments on this age-or-service weighted safe harbor evidenced confusion on its scope and application. Accordingly, the final regulations clarify the safe harbor consistent with the original intent and with the typical plan design upon which the safe harbor was based. See Rev. Rul. 84-155, 84-2 C.B. 95. Thus, under the final regulations, this safe harbor is applicable only to plans in which (1) points are provided on a uniform basis for compensation and for age or service, and (2) an employee's allocation for a plan year is determined by multiplying the total amount to be allocated to all employees by a fraction, the numerator of which is the employee's points for the plan year, and the denominator of which is the sum of the points of all employees in the plan for the plan year.



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As clarified, the safe harbor is narrower in some respects, but is consistent with the basic policy underlying the general requirement that nondiscrimination in amounts be established on the basis of actual allocation or accrual rates rather than averaged rates and the attendant concern that exceptions that permit some averaging, such as the age and service weighted safe harbor, be narrowly drawn.

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Defined benefit safe harbors

The final regulations retain the four defined benefit safe harbors provided in the proposed regulations under which a plan is considered nondiscriminatory with respect to the amount of benefits in §1.401(a)(4)-3(b). In addition, the final regulations add an additional safe harbor applicable to certain insurance contract plans described in section 412(i).

The first two safe harbors in the final regulations cover certain unit credit plans. A unit credit plan, for purposes of the safe harbors, is a plan that contains a benefit formula that provides all employees with the same number of years of service the same benefit (either as a percentage of compensation or as a dollar amount). The first safe harbor enables unit credit plans to satisfy section 401(a)(4) with respect to the amount of benefits on the basis of plan design. The second unit credit safe harbor permits a plan under which normal retirement benefits are calculated under a unit credit formula but are accrued under the fractional accrual rule of section 411(b)(1)(C) to satisfy the unit credit safe harbor on the basis of plan design if certain requirements are met, even though all employees with the same number of years of service may not accrue the same benefit if they terminate employment at different ages before normal retirement age.

The third safe harbor in the final regulations is a design-based safe harbor for flat benefit plans that satisfy the fractional accrual rule of section 411(b)(1)(C) (e.g., a plan that provides a benefit of 50 percent of average annual compensation, accrued ratably over all years of service), provided the maximum flat benefit is accrued over a period of at least 25 years.

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The fourth safe harbor, also for flat benefit plans, requires that the average accrual rate of nonhighly compensated employees as a group be at least 70 percent of the average accrual rate of highly compensated employees as a group. Under the final regulations, the determination of accrual rates for this purpose can be done under any of the methods in §1.401(a)(4)-3(d). This safe harbor is applied by taking into account all nonexcludable employees of the employer, whether they are covered under the plan or not, and by disregarding benefits provided under any other plans of the employer.

In response to comments, the final regulations provide a new safe harbor for section 412(i) insurance contract plans. Because these plans are subject to special accrual rules and deliver benefits in the form of insurance contract cash values, they are not designed in a way that accords with any of the four safe harbors that were provided in the proposed regulations. A section 412(i) plan generally satisfies this new safe harbor in the final regulations if it satisfies the accrual rule of section 411(b)(1)(F) and certain funding requirements, and if the stated benefit formula under the plan would satisfy either the unit credit fractional accrual safe harbor or the flat benefit fractional accrual safe harbor if the stated normal retirement benefit were accrued ratably over each employee's period of plan participation through normal retirement age.

Other safe harbor testing methods

Target benefit plans

The proposed regulations provided a safe harbor testing method for target benefit plans based on and replacing the rules of Rev. Rul. 76-464, 1976-2 C.B. 115. Target benefit plans are defined contribution plans that calculate contributions by reference to an

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employee's benefit under a stated, or so-called target, benefit formula. Because target benefit plans are defined contribution plans that determine allocations based on a defined benefit funding approach, this safe harbor was set forth in the rules under §1.401(a)(4)-8 which provided methods for testing defined contribution plans and defined benefit plans on the basis of equivalent benefits or contributions, respectively. The final regulations retain this safe harbor testing method under the cross-testing rules, but clarify certain provisions of the safe harbor in response to comments.

Many of the comments requested clarification of the contribution requirements under the target benefit safe harbor in the proposed regulations. A number of comments expressed

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particular uncertainty as to the application of the unit credit funding method alternative permitted in the proposed regulations. Thus, the final regulations contain a step-by-step procedure for determining contributions under the individual level premium funding method based on an employee's stated benefit and "theoretical reserve." An employee's theoretical reserve generally consists of prior contributions with interest accumulated at the plan's assumed interest rate used for funding purposes for prior years. This new procedure requires contributions to be determined exclusively under the individual level premium method.

The unit credit funding method alternative provided in the proposed regulations was eliminated in the final regulations after discussions with practitioners, because practitioners generally found it confusing and found the individual level premium method more useful in that it provided more predictable, level contribution requirements. Consistent with this requirement, the final regulations require the stated benefit formula under a target benefit plan to comply with one of the defined benefit plan safe harbors that uses the fractional



accrual rule. The final regulations also generally prohibit the use of employee contributions to fund an employee's stated benefit under the safe harbor, an issue that was reserved in the proposed regulations.

A number of the comments also requested clarification of the impact of the new rules in the proposed regulations on contributions and benefits under an existing target benefit plan. The final regulations clarify that the plan's stated benefit formula must satisfy the transition rules generally applicable to safe harbor defined benefit plans. The final regulations also provide a special method for determining an employee's theoretical reserve prior to the effective date of the regulations, but otherwise require contributions to be determined after the effective date under the method described in the preceding paragraph, i.e., without disregarding the prior benefit formula or normal cost base in computing contributions in subsequent years.

Cash balance plans

Several commentators requested clarification of the treatment of cash balance plans, another hybrid plan design that, unlike target benefit plans, was not addressed in the proposed regulations. Comments indicated that cash balance plans are becoming increasingly popular. Cash balance plans are defined benefit plans that generally determine benefits by reference to an employee's "cash balance" or hypothetical account in a manner analogous to the allocation of contributions and earnings to an employee's account under a defined contribution plan. Under a cash balance plan, each employee's hypothetical account is the sum of the hypothetical allocations for prior plan years provided under a hypothetical



allocation formula resembling the allocation formula under a defined contribution plan, plus subsequent interest adjustments through normal retirement age.

The final regulations have added a safe harbor testing method for cash balance plans. Because cash balance plans are defined benefit plans that calculate benefits in a manner similar to defined contribution plans, the safe harbor testing method is provided under the cross-testing rules of §1.401(a)(4)-8(c). The safe harbor testing method permits a cash balance plan to be tested on the basis of the hypothetical allocation formula used to determine an employee's cash balance, rather than on the actual benefits provided under the plan, if certain conditions are satisfied. Among other requirements, the interest adjustments through normal retirement age must be accrued under the plan in the year the hypothetical allocation to which they relate is accrued, and interest adjustments must be determined using a fixed interest rate between 7.5 and 8.5 percent, or one of a list of variable interest rates provided in the regulations. The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan. The safe harbor also imposes limitations on the granting of past service credit and the provision of subsidized optional forms of benefit.

Some of the comments involving cash balance plans also requested that the final regulations provide special relief for cash balance plans from the requirements of section 417(e). Section 417(e) prescribes certain interest rates that must be used in determining the amount of a single-sum benefit provided under a defined benefit plan. These rates, when combined into a single blended rate, are sometimes lower than the rates used by existing cash



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balance plans in determining employees' cash balances, and can therefore require a plan that does not use the section 417(e) rates to determine interest adjustments to pay an employee more than the amount of the employee's hypothetical cash balance when benefits are paid in a single sum. The Treasury and the Service have determined that such relief cannot be granted consistent with the requirements of section 417(e). However, in order to minimize the occasions when this problem will arise, the final regulations include a blended section 417(e) interest rate among the alternative safe harbor interest rates a cash balance plan may use in determining interest adjustments.

Plans offsetting benefits with benefits provided under other plans

The proposed regulations also provided a safe harbor for defined benefit plans that are part of a floor-offset arrangement under the cross-testing rules of §1.401(a)(4)-8(d). This safe harbor allowed the floor defined benefit plan to be tested on the basis of gross benefits (i.e., prior to the offset) rather than net benefits, if certain conditions were satisfied. This safe harbor has been retained in the final regulations and amended to permit the defined benefit and defined contribution plans to be tested taking into account the restructuring rules of §1.401(a)(4)-9(c). This safe harbor has also been expanded to provide relief to certain qualified offset arrangements involving plans tested under section 401(k). The floor-offset arrangement has been clarified to state that the offset is applied after application of the defined benefit plans vesting schedule.

Other safe harbor issues

The preamble to the May 1990 proposed regulations indicated that the Treasury and the Service had considered providing a safe harbor for a plan that offsets benefits by a



portion of an employee's primary insurance amount (PIA) under Social Security and explained why such a safe harbor had been rejected. Commentators asked that the decision be reconsidered.

Under the statutory provisions of section 401(*l*), an employee's offset must be determined with reference to the average of the employee's compensation not in excess of the Social Security wage base over the last three years ("final average compensation"), rather than with reference to PIA. Thus, providing a safe harbor for PIA-offset plans would be inconsistent with section 401(*l*) and its legislative history. Moreover, such a safe harbor would require the development and maintenance of additional rules for determining PIA and limiting the amount of the offset. The decision was, therefore, made not to provide a safe harbor for PIA-offset plans. However, changes have been made to the section 401(*l*) regulations that will enable employers to design a plan that will provide benefit levels generally comparable to those under a PIA-offset formula while still meeting the requirements of section 401(*l*). This in turn will allow these plans access to safe harbor treatment under section 401(a)(4). These section 401(*l*) changes are described in more detail in the preamble to the final regulations under section 401(*l*).

General test and restructuring rules under the proposed regulations

General test

Under the proposed regulations, plans (other than section 401(k) plans or section 401(m) plans) that did not satisfy one of the safe harbors were required to satisfy the general test under §1.401(a)(4)-2(c) or 1.401(a)(4)-3(c) to be nondiscriminatory. In general, that test was satisfied only if no highly compensated employee under the plan had an allocation or



accrual rate that exceeded that of any nonhighly compensated employee under the plan. In the case of a defined benefit plan, this test was generally applied to both normal accrual rates and most valuable accrual rates. In addition, the proposed regulations provided that separate testing of the normal accrual rates was not required if the plan provided uniform normal retirement benefits and early retirement subsidies and joint and survivor subsidies were provided on a substantially uniform basis. In that case, only the most valuable accrual rate was tested.

Determination of accrual rates

The proposed regulations contained provisions for determining allocation or accrual rates and rules explaining the comparison of these rates for purposes of the general test under the nondiscriminatory amounts requirements. The proposed regulations provided three methods for determining accrual rates under a defined benefit plan: an annual method, an accrued-to-date method, and a projected method.

In general, under the annual method, an employee's normal accrual rate was determined by subtracting the employee's accrued benefit as of the close of the prior year (expressed as a percentage of compensation) from the employee's accrued benefit as of the close of the current year. The annual method generally measures the increase in the employee's benefits that have accrued during the current plan year. Under the accrued-to-date method, an employee's normal accrual rate was equal to the employee's accrued benefit to date (expressed as a percentage of compensation) divided by the employee's years of service to date. Under the projected method, an employee's normal accrual rate equaled the



employee's projected accrued benefit at normal retirement age divided by the employee's projected years of service as of that date.

Under any of the three methods, the employer was generally required to determine accrual rates with respect to not only the normal form of benefit, i.e., a single life annuity payable at normal retirement age (the normal accrual rate), but also the most valuable form of benefit (the most valuable accrual rate).

Restructuring

To facilitate testing under the general test, the proposed regulations provided restructuring alternatives that permitted the employer, in certain situations, to divide a single plan into component plans and test each of the component plans separately. Restructuring was permitted under the proposed regulations on the basis of employee groups, total rates, and rate segments. If each of the restructured component plans satisfied the nondiscrimination requirements of section 401(a)(4) and if the group of employees who benefited under the component plan satisfied section 410(b), then the plan in total satisfied section 401(a)(4). The premise of the proposed restructuring rules was to permit an employer to provide under one plan what could otherwise have been provided by establishing a series of separate plans (each of which would have been nondiscriminatory and would have met the coverage requirements).

General test and restructuring rules under the final regulations

General test--revised to automatically incorporate restructuring

Many comments were received on the general test and on the restructuring rules after publication of the May 1990 proposed regulations. A number of these comments related to



the operation of the general test. In addition, many indicated that, while the restructuring rules were of assistance in satisfying the general test, they were too limited, particularly in the context of testing defined benefit plans for nondiscrimination both as to normal and most valuable accrual rates. Comments further noted a number of technical difficulties encountered in testing the more complex plan designs on a restructured basis. Some of the restructuring issues were addressed in the September 1990 modifications to the proposed regulations. As modified, the proposed regulations permitted employers to restructure sequentially. For example, a plan could be restructured on the basis of employee groups and then the resulting component plans further restructured on the basis of total rates or rate segments. The preamble to these September 1990 proposed regulations acknowledged that the Treasury and the Service wished to develop a more comprehensive solution and requested comments on additional or alternative restructuring approaches towards that end.

Comments on the revisions made by the September 1990 proposed regulations welcomed the increased flexibility but, continued to indicate that greater flexibility was needed. After consideration of these comments, and, in particular, consideration of various alternative restructuring approaches suggested both in comments and oral testimony, the final regulations reformulate the general test to incorporate automatically the concept of the rate-segment restructuring rules provided in the proposed regulations in a simpler and more flexible manner.

In applying the new general test under §§1.401(a)(4)-2(c) and 1.401(a)(4)-3(c) of the final regulations, the employer must identify, for each highly compensated employee benefiting under the plan, the group of employees consisting of that highly compensated



employee and all other employees (both highly compensated and nonhighly compensated) with equal or greater normal and most valuable accrual rates ("a rate group"). Thus, depending on their accrual rates, employees may be included in more than one rate group. A rate group must be determined for each highly compensated employee benefiting under the

plan. Each rate group so identified must satisfy the requirements of section 410(b) as though it were a separate plan. Special rules are provided for application of the average benefits test in rate groups.

Thus, under the reformulated approach of the final regulations, the plan is first restructured into rate groups, each of which is tested as though it were a separate plan currently benefiting the group of employees included in the rate group. If each of these rate groups satisfies the requirements of section 410(b) as though it were a separate plan, the plan in total satisfies the nondiscriminatory amount requirement. Because restructuring on the basis of rate groups takes into account all employees with accrual or allocation rates at or above the allocation or accrual rate being tested, this approach automatically achieves the most favorable results that were available under the restructuring rules in the proposed regulations, and, in many situations in fact produces more favorable results than could have been achieved under the rules in the proposed regulations, without the design and technical complexity involved in establishing rate and rate-segment component plans.

In the case of plans tested on the basis of both normal and most valuable accrual rates, this automatic restructuring approach has two significant advantages. First, because employees are taken into account in every rate group with an equal or lower accrual rate, this method achieves positive results for plans attempting to satisfy the nondiscriminatory



amounts requirements that would have been impossible to achieve under the sequential restructuring methods available in the proposed regulations. In addition, this automatic restructuring approach takes both normal and most valuable accrual rates into account, thereby eliminating the difficulties that arose under the proposed regulations in determining the most valuable rates associated with normal rates (where that determination was required).

Included in the many comments on restructuring that were considered in developing this new more flexible restructuring approach were comments suggesting that averaging be permitted for purposes of nondiscriminatory amounts testing. After considering the comments, the Treasury and the Service believe that the new restructuring approach in the final regulations gives the broadest range of employers necessary flexibility while remaining consistent with the statutory nondiscrimination requirements. Furthermore, averaging can produce arbitrary results, particularly in the case of small and medium-sized employers. For example, assume that, in order to satisfy section 410(b), a salaried plan covering predominantly highly compensated employees and providing a benefit of 10 percent of compensation must be aggregated with an hourly plan covering mostly nonhighly compensated employees and providing a benefit of 15 percent of compensation. The aggregated plans satisfy section 410(b) and would satisfy section 401(a)(4) either on the basis of the restructuring rules provided in the regulations or on the basis of averaging. The hourly plan is then amended to cover additional nonhighly compensated employees, and provides these employees with a benefit of 5 percent of compensation. At some point the additional coverage of nonhighly compensated employees may cause the average for nonhighly compensated employees to drop below the 10 percent average for highly



compensated employees. Under those circumstances, this plan would satisfy nondiscriminatory amounts testing under the restructuring approach in the final regulations because the rate groups for the highly compensated employees satisfy the ratio percentage test of section 410(b). The plan would fail under an averaging approach.

Testing solely on the basis of most valuable accrual rates

The final regulations retain a general test alternative under which a plan may, in certain circumstances, satisfy the general test solely on the basis of testing the most valuable accrual rates without separate testing of normal accrual rates. This test recognizes that, if the general test is satisfied with regard to employees' most valuable accrual rates, and the adjustments from normal to most valuable benefits under the plan are calculated on a consistent basis for all employees, then the normal accrual rates automatically satisfy the general test. The proposed regulations attempted to implement this concept by requiring a uniform normal retirement benefit formula and substantial uniformity in early retirement subsidies and joint and survivor subsidies. Because the proposed regulations did not provide guidance on the uniformity requirement, and because the same concept was applied differently in the safe harbors, there was confusion as to the scope and application of most-valuable-only testing. The final regulations modify the tests by eliminating the requirement for equivalent normal retirement benefits while providing more explicit requirements for

uniformity in benefit subsidies. Although some plans that formerly appeared to fall within the scope of most valuable only testing may no longer qualify under the rule, as modified, these plans should generally satisfy the modified general test on the basis of both normal and most valuable benefits using the new automatic restructuring provisions.

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Accrual rates

Qualified social security supplements

The proposed regulations provided that, for purposes of the general test, only accrued benefits within the meaning of section 411(a) could be taken into account. Several commentators argued in favor of taking social security supplements into account in determining the most valuable accrual rate. While social security supplements are clearly retirement-related, they are ancillary benefits and, unlike accrued benefits, early retirement benefits, and retirement-type subsidies, are not protected from retroactive elimination or reduction by section 411(d)(6). Nevertheless, commentators on the proposed regulations indicated that there are a number of plans that provide social security supplements as part of the employees' retirement benefits and that treat these amounts in the same manner as any other accrued retirement benefit.

In response to these comments, the final regulations provide that an employer may take "qualified social security supplements" into account, both in determining the most valuable accrual rate for use in satisfying the nondiscriminatory amounts requirement and in determining permitted disparity under section 401(*l*). The regulations define a "qualified social security supplement," and require that these qualified social security supplements be subject to accrual and anti-cutback protections under the plan in a manner directly analogous to early retirement benefits and retirement-type subsidies protected by the statutory language of section 411(d)(6). These protections must be provided explicitly in the plan. It should be noted that social security supplements must be described in the summary plan description of the plan and any summary of material modifications of the plan in a manner consistent with

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the requirements of section 102 of the Employee Retirement Income and Security Act of 1974, as amended, and the regulations thereunder (Pub. L. No. 93-406).

Determination of accrual rates

General methodology

The written and oral comments on the proposed regulations indicated that the accrual rates used in applying the general test were not being calculated in a consistent manner by practitioners and plan sponsors. In particular, many of those attempting to apply the tests were uncertain about how to calculate most valuable accrual rates and the option to exclude benefits accruing after a date selected by the employer. In response to these comments, the final regulations provide specific guidance on the determination of accrual rates by incorporating step-by-step procedures that spell out the details of the calculations in §1.401(a)(4)-3(d). This guidance is intended to achieve consistency in the general test and to provide certainty for employers and practitioners in the application of the test. Although guidance of this type is often provided in revenue procedures, the integral relationship of these calculations to the general test made its inclusion in §1.401(a)(4)-3 preferable.

Annual, accrued-to-date, and projected methods

The final regulations generally retain the three methods for determining accrual rates provided in the proposed regulations. However, changes were made in the annual method in order to insure that the method was administrable and operated in a manner consistent with the purposes of the nondiscriminatory amount requirement. The annual method under the proposed regulations was intended to measure the increase in an employee's benefits during the current plan year. The May 1990 proposed regulations, however, attempted to permit

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elimination of current year accruals attributable to compensation increases under a final pay formula and current year benefit increases attributable to past service credits granted in the current year from the determination of accrual rates and, thereby, from nondiscrimination testing.

After issuance of the proposed regulations, a number of commentators indicated that this approach, which was intended to stabilize accrual rates generated under the annual method, in fact produced erratic, unintended results including negative accrual rates. In addition, some commentators expressed concern that these adjustments resulted in several significant problems for employers and employees including (1) making the annual method

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unworkable for plans that have a different compensation basis than the compensation used to determine benefits (e.g., a career average accumulation plan tested on the basis of a 3-year average), (2) permitting continued accruals under prior-law excess-only integrated plans that ceased to qualify after TRA '86, and (3) difficulty in defining the relevant past-service credits.

The September 1990 proposed regulations corrected some of the technical problems but left many of the issues unresolved. In developing final regulations, consideration was given to approaches intended to eliminate the technical complexity and arbitrary results arising from the adjustments under the annual method and to control for significant potential discrimination problems. These approaches added significant complexity to the testing process without significantly improving the utility of the test, however. Therefore, the final regulations generally retain the annual method alternative in the September 1990 proposed



regulations, and no longer permit elimination of accruals resulting from increases in compensation and grants of past service as in the original May 1990 proposed regulations.

While this change will reduce the potential utility of the annual method approach for final average pay plans, these plans should generally be able to satisfy section 401(a)(4) using either the accrued-to-date or the projected method alternatives. At the same time, the change makes the annual method a practical method for accumulation plans that were generally not able to satisfy section 401(a)(4) using either of the other two alternative methods under the general test. Further, under the transition rules in §1.401(a)(4)-13, employers who have amended their plans in the past or who amend their plans to comply with TRA '86 by the last day of the first plan year beginning on or after January 1, 1992, may disregard certain increases in accruals resulting from increases in compensation relating to any benefits under the prior plan formula.

Other issues

Many commentators requested clarification of the treatment of early retirement window benefits. The final regulations clarify that these benefits are taken into account in determining most valuable accrual rates but provide a simplified testing method under which employees who will be eligible by the end of the window period are treated as eligible as of the first day of the window period.

Several commentators expressed concern that disability benefits provided under defined benefit plans may result in failure of these plans to satisfy amounts testing and asked for special rules. The final regulations do not provide any special rules. However, in general, the provision of disability benefits should not result in a failure of a defined benefit



plan to satisfy the nondiscriminatory amounts requirement. A disability benefit that is not in excess of a qualified disability benefit is an ancillary benefit that is not subject to amounts testing. Under section 411(a)(9), a qualified disability benefit can be provided up to the maximum normal retirement benefit, and can commence either at the time of disability (without actuarial reduction) or at normal retirement age. A benefit attributable to the period while an employee is disabled continues to be characterized as a qualified disability benefit even though an employee returns to work or reaches normal retirement age. Consequently, a plan that provides benefits attributable to the period an employee is disabled does not have to test these benefits under the nondiscriminatory amounts requirement of section 401(a)(4) because these benefits are qualified disability benefits and thus, are not included in the calculation of an employee's accrued benefit.

Correction mechanisms

Many commentators stressed that practical problems often prevented data collection and plan testing in sufficient time to correct for failure to satisfy the nondiscrimination requirements. In developing the final regulations two basic alternatives were considered. Use of prior year data, which was suggested by some commentators, is not generally permitted in the final regulations. The primary reason is that use of prior year data could materially undercut the statutory nondiscrimination requirements, unless the old data were required to be modified to reflect certain significant changes (such as significant changes in the composition of the employer's workforce and plan participants). Such an approach would have been difficult for practitioners to apply and the Service to administer.





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The other approach suggested by a number of commentators was to permit retroactive correction of the plan for a reasonable period of time after the end of the plan year for purposes of satisfying the nondiscriminatory amounts requirement. This alternative has been adopted in §1.401(a)(4)-11(g) of the final regulations. The retroactive correction period in the final regulations extends through the 15th day of the 10th month after the end of the plan year. This approach, which is similar to that contained in section 401(b) with respect to certain disqualifying provisions, provides the employer with a significant period within which to run any necessary tests and take corrective action.

In order to permit employers to make practical choices based on administrative concerns, use of the retroactive correction period is not conditioned on a demonstration that the plan actually failed to satisfy the nondiscrimination requirements. In addition, the correction is not limited to amendments correcting disqualifying defects. The final regulations do require, however, that any retroactive amendment under this provision be nondiscriminatory standing alone and be consistent with the anti-cutback rules of section 411(d)(6).

2. Nondiscriminatory Availability of Benefits, Rights, and Features.

The second requirement a plan must satisfy under the regulations is that the benefits, rights, and features provided under the plan must be made available to the employees in the plan in a nondiscriminatory manner. Rules for satisfying this requirement are set forth in §1.401(a)(4)-4. The final regulations retain the basic structure of the proposed regulations in testing nondiscriminatory availability and incorporate the relevant provisions of the prior final regulations under §1.401(a)-4 on optional forms of benefit.

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The final regulations, like the proposed regulations, require that each optional form of benefit, each ancillary benefit, and each other right or feature provided under a plan must separately satisfy section 401(a)(4) with respect to its availability. However, this rule has been modified in the final regulations to permit two or more benefits, rights, and features to be permissively aggregated if one of the benefits, rights, or features is inherently of equal or greater value than the other, and the more valuable benefit, right, or feature, standing alone, satisfies the current and effective availability requirements of §1.401(a)(4)-4.

Under the proposed regulations, optional forms of benefit available to a group of employees affected by a merger or acquisition were deemed to satisfy the nondiscriminatory availability requirement if they were available to a group of employees that satisfied section 410(b) immediately before and immediately after the transaction (the special merger rule). The final regulations retain the special merger rule but broaden it in response to comments. Under the final regulations, an employer may expand the group of employees to whom the special merger rule applies to include new employees who come into the acquired group of employees during the period described in section 410(b)(6)(D). In addition, the final regulations are clarified to provide explicitly that the special merger rule is applicable to both stock and asset acquisitions and any similar types of transactions involving a change in employers for employees of a trade or business.

The proposed regulations also provided a special rule for testing the availability of optional forms of benefit that were eliminated with respect to prospective accruals but retained, as required by section 411(d)(6) for existing accruals. Under this special rule, the availability of such optional forms of benefits satisfied section 401(a)(4) if the optional form

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of benefit satisfied the current and effective availability requirements of the regulation immediately before the effective date of the prospective elimination.

The nondiscriminatory availability requirements in the proposed regulations built on the approach taken in the final regulations under §1.401(a)-4 regarding optional forms of benefit and extended the substantive rules of that section to other plan benefits, rights, and features. Under the proposed regulations, any age and service conditions on availability were generally disregarded for purposes of the current availability requirements. This provision permitted testing on the assumption that employees will ultimately satisfy the age or service condition and, when applied to benefits that are protected against reduction or elimination by section 411(d)(6), is consistent with the policies underlying the nondiscrimination testing of retirement benefits. However, ancillary benefits and other rights

and features provided under the plan (e.g., loans and investment alternatives) may be reduced or eliminated at any time and, therefore, are of value only to the participants to whom they are available in the current year. Nondiscriminatory availability of these benefits therefore requires that they be currently and effectively available in the current year taking age and service conditions into account. The final regulations are modified to so limit the rule consistent with its original intent. Under an exception, however, the special testing rule is extended to social security supplements as well. Thus, under the final regulations, age and service conditions are disregarded only with respect to optional forms of benefit and social security supplements.

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3. Nondiscriminatory Effect of Plan Amendments and Terminations.

The third requirement a plan must satisfy under the regulations is that the effect of plan amendments (including grants of past service) and terminations be nondiscriminatory. Rules for satisfying this requirement are set forth in §1.401(a)(4)-5. Under the proposed regulations, plan amendments must not have the effect of discriminating in favor of highly compensated employees. For grants of past service credit, the standard was significant discrimination. In both cases, whether a plan met the requirement depended in general on the relevant facts and circumstances. The use of a general anti-abuse standard based on facts and circumstances was designed to permit plans to be amended and past service credit to be granted in a manner consistent with both the nondiscrimination rules and business practices.

In response to comments, the final regulations consolidate the plan amendment and past service credit rules, broaden the significant discrimination standard to apply to both plan amendments and grants of past service, clarify the definition of plan amendment, and specify the time at which testing is done. The final regulations also clarify that if an amendment is prospective and the benefits under the plan as amended satisfy the nondiscriminatory amounts requirement under section 401(a)(4), the amendment generally will not violate §1.401(a)(4)-5.

Under the proposed and final regulations, as under prior guidance, the determination of whether a grant of past service is discriminatory is based on facts and circumstances. In developing the proposed and final regulations, Treasury and the Service recognized that past administration of the nondiscrimination requirements in this area has sometimes been inconsistent. Therefore, in order to provide greater certainty and to enhance consistency in

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administration, the proposed regulations provided a five year safe harbor and further provided a list of some of the relevant factors for facts and circumstances testing, based on existing guidance.

The final regulations retain both the past service safe harbor and the enumerated factors contained in the proposed regulations. Under the safe harbor, a grant of up to 5 years of past service credit is deemed to be nondiscriminatory. The existence of this safe harbor does not mean that a grant of past service credit for a longer period violates the nondiscrimination rules.

The requirement that a plan's effect in certain special circumstances be nondiscriminatory also covers plan terminations. The proposed regulations significantly liberalized the rules under §1.401-4(c) restricting distributions to highly compensated employees upon termination of a defined benefit plan. Under these final regulations, as under the proposed regulations, the early termination restrictions are inapplicable if the payment is less than 1 percent of plan assets or, after the payment of the benefit, the value of plan assets is at least 110 percent of the plan's current liabilities, as defined in section 412(*l*)(7).

A number of commentators expressed confusion about the extent to which the old early termination restrictions and the administrative rules applicable to them are still in effect. As part of these final regulations, the final regulations under §1.401-4(c) are obsolete for distributions after January 1, 1992. In addition, the employer may rely on these regulations and the proposed regulations, in lieu of the regulations under §1.401-4(c), for any distributions on or after May 14, 1990. Furthermore, with respect to distributions that were

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restricted or escrowed under the rules in §1.401-4(c) that may be distributed to the employee under the rules in these final regulations, the employer may either retain the existing restrictions or escrow, or amend the plan to release the distributions to the extent permitted

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under these final regulations. In general, it is intended that the relevant administrative procedures applicable to restricted amounts under §1.401-4(c) will continue to be available for restricted amounts under the new provisions. A revenue ruling reinstating these procedures, and in particular the provisions for escrow arrangements, will be issued in the near future.

4. Employee Contributions.

Section 1.401(a)(4)-6 provides rules for defined benefit plans that include employee contributions that are essentially the same as in the proposed regulations. Generally, under the proposed and final regulations, benefits derived from employer contributions and benefits derived from employee contributions must separately satisfy section 401(a)(4). Rules are provided for determining the employer-derived benefit in a defined benefit plan that also includes employee contributions not allocated to separate accounts as well as for determining whether employee contributions under a defined benefit plan are nondiscriminatory.

Like the proposed regulations, the final regulations provide that the determination of the employer-derived benefit generally follows the method prescribed in section 411(c). In addition, the final regulations retain and clarify several simpler alternatives provided in the proposed regulations. The final regulations have also been revised to consolidate rules in the proposed regulations under section 401(*l*) relating to employee contributions under a defined benefit plan with the section 401(a)(4) rules. In response to comments, the option of using a



uniform factor to determine the portion of an employee's benefit attributable to employee contributions has been expanded to apply in certain cases where the rate of employee contributions increases at higher levels of compensation ("integrated" or "step-rate contributions"). Under the proposed regulations, a plan that included step-rate employee contributions could determine the employee-provided benefit on an individual basis, usually resulting in an employer-provided benefit that would fail to satisfy section 401(*l*). The modification made in the final regulations allows a plan that includes step-rate employee contributions to determine the employee-provided benefit more simply and should result in a rate of employer-provided benefit that is more likely to satisfy section 401(*l*).

5. Permitted Disparity

The final regulations, like the proposed regulations, allow the disparity permitted by section 401(*l*) to be taken into account in showing that the amount of contributions or benefits satisfies section 401(a)(4). As under the proposed regulations, the determination of whether a plan satisfies the permitted disparity requirements in many cases merely requires inspection of the plan benefit or contribution formula, i.e., where a plan is using one of the safe harbor rules for showing nondiscrimination in the amount of contributions or benefits and thus is required to satisfy section 401(*l*) in form.

If a plan does not use the safe harbor rules, permitted disparity is taken into account by using specified formulas that adjust allocation or accrual rate to reflect the amount of permitted disparity that may be taken into account. The rules for imputing permitted disparity are set forth in §1.401(a)(4)-7. The adjusted rates effectively transform the allocations or accruals under the plan for each employee to determine the excess rate each



employee would receive if the same dollar value of allocation or accrual had been received under a plan formula containing the maximum permitted disparity under section 401(*l*). The resulting excess rates are the allocation rates or accrual rates that are compared to determine whether the plan satisfies the general tests in §1.401(a)(4)-2 or 1.401(a)(4)-3.

Because of the close interrelationship between sections 401(a)(4) and 401(*l*), the final regulations under both sections were developed together and have been clarified and modified where necessary to reflect a consistent and coordinated approach to permitted disparity. The modifications that have been made with respect to the permitted disparity rules are discussed in detail in the preamble to the final regulations under section 401(*l*), published simultaneously with these final regulations.

6. Cross-Testing Defined Benefit and Defined Contribution Plans.

The proposed regulations provided methods for testing defined benefit plans on the basis of equivalent contributions and testing defined contribution plans on the basis of equivalent benefits. These rules were generally based on and replaced the rules of Rev. Rul. 81-202. The final regulations clarify these methods and coordinate them with the general

testing methods provided in the general testing methods. In response to comments, they also provide that standard interest and mortality assumptions must be used to determine equivalent benefits under a defined contribution plan, and clarify the availability of various optional methods of calculating allocations and accruals under §§1.401(a)(4)-2 and 1.401(a)(4)-3 when a plan is cross-tested. As discussed above, the cross testing rules have been expanded to provide safe harbor testing methods for cash balance plans, to expand the safe harbor testing



methods for floor offset plans, and to clarify the safe harbor testing methods for target benefit plans.

7. Definition of a Plan and Plan Aggregation.

The proposed and final regulations require plans that are aggregated for purposes of section 410(b) to be tested on an aggregated basis under section 401(a)(4). Under the proposed regulations, allocation and accrual rates under an aggregated plan were calculated by adding together the allocation and accrual rates for each employee, separately determined for each plan in the aggregated plan. The final regulations simplify this determination by providing that all plans of a single type (i.e., defined benefit or defined contribution) within a single aggregated plan are treated as a single plan, and are thus not subject to any special aggregation rules. Thus, only aggregated plans consisting of both defined benefit and defined contribution plans are subject to the special testing rules of §1.401(a)(4)-9(b). The final regulations also clarify that the amount of permitted disparity that may be taken into account with respect to an aggregated plan is determined after calculating employees' aggregate allocation and accrual rates under the plan and taking into account the overall permitted disparity imputation with respect to employees'. This approach avoids an unintended limitation on the use of permitted disparity that could have resulted under the proposed regulations.

The proposed regulations contained a special rule for determining whether benefits, rights and features under an aggregated plan that includes both defined benefit and defined contribution plans were currently available on a nondiscriminatory basis. The final regulations retain this rule and expand it to include the effective availability test as well as



the current availability test under §1.401(a)(4)-4. The proposed regulations provided special testing rules for spousal benefits required under section 401(a)(11) in this section. This rule is retained in the final regulations, but is provided in §1.401(a)(4)-4. In response to comments, the final regulations clarify that whether a spousal benefit is subsidized for this purpose may generally be determined using the plan's own actuarial assumptions.

8. Plan Restructuring.

The proposed regulations permitted a plan to be restructured into component plans using one of three methods: employee group restructuring, total rate restructuring, and rate segment restructuring. As discussed earlier in the context of testing for nondiscrimination in amounts, the total rate and rate-segment restructuring rules in the proposed regulations have become an automatic part of the nondiscriminatory amounts general test in the final regulations. The final regulations retain, in §1.401(a)(4)-9(c), the employee group restructuring alternative. However, because of the integration of the rate-segment restructuring rules in the general test, it has been possible in the final regulations to eliminate most restrictions on the employee group restructuring alternative. Thus, the final regulations no longer require that employee group restructuring be limited to situations in which the members of the employee group have some common attribute other than allocation or accrual rates. In addition, as a result of this change, it has been possible to eliminate other restrictions on the use of employee group restructuring, including special rules that were relevant primarily to total rate and rate segment restructuring. Thus, the employee groups used to form component plans may generally be selected using any method. The final regulations also clarify that the restructuring rules apply for purposes of section 401(*l*), and



those portions of sections 410(b), 414(s), and other provisions that are specifically applicable in determining whether the requirements of section 401(a)(4) are satisfied.

9. Testing of Plans with Respect to Former Employees.

Under both the proposed regulations and the final regulations, §§1.401(a)(4)-1 and 1.401(a)(4)-10 require that a plan separately satisfy section 401(a)(4) with respect to the

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amount of benefits or contributions and with respect to the availability of benefits, rights, and features provided to employees and former employees.

In general, the final regulations retain the rules provided in the proposed regulations but clarify certain aspects of the requirements in response to comments. For example, the final regulations provide additional guidance with respect to the manner in which the safe harbors and the general test apply to former employees, including coordinating these rules with the rules for former employees under section 410(b). In addition, a safe harbor is provided in the final regulations for plans that are amended to provide an ad hoc cost-of-living adjustment. In order to satisfy this safe harbor, a cost-of-living increase must be provided on a uniform and consistent basis and must generally be limited to the percentage increase in social security benefits under the provisions of the Social Security Act. In determining permissible uniform increases, an employer may group former employees based on their date of retirement into bands not exceeding 5 consecutive years in length. Because automatic cost-of-living adjustments are part of the accrued benefit and are taken into account in satisfying the nondiscriminatory amounts requirements for employees, they are not tested again with respect to former employees.



The rules in both the proposed and final regulations for determining whether a plan satisfies section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees are also generally the same as those applicable to current employees. The final regulations expand a rule in the proposed regulations under which a plan is generally deemed to satisfy section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees if the availability of any benefits, rights, or features subject to availability testing has not been amended during the current plan year, or, alternatively, if any changes in availability in the current plan year are made in a nondiscriminatory manner. Thus, under the final regulations, nondiscrimination testing of the availability of benefits, rights, and features to former employees is required only in the year in which an amendment to the availability of benefits, rights, and features to former employees is first effective.

10. Additional Rules.

Like the proposed regulations, the final regulations provide that benefits and account balances attributable to rollovers and elective transfers generally are not taken into account in determining whether the amount of benefits or contributions provided under the plan satisfies section 401(a)(4). Similarly, the final regulations continue the current requirement that the manner in which employees vest in their accrued benefits under a plan must not discriminate in favor of highly compensated employees.

The final regulations add a requirement that service be credited on a nondiscriminatory basis. A special rule is provided permitting service to be credited for certain periods during which the employee is on a leave of absence. This is necessary to



coordinate the nondiscrimination testing rules in section 401(a)(4) with the new rules contained in the final regulations under section 414(s) that permit compensation to be imputed during certain leaves of absence.

11. Transition and Fresh-Start Rules.

The September 1990 proposed regulations set forth several alternative methods for taking into account benefits attributable to years prior to the effective date of the regulations for purposes of applying the safe harbors for defined benefit plans. These methods generally required the pre-effective date benefits to be frozen, and benefits for future years to be determined as the sum of the pre-effective date benefits and the post-effective date benefits. Alternatively, a plan was permitted to determine the benefits for all years under one of two "wear-away" approaches that provided plans additional flexibility in transitioning into the post-TRA '86 nondiscrimination rules while continuing to satisfy the anti-cutback rules of section 411(d)(6). The proposed regulations also provided that, in certain circumstances, an employee's frozen benefit under a final or career average pay plan could be increased to reflect subsequent increases in compensation. In addition, the proposed regulations permitted the accrued-to-date and projected methods to be applied with respect to benefits accruing and service after a date selected by the employer before December 31, 1991, but did not provide guidance on applying this "fresh-start" option.

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The final regulations generally retain these effective date transition rules in §1.401(a)(4)-13, but coordinate them with the fresh-start option for the accrued-to-date and projected methods, in addition to clarifying and expanding the rules in certain respects. For example, the final regulations provide additional guidance on what changes can be made to a

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benefit, while still allowing the benefit to be considered frozen. In addition, under the final regulations, all of the transition and fresh-start rules have been expanded to permit transitions and fresh starts in any year after the effective date as well as before. However, the adjustment to an employee's frozen benefit under a final or career average pay-type plan to reflect subsequent increases in compensation only applies to transitions or fresh starts before the effective date. In addition, special transition rules have been added in the final regulations for target benefit plans and cash balance plans.

12. Governmental plans.

Under the proposed regulations, section 401(a)(4) was considered to be satisfied in the case of governmental plans described in section 414(d) for plan years beginning before 1993. This provision has been retained in the final regulations. In addition, the final regulations provide that, if the governing body with authority to amend the plan does not meet continuously, section 401(a)(4) will be considered satisfied for plan years beginning before 90 days after the opening of the first legislative session on or after January 1, 1993.

The delayed effective date provision in the proposed regulations resulted in some comments that governmental plans should not be subject to nondiscrimination testing. In the absence of statutory provisions excepting governmental plans from these requirements, the final regulations recognize their applicability. Nevertheless, the Treasury and the Service recognize that governmental plans may have some unique features that arise because the sponsoring employer is a governmental entity. Some comments have been received on such features and additional comments are specifically requested from governmental employers regarding the appropriate modifications to the regulations to take into account the operation

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of government plans. A section in the final regulations has been reserved for rules that will address these unique features.

13. Merger and Acquisitions.

In general, although some expanded guidance is provided in the final regulations regarding nondiscrimination testing under section 401(a)(4) and related Code sections where the employer has engaged in a merger, acquisition, or similar transaction, the final regulations do not address these issues in a comprehensive way. The Treasury and the Service have opened a regulations project relating to these issues, and intend to address them separately. Comments are specifically requested concerning areas of practical concern and appropriate modifications to the regulations to address these matters. While these regulations are generally effective for plan years beginning after December 31, 1991, the Treasury and the Service recognize that in some situations, unique problems related to a merger or acquisition may make exact adherence to some of the provisions of the regulations impossible. For example, it may be difficult to obtain prior year data necessary for determining with certainty whether certain acquired employees are highly compensated employees. Pending issuance of further guidance, in limited situations, in the context of a merger or acquisition, a reasonable good faith effort to satisfy the nondiscrimination requirements consistent with the statutory and regulatory requirements will be acceptable. Whether compliance is reasonable and in good faith in this context require that the employer make every reasonable effort to satisfy all relevant portions of this regulation.

14. Plans maintained by more than one employer.

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Multiple employer plans must satisfy section 401(a)(4) on an employer-by-employer basis rather than on the basis of participating employers in the aggregate. Any non-collectively bargained portion of a multiemployer plan is tested as a multiple employer plan. The consequences of failure to satisfy section 401(a)(4) with respect to any component of this testing process may effect the plan for all participating employers. The final regulations, like the proposed regulations, do not provide an exception to this rule. However, where a multiemployer plan or a multiple employer plan fails to satisfy section 401(a)(4), in a proper case, the Commissioner could treat the plan as satisfying section 401(a)(4) for innocent employers by requiring corrective and remedial action with respect to the plan, such as



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allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have knowledge of the disqualifying event or was otherwise notified by the Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events.

15. Effective Dates.

The final regulations are generally effective for plan years beginning after December 31, 1991. For plan years beginning before that date and on or after the first day of the first plan year to which the amendments made by section 1112(a) of TRA '86 apply to a plan §1.401(a)(4)-13 provides that a plan must be operated in accordance with a reasonable, good faith interpretation of the requirements of section 401(a)(4), taking into account pre-existing guidance and the amendments made by TRA '86 to related Code provisions, such as sections 401(*l*), 401(a)(17), and 410(b). Whether compliance is reasonable and in good faith will generally be determined on the basis of facts and circumstances, including the extent to



which the employer has consistently resolved all unclear issues in its favor. Reasonable, good faith compliance will be deemed to exist, however, if a plan is operated in accordance with the proposed regulations.

In Rev. Proc. 90-73, 1990-2 C.B. 786, the Internal Revenue Service extended the date by which the plan amendments to comply with TRA '86 must be made until the close of the 1992 plan year. This extended amendment date, combined with the reasonable, good faith compliance standard contained in these proposed regulations, is designed to ensure that plan sponsors have a reasonable period in which to amend qualified plans.

16. Failure to comply.

In general, under section 402(b)(1) of the Code, if a plan fails to satisfy the qualification requirements contained in section 401(a) of the Code, the tax-exempt status of plan earnings is revoked, employer deductions for contributions may be deferred or denied, and all employees must include the value of plan contributions in income in accordance with section 83. Thus, if contributions are made to the plan with respect to vested accounts or benefits, employees must include these amounts in income.

In addition to the general rule of section 402(b)(1), section 402(b)(2) contains special rules that apply if the plan fails to satisfy section 401(a)(26) or 410(b). If the plan fails to satisfy either of these sections, each highly compensated employee must include in income an amount equal to the employee's entire vested accrued benefit not yet included in income. If, however, the plan is not qualified solely because it fails to satisfy the requirements of section 401(a)(26) or 410(b), no adverse tax consequences are imposed on nonhighly compensated employees.



Under the integrated approach to sections 401(a)(4) and 410(b) underlying the regulations, any failure to satisfy section 401(a)(4) constitutes a failure to satisfy section 410(b). Consequently, failure to meet the requirements of section 401(a)(4) will cause section 402(b)(2) to apply with respect to a plan, and will therefore subject highly compensated employees to the special sanctions contained in that section. Similarly, if the plan satisfies all qualification requirements other than sections 410(b) and 401(a)(26), no adverse tax consequences will be imposed on nonhighly compensated employees.

17. Incomplete or Inaccurate Data.

In some cases, use of a decentralized payroll or personnel record keeping system may result in incomplete data that makes it impossible to confirm compliance with sections 401(a)(4), 401(*l*), 410(b), and 414(s) or inaccurate data that indicates apparent noncompliance with those sections. The preamble to the proposed regulations provided that, in limited cases, the Service would generally permit an employer to use reasonable estimates in lieu of missing or inaccurate data.

Comments on the conditions for estimating data set forth in the preamble to the proposed regulations indicate that many employers maintaining defined benefit plans have difficulty meeting the conditions in the case of employee compensation data. In response to the comments received, the Service has established separate conditions for estimating missing or inaccurate employee compensation data for plan years beginning before January 1, 1995. These are described below. For estimating data other than compensation data, the conditions set forth in the preamble to the proposed regulations are retained.

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General rule

For noncompensation data or compensation data for plan years beginning on or after January 1, 1995, an employer is permitted to use reasonable estimates of data provided the following conditions are met: (1) the incomplete or inaccurate data pertain to no more than a de minimis number of employees relative to the number of employees in the testing population; (2) if the data pertain to highly compensated employees, they do not pertain to the most highly compensated employees in the testing population, and the employer has more than a small number of highly compensated employees in its overall workforce; (3) the data difficulties could not have been avoided through reasonably careful administrative procedures; (4) in the case of incomplete data, the employer has made a reasonable effort to obtain the data without success; (5) in the case of inaccurate data, the data are obviously inaccurate on their face given the characteristics of the plan and the employer's workforce, and the employer has made a reasonable effort to obtain accurate data without success; and (6) the employer takes appropriate steps to correct the data difficulties in future years.

Special rule for compensation data for plan years beginning before January 1, 1995

A special rule is provided for estimating compensation data for plan years beginning before January 1, 1995. Under this rule, an employer is permitted to use reasonable estimates of compensation data provided the following conditions are met: (1) the incomplete or inaccurate data does not pertain to a significant number of employees relative to the number of employees in the testing population; (2) if the data pertain to highly compensated employees, they do not pertain to the most highly compensated employees in the testing population, and the employer has more than a small number of highly



compensated employees in its overall workforce; (3) the employer takes reasonable steps to correct the data difficulties as soon as possible and no later than plan years beginning on or after January 1, 1995; (4) the estimate is a reasonable approximation of actual data based on reasonable assumptions. These requirements do not apply to plans that determine compensation using an employee's rate of pay as otherwise permitted under the regulations for section 414(s).

18. Effect on other laws.

Compliance with the provisions of this regulation does not ensure compliance with other applicable Federal laws, including, but not limited to, the provisions of Title I of the Employee Retirement Income Security Act of 1974 which are administered by the Secretary of Labor pursuant to Reorganization Plan Number 4 0f 1978. Employers should note that plan amendments pursuant to this regulation may necessitate reporting and disclosure under such Act, including requirements related to summary plan descriptions and summaries of material modifications.

19. Additional Authority.

The rules in the regulations regarding section 401(a)(4) are the exclusive rules for determining whether the requirements of that section are met. The regulations also provide, however, that the commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4).



Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notices of proposed rulemaking for these regulations published after November 20, 1988, were submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these proposed regulations are Nancy J. Marks, David Munroe, Marjorie Hoffman, Patricia McDermott, Suzanne Tank, and Rebecca Wilson of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

List of subjects in 26 CFR 1.401-0 through 1.419(A)-2T

Bonds, Employee benefit plans, Income taxes, Reporting and recordkeeping requirements, Securities, Trusts and Trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953



Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * *

Par. 2. Section 1.401-4 is amended by revising the section heading and adding a paragraph (d) to read as follows:

§1.401-4 Discrimination as to contributions or benefits (before 1992).

* * * * *

(d) The provisions of this section do not apply to plan years beginning on or after January 1, 1992. For rules applicable to plan years beginning on or after January 1, 1992, see §§1.401(a)(4)-1 through 1.401(a)(4)-13.

Par. 3. Section 1.401(a)-4 is amended by revising the section heading, A-2(a)(2)(ii), Q-6, and A-6(a) to read as follows:

§1.401(a)-4 Optional forms of benefit (before 1992).

* * * * *

A-2: (a) * * *

(2) * * *

(ii) Plan years commencing on or after TRA '86 effective date. Except as provided in paragraph (a)(2)(iii) of this Q&A-2, for plan years commencing on or after the effective date on which the amendments made to section 410(b) by section 1112(a) of TRA '86 first apply to a plan, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the percentage test set forth in section 410(b)(1)(A), the ratio test set forth in section 410(b)(1)(B), or the



nondiscriminatory classification test set forth in section 410(b)(2)(A)(i). The employer need not satisfy the average benefit percentage test in section 410(b)(2)(A)(ii) in order for the optional form to be currently available to a nondiscriminatory group of employees.

* * * * *

Q-6: For what period are the rules of this section effective?

A-6: (a) General effective date. Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986. The provisions of this section do not apply to plan years beginning on or after January 1, 1992. For rules applicable to plan years beginning on or after January 1, 1992, see §§1.401(a)(4)-1 through 1.401(a)(4)-13.



Par. 4. New §§1.401(a)(4)-0 through 1.401(a)(4)-13 are added at the appropriate place to read as follows:

§1.401(a)(4)-0 Table of contents.

This section contains a listing of the headings of §§1.401(a)(4)-1 through 1.401(a)(4)-13.

§1.401(a)(4)-1 Nondiscrimination requirements of section 401(a)(4).



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§1.401(a)(4)-1 Nondiscrimination requirements of section 401(a)(4).

(a) In general. Section 401(a)(4) provides that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of highly compensated employees. Whether a plan satisfies this requirement depends on the form of the plan and on its effect in operation. In making this determination, intent is irrelevant. This section sets forth the exclusive rules for determining whether a plan satisfies section 401(a)(4). A plan that complies in form and operation with the rules in this section therefore satisfies section 401(a)(4).

(b) Requirements a plan must satisfy--(1) In general. In order to satisfy section 401(a)(4), a plan must satisfy the requirements of paragraphs (b)(2) through (b)(4) of this section.

(2) Nondiscrimination in amount of contributions or benefits--(i) In general. Either the contributions or the benefits provided under the plan must be nondiscriminatory in amount. It need not be shown that both the contributions and the benefits provided are nondiscriminatory in amount, but only that either the contributions alone or the benefits alone are nondiscriminatory in amount.

(ii) Defined contribution plans. A defined contribution plan generally satisfies this paragraph (b)(2) if the contributions allocated under the plan (including forfeitures) are nondiscriminatory in amount under §1.401(a)(4)-2. Alternatively, a defined contribution plan (other than an ESOP, a section 401(k) plan, or a section 401(m) plan) satisfies this paragraph (b)(2) if the equivalent benefits provided under the plan are nondiscriminatory in amount



under §1.401(a)(4)-8(b). These latter rules include a safe harbor testing method for contributions provided under a target benefit plan.

(iii) Defined benefit plans. A defined benefit plan generally satisfies this paragraph (b)(2) if the benefits provided under the plan are nondiscriminatory in amount under §1.401(a)(4)-3. Alternatively, a defined benefit plan satisfies this paragraph (b)(2) if the equivalent allocations provided under the plan are nondiscriminatory in amount under §1.401(a)(4)-8(c). These latter rules include a safe harbor testing method for benefits

provided under a cash balance plan. In addition, §1.401(a)(4)-8(d) provides a safe harbor testing method for benefits provided under a defined benefit plan that is part of a floor-offset arrangement.

(iv) Permitted disparity. In determining whether the contributions or benefits provided under a plan are nondiscriminatory in amount, the disparity permitted under section 401(*l*) may be taken into account, both by plans that satisfy section 401(*l*) in form and by those that do not. A plan that satisfies section 401(*l*) in form may be able to satisfy certain design-based safe harbors under §§1.401(a)(4)-2, 1.401(a)(4)-3, and 1.401(a)(4)-8. Alternatively, a plan may be able to satisfy the general tests in §§1.401(a)(4)-2, 1.401(a)(4)-3, and 1.401(a)(4)-8 by imputing the disparity permitted under section 401(*l*) on an employee-by-employee basis, even in the case of a plan that does not satisfy section 401(*l*) in form. Rules for taking into account the disparity permitted under section 401(*l*) are set forth in §§1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-7, 1.401(a)(4)-8, and 1.401(a)(4)-9. In no event may these rules be used by a plan to which sections 401(a)(5)(C) and 401(*l*) are not available.

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(3) Nondiscriminatory availability of benefits, rights, and features. The benefits, rights, and features provided under the plan must be made available to employees in the plan in a nondiscriminatory manner. The benefits, rights, and features subject to this requirement are all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan. Rules for determining whether the requirement of this paragraph (b)(3) is met are set forth in §§1.401(a)(4)-4 and 1.401(a)(4)-9.

(4) Nondiscriminatory effect of plan amendments and terminations. The effect of plan amendments (including plan amendments granting past service credit) and plan terminations must be nondiscriminatory. Rules for determining whether the requirement of this paragraph (b)(4) is met are set forth in §1.401(a)(4)-5.

(c) Application of requirements--(1) In general. The requirements of paragraph (b) of this section must be applied in accordance with the rules set forth in this paragraph (c).

(2) Interpretation. The provisions of §§1.401(a)(4)-1 through 1.401(a)(4)-13 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees.

(3) Former employees. In applying the nondiscriminatory amount and availability requirements of paragraphs (b)(2) and (b)(3) of this section, former employees are tested separately from active employees unless otherwise provided. Rules for applying the requirements of paragraphs (b)(2) and (b)(3) of this section to former employees are set forth in §1.401(a)(4)-10.

(4) Employee-provided contributions and benefits. In applying the nondiscriminatory amount requirement of paragraph (b)(2) of this section, employee-provided contributions and

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benefits are tested separately from employer-provided contributions and benefits, unless otherwise provided. Rules for applying the requirements of paragraph (b)(2) of this section to employee contributions allocated to separate accounts are set forth in §1.401(a)(4)-2(d)(2). Rules for determining the amount of employer-provided benefits under a defined benefit plan that includes employee contributions not allocated to separate accounts are set forth in §1.401(a)(4)-6(b), and rules for applying the requirements of paragraph (b)(2) of this section to employee contributions under such a plan are set forth in §1.401(a)(4)-6(c).

(5) Plans providing section 401(h) benefits. In applying the requirements of paragraph (b) of this section, the portion of a plan providing benefits described in section 401(h) is tested separately from the portion of the same plan providing retirement benefits. Rules applicable to plans providing section 401(h) benefits are set forth in §1.401-14(b)(2).

(6) Collectively bargained plans. The requirements of paragraph (b) of this section are treated as satisfied by a collectively bargained plan that automatically satisfies section 410(b) under §1.410(b)-2(b)(7). This rule applies even if the collectively bargained plan is also a governmental plan within the meaning of section 414(d) that is subject to section 410(c). See §1.410(b)-2(e).

(7) Employee stock ownership plans. [Reserved]

(8) Scope of plan subject to testing--(i) Relationship with section 410(b). To be a qualified plan, a plan must satisfy both sections 410(b) and 401(a)(4). Section 410(b) requires that a plan benefit a nondiscriminatory group of employees, and section 401(a)(4) requires that the contributions or benefits provided to employees benefiting under the plan



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not discriminate in favor of those employees who are highly compensated. Consistent with

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this requirement, the definition of a plan subject to testing under section 401(a)(4) is the same as the definition of a plan subject to testing under section 410(b), i.e., the plan determined after applying the mandatory disaggregation rules of §1.410(b)-7(c) and the permissive aggregation rules of §1.410(b)-7(d). In addition, whichever testing option is used for the plan year under §1.410(b)-8(a) must also be used for purposes of applying section 401(a)(4) to the plan for the plan year.

(ii) Special rules for certain aggregated plans. Special rules are set forth in §1.401(a)(4)-9(b) for testing a plan that includes one or more defined benefit plans and one or more defined contribution plans that have been permissively aggregated under §1.410(b)-7(d). By contrast, an aggregated plan that includes only defined benefit plans or only defined contribution plans is tested exclusively under the rules applicable to a single plan without regard to the special rules in §1.401(a)(4)-9(b).

(iii) Restructuring. In certain circumstances, a plan may be restructured on the basis of employee groups and treated as comprising two or more plans, each of which is treated as a separate plan that must independently satisfy sections 401(a)(4) and 410(b). In effect, restructuring permits a plan that might otherwise fail to satisfy section 401(a)(4) as a single plan to demonstrate compliance with section 401(a)(4) based on the components of the plan, if those components separately satisfy section 410(b). Rules relating to restructuring plans for purposes of applying the requirements of paragraph (b) of this section are set forth in §1.401(a)(4)-9(c).

(iv) Reference to section 410(b) includes section 410(c). In the case of a plan described in section 410(c)(1), a reference to section 410(c)(2) may be substituted for any

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reference to section 410(b) in §§1.401(a)(4)-1 through 1.401(a)(4)-13. The preceding sentence does not apply to a plan that has made the election provided in section 410(d) or that is subject to section 403(b)(12)(A)(i).

(9) Plan year basis of testing--(i) In general. The requirements of paragraph (b) of this section are generally applied on the basis of the plan year. Thus, unless otherwise provided, the compensation, contributions, benefit accruals, and other items used to apply these requirements must be determined with respect to the plan year being tested.

(ii) Retroactive correction. In accordance with paragraph (c)(9)(i) of this section, the requirements of paragraph (b) of this section are generally applied on the basis of the terms of the plan in effect during the plan year. However, §1.401(a)(4)-11(g) provides rules allowing a plan to be retroactively amended after the close of the plan year to satisfy certain requirements under paragraph (b) of this section.

(10) Rollovers and transfers. In applying the requirements of paragraph (b) of this section, rollover contributions described in section 402(a)(5), 403(a)(4), or 408(d)(3), elective transfers described in Q&A-3(b) of §1.411(d)-4, and transfers of assets and liabilities described in section 414(*l*) are treated in accordance with the rules set forth in §1.401(a)(4)-11(b).

(11) Vesting. Notwithstanding any other provision in the regulations, a plan does not satisfy the nondiscriminatory amount requirement of paragraph (b)(2) of this section if the manner in which employees vest in their accrued benefits under the plan discriminates in favor of highly compensated employees. Rules for making this determination are set forth in §1.401(a)(4)-11(c).

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(12) Crediting service. Notwithstanding any other provision in the regulations, a plan does not satisfy the nondiscriminatory amount requirement of paragraph (b)(2) of this section if the manner in which employees' service is credited under the plan discriminates in favor of highly compensated employees. Rules for making this determination are set forth in §1.401(a)(4)-11(d).

(13) Governmental plans. The rules of this section apply to a governmental plan within the meaning of section 414(d), except as provided in §§1.401(a)(4)-11(f) and 1.401(a)(4)-13(b).

(14) Allocation of earnings. Notwithstanding any other provision in the regulations, a defined contribution plan does not satisfy the nondiscriminatory amount requirement of paragraph (b)(2) of this section if the manner in which income, expenses, gains, or losses are





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allocated to employee accounts under the plan discriminates in favor of highly compensated employees.

(15) Definitions. In applying the requirements of this section, the definitions set forth in §1.401(a)(4)-12 govern, unless otherwise provided.

(16) Effective dates and fresh-start rules. In applying the requirements of this section, the effective dates set forth in §1.401(a)(4)-13 govern. Section 1.401(a)(4)-13 also provides certain transition and fresh-start rules that apply for purposes of this section.

(d) Additional rules. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4).

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§1.401(a)(4)-2 Nondiscrimination in amount of contributions under a defined contribution plan.

(a) Introduction--(1) General rule. The amount of contributions under a defined contribution plan for a plan year does not discriminate in favor of highly compensated employees if the plan satisfies the requirements of this section for the plan year.

(2) Overview. This section sets forth rules for determining whether the contributions under a defined contribution plan are nondiscriminatory in amount. Certain defined contribution plans that provide uniform allocations are permitted to satisfy the requirements of this section by meeting one of the safe harbor tests in paragraph (b) of this section. Plans that do not satisfy one of these safe harbors generally may comply with the requirements of this section by satisfying the general test in paragraph (c) of this section. Paragraph (d) of this section sets forth the exclusive tests under which section 401(k) plans and section 401(m) plans must satisfy the requirements of this section.

(3) Alternative methods of satisfying nondiscriminatory amount requirement. A plan (other than a section 401(k) plan or a section 401(m) plan) is permitted to satisfy either of the tests in paragraph (b)(3) or (c) of this section on a restructured basis pursuant to §1.401(a)(4)-9(c). Alternatively, a plan (other than an ESOP, a section 401(k) plan, or a section 401(m) plan) is permitted to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) on the basis of equivalent benefits pursuant to §1.401(a)(4)-8(b). These latter rules include a safe harbor testing method for contributions provided under a target benefit plan.

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(4) Separate testing of employer and employee contributions. In applying the requirements of this section, employer contributions are tested separately from employee contributions, except as specifically provided for section 401(m) plans in §§1.401(m)-1 and 1.401(m)-2. To satisfy the requirements of this section, employer contributions must meet one of the tests set forth in paragraph (b), (c), or (d) of this section. Employee contributions under a section 401(m) plan must satisfy the requirements in paragraph (d)(2) of this section.

(b) Safe harbors--(1) In general. A defined contribution plan satisfies the requirements of this section for a plan year if the plan satisfies the uniformity requirements of paragraph (b)(2) of this section and either of the safe harbors in paragraphs (b)(3) and (b)(4) of this section. Paragraph (b)(5) of this section provides exceptions for certain plan provisions that do not cause a plan to fail the requirements of this paragraph (b).

(2) Uniformity requirements--(i) In general. A plan satisfies the uniformity requirements of this paragraph (b)(2) only if it satisfies each of the requirements in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section.

(ii) Uniform normal retirement age and allocation formula. The same uniform normal retirement age and the same allocation formula must apply to all employees in the plan.

(iii) Uniform vesting and service crediting. All employees in the plan must be subject to the same vesting schedule and the same definition of years of service. For purposes of crediting service, only service with the employer (or a predecessor employer within the meaning of section 414(a)) may be taken into account.

(3) Safe harbor for plans with uniform allocation formula. A plan satisfies the safe harbor in this paragraph (b)(3) for a plan year if the plan allocates all amounts taken into

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account under paragraph (c)(2)(ii) of this section for the plan year under a formula that allocates the same percentage of plan year compensation or the same dollar amount to every employee in the plan.

(4) Safe harbor for uniform points plans--(i) In general. A plan satisfies the safe harbor in this paragraph (b)(4) for a plan year if it satisfies each of the following requirements--

(A) The plan is a uniform points plan. A uniform points plan is a plan (other than an ESOP) under which each employee's allocation for the plan year equals the product determined by multiplying all amounts allocated or treated as allocated to all employees in the plan for the plan year (to the extent such amounts are taken into account under paragraph (c)(2)(ii) of this section) by a fraction, the numerator of which is the employee's points for the plan year, and the denominator of which is the sum of the points of all employees in the plan for the plan year. For this purpose, an employee's points for the plan year equal the sum of the employee's points for age, service, and units of plan year compensation for the plan year. Under a uniform points plan, each employee in the plan 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. The unit of plan year compensation used in the allocation formula must be the same for all employees in the plan and must be a single dollar amount that does not exceed $200. A uniform points plan need not grant points for both age and service, but it must grant points for at least one of them. If the plan grants points for years of service, the plan is permitted to limit the number



of years of service taken into account to a single maximum number of years of service. In all cases, a uniform points plan must grant points for plan year compensation.

(B) For the plan year, the average of the allocation rates for the highly compensated employees in the plan does not exceed the average of the allocation rates for the nonhighly compensated employees in the plan. For this purpose, allocation rates are determined in accordance with paragraph (c) of this section, without imputing permitted disparity under paragraph (c)(2)(iv) of this section and §1.401(a)(4)-7, and without grouping allocation rates under paragraph (c)(2)(v) of this section.

(ii) Example. The following example illustrates the safe harbor in this paragraph (b)(4).

Example. (a) Plan A has a single allocation formula that applies to all employees in the plan, and under which each employee's allocation for the plan year equals the product determined by multiplying all amounts taken into account for all employees in the plan for the plan year under paragraph (c)(2)(ii) of this section by a fraction, the numerator of which is the employee's points for the plan year, and the denominator of which is the sum of the points of all employees in the plan for the plan year. Plan A grants each employee 10 points for each year of service and 1 point for each $100 of plan year compensation. For the 1994 plan year, the total allocations are $81,200, and the total points for all employees in the plan are 8,120. Each employee's allocation for the 1994 plan year is set forth in the table below.



| Employee | Years of Service | Plan Year Compensation | Points | Amount of Allocation | Allocation Rate |
|---|---|---|---|---|---|
| H1 | 20 | $200,000 | 2,200 | $22,000 | 11.0% |
| H2 | 10 | $200,000 | 2,100 | $21,000 | 10.5% |
| H3 | 30 | $100,000 | 1,300 | $13,000 | 13.0% |
| H4 | 3 | $100,000 | 1,030 | $10,300 | 10.3% |
| N1 | 10 | $40,000 | 500 | $5,000 | 12.5% |
| N2 | 5 | $35,000 | 400 | $4,000 | 11.4% |
| N3 | 3 | $30,000 | 330 | $3,300 | 11.0% |
| N4 | 1 | $25,000 | 260 | $2,600 | 10.4% |
| Total | – | – | 8,120 | $81,200 | – |

(b) Under these facts, for the 1994 plan year Plan A is a uniform points plan within the meaning of paragraph (b)(4)(i)(A) of this section.

(c) For the 1994 plan year, the average allocation rate for the highly compensated employees in the plan (H1 through H4) is 11.2 percent, and the average allocation rate for nonhighly compensated employees in the plan (N1 through N4) is 11.3 percent. Because the average of the allocation rates for the highly compensated employees in the plan does not exceed the average of the allocation rates for the nonhighly compensated employees in the plan, Plan A satisfies paragraph (b)(4)(i)(B) of this section and, thus, the safe harbor in this paragraph (b)(4) for the 1994 plan year.

(5) Use of safe harbors not precluded by certain plan provisions--(i) In general. A plan does not fail to satisfy the requirements of this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(5). Unless otherwise provided, the provision must apply uniformly to all employees in the plan.

(ii) Section 401(*l*) permitted disparity. The plan takes permitted disparity into account in a manner that satisfies section 401(*l*) in form. Thus, differences in employees' allocations under the plan attributable to disparities permitted under §1.401(*l*)-2 (including differences in disparities that are deemed uniform under §1.401(*l*)-2(c)(2)) do not cause a plan to fail to



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satisfy the requirements of this paragraph (b). This paragraph (b)(5)(ii) applies solely for purposes of the uniform allocation safe harbor in paragraph (b)(3) of this section.

(iii) Entry dates. The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).

(iv) Prior vesting schedules. The plan provides different vesting schedules solely to the extent necessary to comply with section 411(a)(10) (relating to changes in vesting schedules).

(v) Certain conditions on allocations. The plan provides that an employee's allocation for the plan year is conditioned on the employee's employment on the last day of the plan year or on the employee's completion of a minimum number of hours of service during the plan year (not to exceed 1,000). Such a provision may include an exception for all employees who terminate employment during the plan year or only for those employees who terminate employment during the plan year on account of one or more of the following circumstances: retirement, disability, death, or military service.

(vi) Certain limits on allocations. The plan limits allocations otherwise provided under the allocation formula to a maximum dollar amount or a maximum percentage of plan year compensation, or limits the dollar amount of plan year compensation taken into account in determining the amount of allocations. The plan may apply these limits solely to all highly compensated employees in the plan.

(vii) Dollar allocation per uniform unit of service. The plan determines allocations based on the same dollar amount for each uniform unit of service (not to exceed 1 week) performed by each employee in the plan during the plan year. This paragraph (b)(5)(vii)



applies solely for purposes of the uniform allocation safe harbor in paragraph (b)(3) of this section.

(viii) Section 409(n) limits. The plan limits allocations to employees in accordance with section 409(n) (or section 1042(b)(3) of the Internal Revenue Code of 1954 as in effect immediately prior to the Tax Reform Act of 1986).

(ix) Section 415 limits. The plan limits allocations to employees in accordance with section 415.

(x) Multiple definitions of service--(A) In general. The plan provides different definitions of years of service for different purposes under the plan, provided that, for each purpose, the same definition of years of service applies to all employees in the plan. Thus, for example, the plan may define years of service for purposes of vesting as all years of service in which the employee has completed at least 500 hours of service, and for purposes of eligibility for plan participation as all years of service in which the employee has completed at least 1,000 hours of service.

(B) Hour-of-service equivalencies. The plan credits service for a specific purpose for some employees (e.g., hourly employees) based on hours of service as provided for in 29 CFR 2530.200b-2, but credits service for the same purpose for other employees (e.g., salaried employees) based on one of the equivalencies set forth in 29 CFR 2530.200b-3.

(C) Recognition of prior employment for eligibility and vesting. The plan credits service for purposes of eligibility or vesting, or both, for service with a prior employer. This rule applies solely to employees who become employees of the employer pursuant to a transaction between the employer and the prior employer that is a stock or asset acquisition,



a merger, or other similar transaction involving a change in the employer of the employees of a trade or business.

(D) Imputed service. The plan credits imputed service as permitted under §1.401(a)(4)-11(d)(2).

(xi) Multiple formulas--(A) In general. The plan provides that an employee's allocation under the plan is the greater of the allocations determined under two or more formulas. Alternatively, the plan provides that an employee's allocation under the plan is the sum of the allocations determined under two or more formulas. This paragraph (b)(5)(xi) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraphs (b)(5)(xi)(B) through (D) of this section. See §1.401(*l*)-5(b)(8)(ii) for rules regarding the overall permitted disparity limitations.

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(B) Sole formulas. The formulas are the only formulas under the plan.

(C) Separate testing. Each of the formulas separately satisfies the uniformity requirements of paragraph (b)(2) of this section and also separately satisfies either of the safe harbors in paragraphs (b)(3) and (b)(4) of this section. For this purpose, the formulas need not satisfy the same safe harbor. In addition, a formula that is available solely to some or all nonhighly compensated employees in the plan is deemed to satisfy this paragraph (b)(5)(xi)(C).

(D) Availability--(1) General rule. All of the formulas are available on the same terms to all employees in the plan.

(2) Formulas for nonhighly compensated employees. A formula does not fail to be available on the same terms to all employees in the plan, merely because the formula is



available solely to some or all nonhighly compensated employees in the plan on the same terms as all the other formulas in the plan.

(3) Top-heavy formulas. In the case of a plan that provides the greater of the allocations under two or more formulas, one of which is a top-heavy formula, the top-heavy formula does not fail to be available on the same terms to all employees in the plan, merely because the formula is available solely to all non-key employees in the plan on the same terms as all the other formulas under the plan. Furthermore, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan, merely because the top-heavy formula is conditioned on the plan's being top-heavy within the meaning of section 416(g). Finally, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan, merely because the top-heavy formula is available to all employees described in §1.416-1, Q&A M-10 (i.e., all non-key employees who have not separated from service as of the last day of the plan year). The preceding sentence does not apply, however, unless the plan would satisfy section 410(b) if all employees whose only allocation under the plan is provided under the top-heavy formula were treated as not currently benefiting under the plan. For purposes of this paragraph (b)(5)(xi)(D)(3), a top-heavy formula is a formula that provides the minimum benefit described in section 416(c)(2) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(II)).

(E) Provisions may be applied more than once. The provisions of this paragraph (b)(5)(xi) may be applied more than once. For example, a plan satisfies the requirements of this paragraph (b) if an employee's allocation under the plan is the greater of the allocations



under two or more formulas, and one or more of those formulas is the sum of the allocations under two or more other formulas, provided that each of the formulas under the plan satisfies the requirements of paragraphs (b)(5)(xi)(B) through (D) of this section.

(F) Examples. The following examples illustrate the rules regarding multiple formulas in this paragraph (b)(5)(xi).

Example 1. Under Plan A, each employee's allocation equals the sum of the allocations determined under two formulas. The first formula provides an allocation of 5 percent of plan year compensation. The second formula provides an allocation of $100. Plan A is eligible to apply the rules in this paragraph (b)(5)(xi).

Example 2. Under Plan B, each employee's allocation equals the greater of the allocations determined under two formulas. The first formula provides an allocation of 7 percent of plan year compensation and is available to all employees in the plan who complete at least 1,000 hours of service during the plan year and who have not separated from service as of the last day of the plan year. The second formula is a top-heavy formula that provides an allocation of 3 percent of plan year compensation (determined using section 414(s) compensation as defined in §1.414(s)-1(c)(2)), and that is available to all employees described in §1.416-1, Q&A M-10. Plan B does not satisfy the general rule in paragraph (b)(5)(xi)(D)(1) of this section because the two formulas are not available on the same terms to all employees in the plan (i.e., an employee is required to complete 1,000 hours of service during the plan year to receive an allocation under the first formula, but not under the second formula). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(5)(xi)(D)(3) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula, merely because the second formula is available to all employees described in §1.416-1, Q&A M-10, as long as the plan would satisfy section 410(b) if all employees whose only allocation under the plan is provided under the second formula were treated as not currently benefiting under the plan. This is true, even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 3. The facts are the same as in Example 2, except that the first formula is available to all employees who have not separated from service as of the last day of the plan year, regardless of whether they complete at least 1,000 hours of service during the plan year. Plan B still does not satisfy the general rule in paragraph (b)(5)(xi)(D)(1) of this section because the two formulas are not available on the same terms to all employees in the plan (i.e., the second formula is only available to all non-key employees in the plan). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(5)(xi)(D)(3) of this section apply. Thus, the second



formula does not fail to be available on the same terms as the first formula, merely because the second formula is available solely to all non-key employees in the plan.



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(c) General test for nondiscrimination in amount of contributions--(1) In general. A plan satisfies the requirements of this section for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c), a rate group exists under a plan for each highly compensated employee in the plan and consists of the highly compensated employee and all other employees in the plan (both highly and nonhighly compensated) who have an allocation rate greater than or equal to the highly compensated employee's allocation rate. Thus, an employee is in the rate group for each highly compensated employee in the plan who has an allocation rate less than or equal to the employee's allocation rate.

(2) Determination of allocation rates--(i) In general. The allocation rate for an employee for a plan year equals the sum of the allocations to the employee's account for the plan year, expressed either as a percentage of plan year compensation or as a dollar amount.

(ii) Allocations taken into account. The amounts taken into account in determining allocation rates for a plan year include all employer contributions and 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 paragraph (c)(2)(iii) of this section. For this purpose, employer contributions include annual additions described in §1.415-6(b)(2)(i) (regarding amounts arising from certain transactions between the plan and the employer). In the case of a defined contribution plan subject to section 412, the amount of employer contributions taken into account is the amount of employer contributions required to be allocated under the plan to the employee's account for the plan year, even if all or part of the required



contribution is not actually made. For purposes of this paragraph (c)(2)(ii), amounts that would be allocated to the account of an employee for the plan year but for the limits of section 415 are not treated as allocated to the account of the employee. However, amounts that would be allocated to the account of an employee for the plan year but for the limits of section 409(n) (or section 1042(b)(3) of the Internal Revenue Code of 1954 as in effect immediately prior to the Tax Reform Act of 1986) are treated as allocated to the account of the employee.

(iii) Allocations not taken into account. Allocations of earnings, expenses, gains, and losses attributable to the balance in an employee's account are not taken into account in determining allocation rates.

(iv) Imputation of permitted disparity. The disparity permitted under section 401(*l*) may be imputed in accordance with the rules of §1.401(a)(4)-7.

(v) Grouping of allocation rates. An employer may treat all employees who have allocation rates within a range of no more than 5 percent (not 5 percentage points) above and below a midpoint rate chosen by the employer as having an allocation rate equal to that midpoint rate. If allocation rates are determined as a percentage of plan year compensation (rather than a dollar amount), an employer may, as an alternative, treat all employees who have allocation rates within a range of no more than one-quarter of a percentage point above and below a midpoint rate chosen by the employer as having an allocation rate equal to that midpoint rate. Allocation rates within a given range may be grouped under this paragraph (c)(2)(v) only if the allocation rates of highly and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner and the range does not



overlap with any other range chosen by the employer. An employer may choose to group the allocation rates of some employees into ranges and not to group the allocation rates of other employees into ranges, provided that the allocation rates of all employees within each range chosen by the employer are grouped within that range. If allocation rates are determined as a percentage of plan year compensation (rather than as a dollar amount), an employer may apply either grouping method described in this paragraph (c)(2)(v) and, in addition, may apply one method to one group of employees and the other method to another group of employees, provided that only one method is applied to any given employee or group of employees.

(3) Satisfaction of section 410(b) by a rate group--(i) In general. For purposes of determining whether a rate group satisfies section 410(b), 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. Except as provided in paragraphs (c)(3)(ii) through (v) of this section, the rules that apply in determining whether a rate group satisfies section 410(b) are the same as apply in

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determining whether a plan satisfies section 410(b). Thus, for example, if the rate group does not satisfy the ratio percentage test of §1.410(b)-2(b)(2), the rate group must satisfy the average benefit test of §1.410(b)-2(b)(3) (including the nondiscriminatory classification test of §1.410(b)-4 and the average benefit percentage test of §1.410(b)-5).

(ii) Permissive aggregation not available. The permissive aggregation rules of §1.410(b)-7(d) are not available to a rate group in determining whether it satisfies section 410(b).

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(iii) Deemed satisfaction of reasonable classification requirement. In determining whether a rate group satisfies the nondiscriminatory classification test of §1.410(b)-4, the rate group is deemed to satisfy the reasonable classification requirement of §1.410(b)-4(b).

(iv) Facts-and-circumstances requirements replaced. In determining whether a rate group satisfies the nondiscriminatory classification test of §1.410(b)-4, the facts-and-circumstances requirements of §1.410(b)-4(c)(3) do not apply. Instead, the rate group is deemed to satisfy the facts-and-circumstances requirements of §1.410(b)-4(c)(3), but only if the ratio percentage of the rate group is greater than or equal to the lesser of--

(A) The ratio percentage of the plan, or

(B) The midpoint between the safe and the unsafe harbor percentages applicable to the plan.

(v) Application of average benefit percentage test. A rate group satisfies the average benefit percentage test of §1.410(b)-5 if the plan of which it is a part satisfies §1.410(b)-5 (applied without regard to §1.410(b)-5(f)). In the case of a plan that relies on §1.410(b)-5(f) to satisfy the average benefit percentage test, each rate group under the plan satisfies the average benefit percentage test (if applicable) only if the rate group separately satisfies §1.410(b)-5(f)).

(4) Examples. The following examples illustrate the general test in this paragraph (c).

Example 1. Employer X maintains 2 defined contribution plans, Plan A and Plan B, that are aggregated and treated as a single plan for purposes of sections 410(b) and 401(a)(4) pursuant to §1.410(b)-7(d). For the 1994 plan year, Employee M has plan year compensation of $10,000 and receives an allocation of $200 under Plan A and an allocation of $800 under Plan B. Employee M's allocation rate under the aggregated plan for the 1994 plan year is 10 percent (i.e., $1,000 divided by $10,000).

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Example 2. The employees in Plan C have the following allocation rates (expressed as percentage of plan year compensation): 9.6 percent, 9.7 percent, 9.8 percent, and 10.5 percent. Because all employees have allocation rates within a range of no more than 5 percent above and below 10.0 percent (a midpoint rate chosen by the employer), the employer may treat all employees as having an allocation rate of 10.0 percent (provided, of course, that the allocation rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner).

Example 3. The employees in Plan D have the following allocation rates (expressed as a percentage of plan year compensation): 2.75 percent, 2.80 percent, 2.85 percent, 3.25 percent, 6.65 percent, 7.33 percent, 7.34 percent, and 7.35 percent. Because the first four rates are within a range of no more than one-quarter of a percentage point above and below 3.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an allocation rate of 3.0 percent (provided that the allocation rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner). Because the last four rates are within a range of no more than 5 percent above and below 7.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an allocation rate of 7.0 percent (provided that the allocation rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner).

Example 4. (a) Employer Y has only 6 nonexcludable employees, all of whom benefit under Plan E. The highly compensated employees in the plan are H1 and H2, and the nonhighly compensated employees in the plan are N1 through N4. For the 1994 plan year, H1 and N1 through N4 have an allocation rate of 5.0 percent of plan year compensation. For the same plan year, H2 has an allocation rate of 7.5 percent of plan year compensation.

(b) There are two rate groups under Plan E. Rate group 1 consists of H1 and all those employees in the plan who have an allocation rate greater than or equal to H1's allocation rate (5.0 percent). Thus, rate group 1 consists of H1, H2, and N1 through N4. Rate group 2 consists only of H2 because no other employee in the plan has an allocation rate greater than or equal to H2's allocation rate (7.5 percent).

(c) Rate group 2 does not satisfy the ratio percentage test under §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 0 percent--i.e., 0 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(d) Rate group 2 also does not satisfy the nondiscriminatory classification test of §1.410(b)-4 because the ratio percentage of the rate group (0 percent) is less than the unsafe harbor percentage applicable to the plan under §1.410(b)-4(c)(4) (35.5 percent).

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(e) Rate group 2 therefore does not satisfy section 410(b) and, as a result, Plan E does not satisfy the requirements of paragraph (c) of this section. This is true even though rate group 1 satisfies the ratio percentage test of §1.410(b)-2(b)(2).

Example 5. (a) The facts are the same as in Example 4, except that N4 has an allocation rate of 8.0 percent.

(b) There are 2 rate groups in Plan E. Rate group 1 consists of H1 and all those employees who have an allocation rate greater than or equal to H1's allocation rate (5.0



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percent). Thus, rate group 1 consists of H1, H2 and N1 through N4. Rate group 2 consists of H2, and all those employees who have an allocation rate greater than or equal to H2's allocation rate (7.5 percent). Thus, rate group 2 consists of H2 and N4.

(c) Rate group 1 satisfies the ratio percentage test under §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 100 percent--i.e., 100 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(d) Rate group 2 does not satisfy the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 50 percent--i.e., 25 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) However, rate group 2 does satisfy the nondiscriminatory classification test of §1.410(b)-4 because the rate group is deemed to satisfy the reasonable classification requirement of §1.410(b)-4(b) and the ratio percentage of the rate group (50 percent) is greater than the safe harbor percentage applicable to the plan under §1.410(b)-4(c)(4) (45.5 percent).

(f) If rate group 2 satisfies the average benefit percentage test of §1.410(b)-5, then rate group 2 satisfies section 410(b). In that case, Plan E satisfies the requirements of paragraph (c) of this section because each rate group under the plan satisfies section 410(b).

Example 6. (a) Plan F satisfies section 410(b) by satisfying the nondiscriminatory classification test of §1.410(b)-4 and the average benefit percentage test of §1.410(b)-5 (without regard to §1.410(b)-5(f)). See §1.410(b)-2(b)(3). Plan F utilizes the facts-and-circumstances requirements of §1.410(b)-4(c)(3) to satisfy the nondiscriminatory classification test of §1.410(b)-4. The safe and unsafe harbor percentages applicable to the plan under §1.410(b)-4(c)(4) are 29 and 20 percent, respectively. Plan F has a ratio percentage of 22 percent.

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(b) Rate group 1 under Plan F has a ratio percentage of 23 percent. Under paragraph (c)(3)(iii) of this section, the rate group is deemed to satisfy the reasonable classification requirement of §1.410(b)-4(b). Even though the ratio percentage of the rate group (23 percent) falls below the safe harbor percentage applicable to the plan (29 percent), under paragraph (c)(3)(iv) of this section the rate group is deemed to satisfy the facts-and-circumstances requirements of §1.410(b)-4(c)(3), because the ratio percentage for the rate group (23 percent) is greater than the lesser of--

(1) the ratio percentage for the plan as a whole (22 percent), and

(2) the midpoint between the safe and unsafe harbor percentages (24.5 percent).

Under these facts, the rate group satisfies the nondiscriminatory classification test of §1.410(b)-4. In addition, under paragraph (c)(3)(v) of this section, the rate group satisfies section 410(b) because the plan satisfies the average benefit percentage test of §1.410(b)-5.

(d) Exclusive tests for section 401(k) and (m) plans--(1) Section 401(k) plans. A section 401(k) plan is deemed to satisfy the requirements of this section.

(2) Section 401(m) plans. A section 401(m) plan satisfies the requirements of this section only if the plan satisfies §§1.401(m)-1(b)(1), 1.401(m)-1(b)(3), and 1.401(m)-2.

(3) Scope of exclusive tests. This paragraph (d) does not apply to contributions under a nonqualified cash or deferred arrangement, qualified nonelective contributions treated as elective or matching contributions under §§1.401(k)-1(b)(5) and 1.401(m)-1(b)(5) (except to the extent provided in those sections), or elective contributions described in §1.401(k)-1(b)(4)(iv) that fail to satisfy the allocation and compensation requirements of §1.401(k)-1(b)(4)(i). Contributions described in the preceding sentence must satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) without regard to the rules in paragraphs (d)(1) and (d)(2) of this section.

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§1.401(a)(4)-3 Nondiscrimination in amount of benefits under a defined benefit plan.

(a) Introduction--(1) General rule. The amount of employer-provided benefits under a defined benefit plan does not discriminate in favor of highly compensated employees for a plan year if the plan satisfies the requirements of this section for the plan year.

(2) Overview. This section sets forth rules for determining whether the employer-provided benefits under a defined benefit plan are nondiscriminatory in amount. Certain defined benefit plans that provide uniform benefits are permitted to satisfy the requirements of this section by meeting one of the five safe harbor tests in paragraph (b) of this section. Four of these safe harbors are design-based and do not require the determination and comparison of actual benefits under the plan. Plans that do not provide uniform benefits in accordance with any of the safe harbors in paragraph (b) of this section may comply with the requirements of this section only by satisfying the general test in paragraph (c) of this section. The general test requires the determination of individual benefit accrual rates. Paragraph (d) of this section provides rules for determining these accrual rates. Paragraph (e) of this section provides rules for determining compensation for purposes of applying the tests in this section. Paragraph (f) of this section provides additional rules and exceptions that apply generally under this section, for purposes of both the safe harbor tests in paragraph (b) of this section and the general test in paragraph (c) of this section.

(3) Alternative methods of satisfying nondiscriminatory amount requirement. A defined benefit plan is permitted to satisfy any of the tests in paragraph (b) or (c) of this



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section on a restructured basis pursuant to §1.401(a)(4)-9(c). In addition, a defined benefit plan that is part of a floor-offset arrangement is permitted to satisfy the requirements of this

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section pursuant to §1.401(a)(4)-8(d). Alternatively, a defined benefit plan is permitted to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) on the basis of equivalent allocations pursuant to §1.401(a)(4)-8(c). These latter rules include a safe harbor testing method for benefits provided under a cash balance plan.

(4) Separate testing of employer-provided benefits and employee-provided benefits. This section applies for purposes of determining whether the amount of employer-provided benefits under a defined benefit plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2). In the case of a contributory DB plan (i.e., one that includes employee contributions not allocated to separate accounts), §1.401(a)(4)-6(b) provides rules for determining the amount of employer-provided benefits under the plan, and §1.401(a)(4)-6(c) provides rules for determining whether the employee-provided benefits under the plan satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2).

(b) Safe harbors--(1) In general. A defined benefit plan satisfies the requirements of this section for a plan year if the plan satisfies the uniformity requirements of paragraph (b)(2) of this section and any one of the safe harbors in paragraphs (b)(3) (unit credit plans), (b)(4) (unit credit fractional accrual plans), (b)(5) (flat benefit plans), (b)(6) (alternative safe harbor for flat benefit plans), and (b)(7) (insurance contract plans) of this section. Paragraph (b)(8) of this section provides exceptions for certain plan provisions that do not cause a plan to fail the requirements of this paragraph (b).

(2) Uniformity requirements--(i) In general. A plan satisfies the uniformity requirements of this paragraph (b)(2) only if it satisfies each of the requirements in paragraphs (b)(2)(ii) through (b)(2)(vi) of this section.

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(ii) Uniform normal retirement benefit. The same benefit formula must apply to all employees in the plan. The benefit formula must provide all employees in the plan with an annual benefit payable in the same form commencing at the same uniform normal retirement age. The annual benefit must be the same percentage of average annual compensation or the same dollar amount for all employees in the plan who will have the same number of years of service at normal retirement age. The annual benefit must equal the employee's accrued benefit at normal retirement age (within the meaning of section 411(a)(7)(A)(i)) and must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)).

(iii) Uniform post-normal retirement benefits. With respect to an employee with a given number of years of service at any age after normal retirement age, the annual benefit commencing at the employee's age must be the same percentage of average annual compensation or the same dollar amount that would be payable commencing at normal retirement age to an employee who had that same number of years of service at normal retirement age.

(iv) Uniform subsidies. Each subsidized optional form of benefit under the plan must be available to substantially all employees in the plan. In determining whether a subsidized optional form of benefit is available to substantially all employees in the plan, the same criteria apply as in determining whether an optional form of benefit is currently available to a group of employees in the plan under §1.401(a)(4)-4(b). An optional form of benefit is considered subsidized if the normalized optional form of benefit is larger than the normalized normal retirement benefit under the plan.

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(v) Uniform vesting and service crediting. All employees in the plan must be subject to the same vesting schedule and the same definition of years of service for all purposes under the plan. For purposes of crediting service, only service with the employer (or a predecessor employer within the meaning of section 414(a)) may be taken into account.

(vi) No employee contributions. The plan is not a contributory DB plan.

(vii) Examples. The following examples illustrate the uniformity requirements in this paragraph (b)(2).

Example 1. Plan A provides a normal retirement benefit equal to 2 percent of average annual compensation times each year of service commencing at age 65 for all employees in the plan. Plan A provides that employees of Division A receive their benefit in the form of a straight life annuity and that employees of Division B receive their benefit in the form of a life annuity with an automatic cost-of-living increase. Plan A does not provide

a uniform normal retirement benefit within the meaning of paragraph (b)(2)(ii) of this section because the annual benefit is not payable in the same form to all employees in the plan.

Example 2. Plan B provides a normal retirement benefit equal to 1.5 percent of average annual compensation times each year of service at normal retirement age for all employees in the plan. The normal retirement age under the plan is the earlier of age 65 or the age at which the employee completes 10 years of service, but in no event earlier than age 62. Plan B does not provide a uniform normal retirement benefit within the meaning of paragraph (b)(2)(ii) of this section because the same uniform normal retirement age does not apply to all employees in the plan.

Example 3. Plan C is an accumulation plan under which the benefit for each year of service equals 1 percent of plan year compensation payable in the same form to all employees in the plan commencing at the same uniform normal retirement age. Under paragraph (b)(8)(x)(B) of this section, an accumulation plan does not fail to satisfy the requirements of this paragraph (b) merely because it substitutes plan year compensation for average annual compensation. Plan C provides a uniform normal retirement benefit within the meaning of paragraph (b)(2)(ii) of this section, because all employees in the plan with the same number of years of service at normal retirement age will receive an annual benefit that is treated as the same percentage of average annual compensation.

Example 4. The facts are the same as in Example 3, except that the benefit for each year of service equals 1 percent of plan year compensation increased by reference to the increase in the cost of living from the year of service to normal retirement age. Plan C does not provide a uniform normal retirement benefit, because the annual benefit defined by the



benefit formula can vary for employees with the same number of years of service at normal retirement age, depending on the age at which those years of service were credited to the employee under the plan.

Example 5. Plan D provides a normal retirement benefit of 50 percent of average annual compensation at normal retirement age (age 65) for employees with 30 years of service at normal retirement age. Plan D provides that in the case of an employee with less than 30 years of service at normal retirement age, the normal retirement benefit is reduced on a pro rata basis for each year of service less than 30. However, if an employee with less than 30 years of service at normal retirement age continues to work past normal retirement age, Plan D provides that the additional years of service worked past normal retirement age are taken into account for purposes of the 30 years of service requirement. Thus, an employee who has 26 years of service at age 65 but who does not retire until age 69 with 30 years of service will receive a benefit of 50 percent of average annual compensation. Plan D provides uniform post-normal retirement benefits within the meaning of paragraph (b)(2)(iii) of this section.

Example 6. Plan E provides a normal retirement benefit payable in the form of a straight life annuity equal to 1 percent of average annual compensation per year of service. The normal retirement age under the plan is 65. Plan E also provides an optional form of benefit for employees who have at least 10 years of service and who have attained at least age 55. The optional form of benefit provides that for employees retiring before age 65, the normal retirement benefit is reduced by 5 percent for each year that commencement of benefits precedes age 65. Thus, the early retirement benefit at age 55, for example, is 50 percent of the normal retirement benefit. When normalized, this benefit is 131 percent of the normalized normal retirement benefit under the plan. The reduction factor of 5 percent therefore creates a subsidized early retirement benefit for purposes of paragraph (b)(2)(iv) of this section because the normalized early retirement benefit is larger than the normalized normal retirement benefit under the plan. In order to satisfy the uniform subsidies requirement of paragraph (b)(2)(iv) of this section, the early retirement benefit must be available to substantially all employees in the plan.

Example 7. Plan F is amended on February 14, 1994, to provide an early retirement window benefit that is a subsidized optional form of benefit under paragraph (b)(2)(iv) of this section. The early retirement window benefit is available only to employees who retire between June 1, 1994, and December 31, 1994. Paragraph (b)(2)(iv) of this section provides that, in determining whether a subsidized optional form of benefit is available to substantially all employees in the plan, the same criteria apply as in determining whether an optional form of benefit is currently available to a group of employees under §1.401(a)(4)-4(b). Section 1.401(a)(4)-4(b) provides that age and service requirements are not disregarded in determining the current availability of an optional form of benefit if those requirements must be satisfied within a specified period of time. Thus, unless substantially all employees in the plan will satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period, Plan F fails to satisfy the requirements



of paragraph (b)(2)(iv) of this section. However, see §1.401(a)(4)-9(c)(6), Example 3, for an example of how a plan with an early retirement window benefit may be restructured into two component plans, each of which satisfies the safe harbors of this paragraph (b).

(3) Safe harbor for unit credit plans--(i) General rule. A plan satisfies the safe harbor in this paragraph (b)(3) for a plan year if it satisfies each of the following requirements--

(A) The plan satisfies the 133 1/3 percent accrual rule of section 411(b)(1)(B).

(B) An employee's accrued benefit under the plan as of any plan year is determined by applying the plan's benefit formula to the employee's years of service and (if applicable) average annual compensation, both determined as of that plan year. Thus, all employees in the plan who have the same number of years of service as of any plan year will have an accrued benefit that is the same percentage of average annual compensation or the same dollar amount.

(ii) Examples. The following examples illustrate the unit credit safe harbor in this paragraph (b)(3). In each example, it is assumed that the plan has never permitted employee contributions.

Example 1. Plan A provides that the accrued benefit of each employee in the plan as of any plan year equals 1.5 percent of the employee's average annual compensation times the employee's years of service determined as of that plan year. Plan A satisfies this paragraph (b)(3).

Example 2. Plan B provides that the accrued benefit of each employee in the plan as of any plan year equals the employee's average annual compensation times a percentage that depends on the employee's years of service determined as of that plan year. The percentage is 1.5 percent for each of the first 5 years of service, plus 1.75 percent for each of the next 5 years of service, plus 2 percent for all additional years of service. Plan B satisfies this paragraph (b)(3).

Example 3. Plan C provides that the accrued benefit of each employee in the plan as of any plan year equals the employee's average annual compensation times a percentage that depends on the employee's years of service determined as of that plan year. The percentage



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is 2 percent for each of the first 5 years of service, plus 1 percent for all additional years of service. Plan C satisfies this paragraph (b)(3).

(4) Safe harbor for unit credit plans using fractional accrual rule--(i) General rule. A plan satisfies the safe harbor in this paragraph (b)(4) for a plan year if it satisfies each of the following requirements--

(A) The plan satisfies the fractional accrual rule of section 411(b)(1)(C).

(B) An employee's accrued benefit under the plan as of any plan year before the employee reaches normal retirement age is determined by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)-1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. Thus, all employees in the plan who have the same entry age and the same number of years of service as of any plan year will have an accrued benefit at normal retirement age that is the same percentage of average annual compensation or the same dollar amount.

(C) Under the plan, it is impossible for any employee in the plan to accrue in a plan year a portion of the normal retirement or post-normal retirement benefit described in paragraph (b)(2)(ii) or (iii) of this section that is more than 1/3 larger than the portion of the same benefit accrued in that or any other plan year by any other employee in the plan, when each portion of the benefit is expressed as a percentage of each employee's average annual compensation or as a dollar amount. Solely for this purpose, employees with projected service at normal retirement age in excess of 33 years may be disregarded. In addition, in the case of a section 401(*l*) plan, an employee is treated as accruing benefits at a rate equal



to the excess benefit percentage in the case of a defined benefit excess plan, or at a rate equal to the gross benefit percentage in the case of an offset plan.

(ii) Examples. The following examples illustrate the unit credit fractional accrual safe harbor in this paragraph (b)(4). In each example, it is assumed that the plan has never permitted employee contributions.

Example 1. Plan A provides a normal retirement benefit equal to 1.6 percent of average annual compensation times each year of service up to 25. Plan A further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is 1.6 percent of average annual compensation (this is the case for an employee in the plan with 25 or fewer years of projected service at normal retirement age). Among employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in any plan year is 1.212 percent of average annual compensation (this is the case for an employee in the plan with 33 years of projected service at normal retirement age). Plan A satisfies paragraph (b)(4)(i)(C) of this section because 1.6 percent is not more than 1/3 larger than 1.212 percent.

Example 2. Plan B is a section 401(*l*) plan that provides a normal retirement benefit equal to 1.0 percent of average annual compensation up to the integration level, and 1.6 percent of average annual compensation above the integration level, times each year of service up to 35. Plan B further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age. For purposes of satisfying the 1/3 larger rule in paragraph (b)(4)(i)(C) of this section, all employees in the plan are assumed to accrue benefits at the rate of 1.6 percent of average annual compensation (the excess benefit percentage under the plan). Plan B satisfies the requirements of paragraph (b)(4)(i)(C) of this section because all employees with 33 or fewer years of projected service at normal retirement age accrue in each plan year a benefit of 1.6 percentage of average annual compensation.

Example 3. Plan C provides a normal retirement benefit equal to 4 percent of average annual compensation times each year of service up to 10 and 1 percent of average annual compensation times each year of service in excess of 10 and not in excess of 30. Plan C further provides that an employee's accrued benefit as of any plan year equals the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the



employee's projected years of service as of normal retirement age. The greatest benefit that an employee could accrue in any plan year is 4 percent of average annual compensation (this is the case for an employee with 10 or fewer years of projected service at normal retirement age). Among employees with 33 or fewer years of projected service at normal retirement age, the lowest benefit that an employee could accrue in a plan year is 1.82 percent of average annual compensation (this is the case of an employee with 33 years of projected service at normal retirement age). Plan C fails to satisfy this paragraph (b)(4) because 4 percent is more than 1/3 larger than 1.82 percent.

Example 4. Plan D is a section 401(*l*) plan that provides a normal retirement benefit equal to 2.0 percent of average annual compensation, plus 0.65 percent of average annual compensation above covered compensation, for each year of service up to 25. Plan D further provides that an employee's accrued benefit as of any plan year equals the sum of--

(1) The employee's fractional rule benefit (determined as if the normal retirement benefit under the plan equaled 2.0 percent of average annual compensation for each year of service up to 25) multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age, plus

(2) 0.65 percent of the employee's average annual compensation above covered compensation multiplied by the employee's years of service (up to 25) as of the current plan year.

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Although Plan D satisfies the fractional accrual rule of section 411(b)(1)(C), the plan fails to satisfy this paragraph (b)(4) because the plan does not determine employees' accrued benefits in accordance with paragraph (b)(4)(i)(B) of this section.

(5) Safe harbor for flat benefit plans--(i) General rule. A plan satisfies the safe harbor in this paragraph (b)(5) for a plan year if it satisfies each of the following requirements--

(A) The plan satisfies the fractional accrual rule of section 411(b)(1)(C).

(B) An employee's accrued benefit under the plan as of any plan year before the employee reaches normal retirement age is determined by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)-1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and

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the denominator of which is the employee's projected years of service as of normal retirement age. Thus, all employees in the plan who have the same entry age and the same number of years of service as of any plan year will have an accrued benefit that is the same percentage of average annual compensation or the same dollar amount.

(C) The normal retirement benefit under the plan is a flat benefit. For this purpose, a flat benefit is a benefit that is the same percentage of average annual compensation or the same dollar amount for all employees in the plan who have a minimum number of years of service at normal retirement age (e.g., 50 percent of average annual compensation), with a pro rata reduction in the flat benefit for employees who have less than the minimum number of years of service at normal retirement age.

(D) The plan requires a minimum of 25 years of service at normal retirement age for an employee to receive the unreduced flat benefit, determined without regard to section 415. Thus, an employee is permitted to accrue the maximum benefit permitted under section 415 over a period of less than 25 years, provided that the flat benefit under the plan, determined without regard to section 415, can accrue over no less than 25 years.

(ii) Examples. The following examples illustrate the flat benefit safe harbor in this paragraph (b)(5). In each example, it is assumed that the plan has never permitted employee contributions.

Example 1. Plan A provides a normal retirement benefit of 100 percent of average annual compensation, reduced by 4 percentage points for each year of service below 25 the employee has at normal retirement age. Plan A further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. In the case of an employee who has 5 years of service as of the current plan year, and who is projected to have 10 years of service at normal retirement age, the employee's

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fractional rule benefit would be 40 percent of average annual compensation, and the employee's accrued benefit as of the current plan year would be 20 percent of average annual compensation (the fractional rule benefit multiplied by a fraction of 5 years over 10 years). Plan A satisfies the requirements of this paragraph (b)(5).

Example 2. The facts are the same as in Example 1, except that the normal retirement benefit is 125 percent of average annual compensation, reduced by 5 percentage points for each year of service below 25 that the employee has at normal retirement age. Plan A satisfies the requirements of this paragraph (b)(5), even though an employee may accrue the maximum benefit allowed under section 415 (i.e., 100 percent of the participant's average compensation for the high 3 years of service) in less than 25 years.

Example 3. The facts are the same as in Example 1, except that plan determines each employee's accrued benefit by multiplying the employee's projected normal retirement benefit by the fraction described in Example 1. In determining an employee's projected normal retirement benefit, the plan defines each employee's average annual compensation as the average annual compensation the employee would have at normal retirement age if the employee's annual section 414(s) compensation in future plan years equaled the employee's plan year compensation for the prior plan year. Under these facts, Plan A does not satisfy paragraph (b)(5)(i)(B) of this section because the projected normal retirement benefit used to determine an employee's accrued benefit is not the employee's fractional rule benefit determined in accordance with §1.411(b)-1(b)(3)(ii)(A).

Example 4. Plan B provides a normal retirement benefit of 50 percent of average annual compensation, with a pro rata reduction for employees with less than 30 years of service at normal retirement age. Plan B further provides that an employee's accrued benefit as of any plan year is equal to the employee's fractional rule benefit multiplied by a fraction, the numerator of which is the employee's years of service as of the plan year, and the denominator of which is the employee's projected years of service at normal retirement age. For purposes of determining this fraction, the plan limits the years of service taken into account for an employee to the number of years the employee has participated in the plan. However, all years of service (including years of service before the employee commenced participation in the plan) are taken into account in determining an employee's normal retirement benefit under the plan's benefit formula. Plan B fails to satisfy the requirements of this paragraph (b)(5) because the definition of years of service for determining the normal retirement benefit differs from the definition of years of service for determining the accrued benefit. See paragraphs (b)(2)(v) and (b)(8)(xi)(D) of this section.

(6) Alternative safe harbor for flat benefit plans. A plan satisfies the safe harbor in this paragraph (b)(6) for a plan year if it satisfies each of the following requirements--

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(i) The plan satisfies the requirements of paragraph (b)(5) of this section, other than the requirement of paragraph (b)(5)(i)(D) of this section that the minimum number of years



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of service for receiving the unreduced flat benefit is at least 25 years.

(ii) For the plan year, the average of the normal accrual rates for all nonhighly compensated nonexcludable employees is at least 70 percent of the average of the normal accrual rates for all highly compensated nonexcludable employees. Thus, the averages in the preceding sentence are determined taking into account all nonexcludable employees (regardless of whether they benefit under the plan). In addition, contributions and benefits under other plans of the employer are disregarded. For purposes of this paragraph (b)(6), normal accrual rates are determined under paragraph (d) of this section, without regard to the grouping rules of paragraph (d)(6)(iv) of this section. Thus, for example, accrual rates may be determined taking into account the imputed disparity rules of §1.401(a)(4)-7.

(7) Safe harbor for insurance contract plans. A plan satisfies the safe harbor in this paragraph (b)(7) if it satisfies each of the following requirements--

(i) The plan satisfies the accrual rule of section 411(b)(1)(F).

(ii) The plan is an insurance contract plan within the meaning of section 412(i).

(iii) The benefit formula under the plan would satisfy the requirements of paragraph (b)(4) or (b)(5) of this section if the stated normal retirement benefit under the formula accrued ratably over each employee's period of plan participation through normal retirement age in accordance with paragraph (b)(4)(i)(B) or (b)(5)(i)(B) of this section. Thus, the benefit formula may not recognize years of service before an employee commences participation in the plan because, otherwise, the definition of years of service for determining



the normal retirement benefit would differ from the definition of years of service for determining the accrued benefit under paragraph (b)(4)(i)(B) or (b)(5)(i)(B) of this section. See paragraph (b)(5)(ii), Example 3, of this section. Notwithstanding the foregoing, a plan adopted and in effect on ~~[INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER]~~ September 19, 1991 may continue to recognize years of service prior to an employee's participation in the plan to the extent provided in the plan on such date. The preceding sentence does not apply in the case of an employee who first becomes a participant in the plan after that date.

(iv) The scheduled premium payments under an individual or group insurance contract used to fund an employee's normal retirement benefit are level annual payments to normal retirement age. Thus, payments may not be scheduled to cease before normal retirement age.

(v) The premium payments for an employee who continues participation after normal retirement age are equal to the amount necessary to fund additional benefits that accrue under the plan's benefit formula for the plan year.

(vi) Experience gains, dividends, forfeitures, and similar items are used solely to reduce future premiums.

(vii) All benefits are funded through contracts of the same series. Among other requirements, contracts of the same series must have cash values based on the same terms (including interest and mortality assumptions), and the same conversion rights. A plan does not fail to satisfy this requirement, however, if any change in the contract series or insurer



applies on the same terms to all employees in the plan. But see §1.401(a)(4)-5(a)(6), Example 12 (change in insurer considered a plan amendment subject to §1.401(a)(4)-5(a)).

(viii) If permitted disparity is taken into account, the normal retirement benefit stated under the plan's benefit formula satisfies the requirements of §1.401(*l*)-3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(*l*)-3(b)(2)(i) or (b)(3)(i), respectively, adjusted in accordance with §1.401(*l*)-3(d)(9) and (e), is reduced by multiplying the factor by 0.80.

(8) Use of safe harbors not precluded by certain plan provisions--(i) In general. A plan does not fail to satisfy the requirements of this paragraph (b) merely because the plan contains one or more of the provisions described in this paragraph (b)(8). Unless otherwise provided, the provision must apply uniformly to all employees in the plan. Paragraph (f) of this section provides additional rules on plan provisions that may be relevant in determining whether a plan satisfies this paragraph (b).

(ii) Section 401(*l*) permitted disparity. The plan takes permitted disparity into account in a manner that satisfies section 401(*l*) in form. Thus, differences in employees' benefits



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under the plan attributable to uniform disparities permitted under §1.401(*l*)-3 (including differences in disparities that are deemed uniform under §1.401(*l*)-3(c)(2)) do not cause a plan to fail to satisfy the requirements of this paragraph (b).

(iii) Entry dates. The plan provides one or more entry dates during the plan year as permitted by section 410(a)(4).



(iv) Prior vesting schedules. The plan provides different vesting schedules solely to the extent necessary to comply with section 411(a)(10) (relating to changes in vesting schedules).

(v) Certain conditions on accruals. The plan provides that an employee's accrual for the plan year is less than a full accrual (including a zero accrual) because of a plan provision permitted by the year-of-participation rules of section 411(b)(4).

(vi) Certain limits on accruals. The plan limits benefits otherwise provided under the benefit formula or accrual method to a maximum dollar amount or to a maximum percentage of average annual compensation or in accordance with section 401(a)(5)(D), or limits the dollar amount of annual section 414(s) compensation or average annual compensation taken into account in determining benefits. The plan may apply these limits solely to all highly compensated employees in the plan. If the plan does so, rules similar to those provided in paragraph (b)(8)(xiii)(D)(2) of this section must be applied in the case of a nonhighly compensated employee who becomes a highly compensated employee and thus subject to a limit.

(vii) Dollar accrual per uniform unit of service. The plan determines accruals based on the same dollar amount for each uniform unit of service (not to exceed 1 week) performed by each employee with the same number of years of service under the plan during the plan year. The preceding sentence applies solely for purposes of the unit credit safe harbor in paragraph (b)(3) of this section.

(viii) Prior benefits accrued under a different formula--(A) All employees in plan. The plan provides benefits that were accrued in plan years beginning before a fresh-start date



under a benefit formula or accrual method that differs from the benefit formula and accrual method used to determine benefit accruals in plan years beginning after the fresh-start date. This paragraph (b)(8)(viii) applies solely to plans that meet the requirements of §1.401(a)(4)-13(c) with regard to benefits accrued after the fresh-start date.

(B) Section 401(a)(17) employees only. The plan provides benefits that were accrued before the effective date applicable to the plan under §1.401(a)(17)-1(d)(1) and determines the accrued benefits of section 401(a)(17) employees under a fresh-start formula that applies solely to such employees, as permitted under §1.401(a)(17)-1(e)(3)(ii).

(ix) Employee contributions--(A) Unit credit safe harbor. The plan is a contributory DB plan that otherwise satisfies the requirements of the unit credit safe harbor in paragraph (b)(3) of this section. This paragraph (b)(8)(ix)(A) applies only if the plan satisfies one of the methods in §1.401(a)(4)-6(b)(2) through (b)(6) (the composition-of-workforce method, the minimum benefit method, the grandfather rule for plans in existence on May 14, 1990, the government plan method, and the cessation-of-employee-contributions method, respectively). Thus, for example, if a plan complies with the minimum benefit method under §1.401(a)(4)-6(b)(3), the plan does not fail to satisfy the safe harbor in paragraph (b)(3) of this section merely because the plan includes employee contributions that are not allocated to separate accounts, or merely because the benefits under the plan are nonuniform solely as a result of the minimum benefit added to the plan to satisfy §1.401(a)(4)-6(b)(3)..

(B) Other safe harbors. The plan is a contributory DB plan that otherwise satisfies the requirements of one of the safe harbors in paragraphs (b)(4) through (b)(7) of this section. This paragraph (b)(8)(ix)(B) applies only if the plan satisfies one of the methods in



§1.401(a)(4)-6(b)(4) through (b)(6) (the grandfather rule for plans in existence on May 14, 1990, the government plan method, and the cessation-of-employee-contributions method, respectively).

(x) Modifications to average annual compensation--(A) Certain years disregarded. In determining average annual compensation, the plan completely disregards either or both of

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the following types of 12-month periods in an employee's compensation history--

(1) The 12-month period in which the employee terminates employment, or

(2) All 12-month periods in which the employee has less than 1,000 hours of service or, in the case of a plan that credits service using the elapsed time method, all 12-month periods in which the employee performs services during less than six months.

(B) Use of plan year compensation by accumulation plan. In the case of an accumulation plan, the plan substitutes plan year compensation for average annual compensation, as required under the definition of accumulation plan in §1.401(a)(4)-12.

(xi) Multiple definitions of service--(A) In general. The plan provides different definitions of years of service for different purposes under the plan, provided that for each purpose, the same definition of years of service applies to all employees in the plan. Thus, for example, the plan may define years of service for purposes of vesting as all years of service in which the employee has completed at least 1,000 hours of service, and for purposes of benefit accrual as all years of participation in which the employee has completed at least 2,000 hours of service (with a pro rata reduction for employees with less than 2,000 hours of service).

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(B) Hour-of-service equivalencies. The plan credits service for a specific purpose for some employees (e.g., hourly employees) based on hours of service as provided for in 29 CFR 2530.200b-2, but credits service for the same purpose for other employees (e.g., salaried employees) based on one of the equivalencies set forth in 29 CFR 2530.200b-3.

(C) Recognition of prior employment for eligibility and vesting. The plan credits service for purposes of eligibility or vesting (or both) for service with a prior employer. This rule applies solely to employees who become employees of the employer pursuant to a transaction between the employer and the prior employer that is a stock or asset acquisition, a merger, or other similar transaction involving a change in the employer of the employees of a trade or business.

(D) Special rule for benefit formula and accrual method. Notwithstanding paragraph (b)(8)(xi)(A) of this section, the plan must use the same definition of years of service for purposes of applying the benefit formula and accrual method under the plan, including the years over which the benefit accrues. Thus, for example, for purposes of the safe harbors in paragraphs (b)(4), (b)(5), and (b)(6) of this section, the plan must use the same definition of years of service to determine both the normal retirement benefit under the plan's benefit formula and the fraction by which an employee's fractional rule benefit is multiplied to derive the employee's accrued benefit as of any plan year. A plan does not fail to satisfy the requirement in this paragraph (b)(8)(xi)(D) merely because the benefit formula limits the years of service used to determine the normal retirement benefit to a fixed number of years of service (e.g., 25).

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(E) Imputed service. The plan credits imputed service as permitted under §1.401(a)(4)-11(d)(2).

(xii) Offsets for benefits accrued under another defined benefit plan--(A) In general. The plan provides that an employee's benefits otherwise determined under the plan are reduced by reference to the employee's benefits under another defined benefit plan maintained by the same or another employer (the "prior plan"). For this purpose, benefits under a defined benefit plan include benefits provided under annuities distributed upon the termination of a defined benefit plan. This paragraph (b)(8)(xii)(A) applies only if the requirements of paragraphs (b)(8)(xii)(B) through (F) of this section are satisfied.

(B) Benefits frozen under prior plan. The employee must cease to accrue benefits under the prior plan before commencing participation in the plan, and the employee's benefits under the prior plan must be frozen as of the date the employee ceases accruing benefits in the prior plan. Thus, for example, the employee's benefits under the prior plan may not be increased due to subsequent increases in the employee's compensation. Notwithstanding the foregoing, adjustments in the employee's frozen accrued benefit that would be permitted under §1.401(a)(4)-13(c)(5)(i), (c)(5)(ii), (c)(5)(iv), (c)(6)(i), and (c)(6)(ii) (regarding increases permitted under section 415(d), increases for former employees, increases in top-heavy minimum benefits, subsequent eligibility and vesting service, and new optional forms of benefit, respectively) may be made under the prior plan.

(C) Wrap-around benefit provided in plan. The plan must provide that the employee's vested accrued benefit under the plan is equal to the employee's vested accrued



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benefit otherwise determined under the plan's benefit formula and accrual method, as applied

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to the employee's total number of years of service under the plan and the prior plan (determined without double-counting any year of service), minus the offset. For this purpose, the offset must equal the actuarial equivalent of the vested portion of the employee's frozen accrued benefit under the prior plan (adjusted, if applicable, in accordance with §1.401(a)(4)-13(c)(5)(i), (ii) and (iv), but not §1.401(a)(4)-13(c)(5)(iii)).

(D) Uniform application of offset. The offset provision in the plan must apply uniformly to all employees in the plan who have, or have had, accrued benefits under the prior plan. For this purpose, the prior plan includes any other plan that is or has been aggregated with the prior plan for purposes of sections 401(a)(4) and 410(b). If the prior plan is or has been aggregated with a defined contribution plan, the requirement of this paragraph (b)(8)(xii)(D) cannot be satisfied, because the offset provision cannot be applied uniformly to all employees in the plan who have, or have had, accrued benefits under the prior plan.

(E) Offset employees not needed to satisfy minimum coverage. The plan would satisfy section 410(b) if §1.410(b)-3(a)(2)(iv) (regarding benefit offset arrangements) did not apply. Thus, the plan must still satisfy section 410(b) if each employee whose benefits are offset is not treated as benefiting under the plan until such time as the employee's accrued benefit under the plan (determined without regard to the offset) is greater than the offset. Notwithstanding the foregoing, §1.410(b)-3(a)(2)(iv) is still applied for this purpose to an employee whose benefits under the prior plan were provided pursuant to a collective bargaining agreement and were accrued in plan years in which the employee was an

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excludable employee under §1.410(b)-6(d) (regarding employees covered by a collective bargaining agreement).

(F) Prior plan maintained by another employer. If the prior plan is maintained by another employer, the employees whose benefits are subject to the offset must have become employees of the employer maintaining the plan pursuant to a transaction between the employer and the other employer that is a stock or asset acquisition, a merger, or other similar transaction involving a change in the employer of the employees of a trade or business.

(xiii) Multiple formulas--(A) In general. The plan provides that an employee's benefit under the plan is the greater of the benefits determined under two or more formulas. Alternatively, the plan provides that an employee's benefit under the plan is the sum of the benefits determined under two or more formulas. This paragraph (b)(8)(xiii) does not apply to a plan unless each of the formulas under the plan satisfies the requirements of paragraphs (b)(8)(xiii)(B) through (D) of this section. See §1.401(*l*)-5(b)(8)(ii) for rules regarding the overall permitted disparity limitations.

(B) Sole formulas. The formulas are the only formulas under the plan.

(C) Separate testing. Each of the formulas separately satisfies the uniformity requirements of paragraph (b)(2) of this section and also separately satisfies one of the safe harbors in paragraphs (b)(3) through (b)(7) of this section. For this purpose, the formulas need not satisfy the same safe harbor. In addition, a formula that is available solely to all nonhighly compensated employees in the plan is deemed to satisfy this paragraph (b)(8)(xiii)(C).

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(D) Availability--(1) General rule. All of the formulas are available on the same terms to all employees in the plan.

(2) Formulas for nonhighly compensated employees. A formula does not fail to be available on the same terms to all employees in the plan merely because the formula is available solely to all nonhighly compensated employees in the plan on the same terms as all the other formulas in the plan. If an employee was previously subject to a formula that was available solely to all nonhighly compensated employees in the plan and the employee subsequently becomes a highly compensated employee, the employee's accrued benefit under the plan in plan years beginning after the last plan year in which the employee was a nonhighly compensated employee must be determined in accordance with one of the formulas in §1.401(a)(4)-13(c)(2) through (c)(4). For purposes of applying the formulas in §1.401(a)(4)-13(c)(2) through (c)(4), the fresh-start date is the last day of the last plan year in which the employee was a nonhighly compensated employee, and the formula applicable to

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benefit accruals in the current plan year is the formula (or formulas) under the plan applicable to the highly compensated employee in plan years beginning after the fresh-start date.

(3) Top-heavy formulas. In the case of a plan that provides the greater of the benefits under two or more formulas, one of which is a top-heavy formula, the top-heavy formula does not fail to be available on the same terms to all employees in the plan merely because the formula is available solely to all non-key employees in the plan on the same terms as all the other formulas under the plan. Furthermore, the top-heavy formula does not fail to be available on the same terms as the other formulas under the plan merely because the top-



heavy formula is conditioned on the plan's being top-heavy within the meaning of section 416(g). For purposes of this paragraph (b)(8)(xiii)(D)(3), a top-heavy formula is a formula that provides a benefit equal to the minimum benefit described in section 416(c)(1) (taking into account, if applicable, the modification in section 416(h)(2)(A)(ii)(I)).

(E) Provisions may be applied more than once. The provisions of this paragraph (b)(8)(xiii) may be applied more than once. For example, a plan satisfies the requirements of paragraph (b) of this section if an employee's benefit under the plan is the greater of the benefits under two or more formulas and one or more of those formulas is the sum of the benefits under two or more other formulas, provided that each of the formulas under the plan satisfies the requirements of paragraph (b)(8)(xiii)(B) through (D) of this section.

(F) Examples. The following examples illustrate the rules regarding multiple formulas in this paragraph (b)(8)(xiii).

Example 1. Under Plan A, each employee's benefit equals the sum of the benefits determined under two formulas. The first formula provides 1 percent of average annual compensation per year of service. The second formula provides $10 per year of service. Plan A is eligible to apply the rules in this paragraph (b)(8)(xiii).

Example 2. Under Plan B, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 500 hours of service during the plan year. The second formula provides 1.5 percent of average annual compensation per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. Plan B does not satisfy this paragraph (b)(8)(xiii) because the two formulas are not available on the same terms to all employees in the plan.

Example 3. Under Plan C, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula provides $15 per year of service and is available to all employees who complete at least 1,000 hours of service during the plan year. The second formula provides the minimum benefit described in section 416(c)(1) and is available to all non-key employees who complete at least 1,000 hours of service during the plan year. Plan C does not satisfy the general rule in paragraph (b)(8)(xiii)(D)(1) of this section because the two formulas are not available on the same terms to all employees in the



plan (i.e., the second formula is only available to all non-key employees in the plan). Nonetheless, because the second formula is a top-heavy formula, the special availability rules for top-heavy formulas in paragraph (b)(8)(xiii)(D)(3) of this section apply. Thus, the second formula does not fail to be available on the same terms as the first formula merely because the second formula is available solely to all non-key employees in the plan on the same terms. This is true even if the plan conditions the availability of the second formula on the plan's being top-heavy for the plan year.

Example 4. Under Plan D, each employee's benefit equals the greater of the benefits determined under two formulas. The first formula is available to all employees in the plan and provides a benefit equal to 2 percent of average annual compensation per year of service, minus the maximum offset allowance permitted under section 401(*l*). The second formula is only available to nonhighly compensated employees in the plan and provides a benefit equal to 2 percent of average annual compensation per year of service, minus 2 percent of the primary insurance amount per year of service. Under paragraph (b)(8)(xiii)(D)(2) of this section, both formulas are treated as available to all employees in the plan on the same terms. Furthermore, even though the second formula does not satisfy any of the safe harbors in this paragraph (b), the formula is deemed to satisfy the separate testing requirement under paragraph (b)(8)(xiii)(C) of this section, because the formula is available solely to all nonhighly compensated employees in the plan.

Example 5. Plan E provides a benefit of 1 percent of average annual compensation per year of service to all employees in the plan. In 1994, the plan is amended to provide a benefit of 2 percent of average annual compensation per year of service after 1993, while retaining the 1-percent formula for all years of service before 1994. This new formula provides a benefit equal to the sum of the benefits determined under two formulas: 1 percent of average annual compensation per year of service, plus 1 percent of average annual compensation per year of service after 1993. Plan E is eligible to apply the rules in this paragraph (b)(8)(xiii).

Example 6. The facts are the same as in Example 5, except that the plan amendment in 1994 decreases the benefit to 0.5 percent of average annual compensation per year of service after 1993, while retaining the 1-percent formula for all years of service before 1994. This new formula provides a benefit equal to the sum of the benefits determined under two formulas: 0.5 percent of average annual compensation per year of service, plus 0.5 percent of average annual compensation per year of service before 1994. Under these facts, the second formula does not separately satisfy any of the safe harbors in this paragraph (b) because the definition of years of service for purposes of applying the benefit formula (years of service before 1994) differs from the definition of years of service over which the resulting benefit accrues (all years of service). See paragraphs (b)(2)(v) and (b)(8)(xi)(B) of this section.



Example 7. Plan F provides a benefit to all employees of 1 percent of average annual compensation per year of service. Employee P was hired as the president of the employer in December 1994 and was not a highly compensated employee under section 414(q) during the

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1994 calendar plan year. In 1994, Plan F is amended to provide a benefit that is the greater of the benefit determined under the pre-existing formula in the plan and a new formula that is available solely to all nonhighly compensated employees in the plan. The new formula does not satisfy any of the safe harbors in this paragraph (b), because the formula provides a greater benefit for Employee P than for other nonhighly compensated employees in the plan. In 1995, when Employee P first becomes a highly compensated employee, the second formula no longer applies to Employee P. It would be inconsistent with the purpose of preventing discrimination in favor of highly compensated employees for Plan F to use the special rule for a formula that is available solely to all nonhighly compensated employees to satisfy the separate testing requirement of paragraph (b)(8)(xiii)(C) of this section for the 1994 calendar plan year. See §1.401(a)(4)-1(c)(2).

(c) General test for nondiscrimination in amount of benefits--(1) Basic test. A plan satisfies the requirements of this section for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c)(1), a rate group exists under a plan for each highly compensated employee in the plan and consists of the highly compensated employee and all other employees (both highly and nonhighly compensated) in the plan who have a normal accrual rate greater than or equal to the highly compensated employee's normal accrual rate, and who also have a most valuable accrual rate greater than or equal to the highly compensated employee's most valuable accrual rate. Thus, an employee is in the rate group for each highly compensated employee in the plan who has a normal accrual rate less than or equal to the employee's normal accrual rate, and who also has a most valuable accrual rate less than or equal to the employee's most valuable accrual rate.

(2) Alternative test--(i) In general. In the case of a plan that determines the QJSA at each age as a uniform percentage of each employee's normal retirement benefit, the plan satisfies the requirements of this section if each rate group under the plan satisfies section



410(b). For purposes of this paragraph (c)(2), a rate group exists under a plan for each highly compensated employee in the plan and consists of the highly compensated employee and all other employees (both highly and nonhighly compensated) in the plan who have a most valuable accrual rate greater than or equal to the highly compensated employee's most valuable accrual rate. Thus, an employee is in the rate group for each highly compensated employee in the plan who has a most valuable accrual rate less than or equal to the employee's most valuable accrual rate.

(ii) Plan requirements. A plan determines the QJSA at each age as a uniform percentage of each employee's normal retirement benefit only if the plan satisfies each of the following requirements--

(A) The plan does not provide a QSUPP;

(B) The plan does not adjust most valuable accrual rates to reflect the value of certain disability benefits under paragraph (d)(6)(vi) of this section;

(C) The same uniform normal retirement age applies to all employees in the plan; and

(D) The QJSA at each age under the plan is determined by multiplying an employee's accrued benefit by a factor for that age that is the same for all employees in the plan.

(iii) Certain QJSA adjustments permitted--(A) In general. A plan does not fail to meet the requirement in paragraph (c)(2)(ii)(D) of this section merely because the plan makes one or more of the adjustments described in this paragraph (c)(2)(iii) in the factor used to determine the QJSA at each age under the plan. In each case, the adjustment must apply on the same terms to all employees in the plan.



(B) Adjustment for marital status or age of spouse. The plan adjusts the factor for determining the QJSA at each age under the plan to take into account the marital status of the employee or the age of the employee's spouse.

(C) Adjustment for termination of employment before earliest retirement age. The factor used to determine the QJSA at each age before normal retirement age under the plan is lower for employees who terminate employment before the earliest retirement age for which they are eligible to commence benefits under the plan than for employees who terminate employment at or after the earliest retirement age for which they are eligible to commence benefits under the plan.

(iv) Minimum service condition on early retirement benefits. A plan also does not fail to meet the requirement in paragraph (c)(2)(ii)(D) of this section merely because the plan provides that early retirement benefits (and thus the QJSA at any age before normal retirement age) are available only to employees who terminate employment after completing a minimum number of years of service.



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(3) Satisfaction of section 410(b) by a rate group--(i) In general. For purposes of determining whether a rate group satisfies section 410(b), the rate group is treated as if it were a separate plan that benefits only the employees included in the rate group. Except as provided in paragraphs (c)(3)(ii) through (v) of this section, the rules that apply in determining whether a rate group satisfies section 410(b) are the same as apply in determining whether a plan satisfies section 410(b). Thus, for example, if the rate group does not satisfy the ratio percentage test of §1.410(b)-2(b)(2), the rate group must satisfy the



average benefit test of §1.410(b)-2(b)(3) (including the nondiscriminatory classification test of §1.410(b)-4 and the average benefit percentage test of §1.410(b)-5).

(ii) Permissive aggregation not available. The permissive aggregation rules of §1.410(b)-7(d) are not available to a rate group in determining whether it satisfies section 410(b).

(iii) Deemed satisfaction of reasonable classification requirement. In determining whether a rate group satisfies the nondiscriminatory classification test of §1.410(b)-4, the rate group is deemed to satisfy the reasonable classification requirement of §1.410(b)-4(b).

(iv) Facts-and-circumstances requirements replaced. In determining whether a rate group satisfies the nondiscriminatory classification test of §1.410(b)-4, the facts-and-circumstances requirements of §1.410(b)-4(c)(3) do not apply. Instead, the rate group is deemed to satisfy the facts-and-circumstances requirements of §1.410(b)-4(c)(3), but only if the ratio percentage of the rate group is greater than or equal to the lesser of--

(A) The ratio percentage of the plan, or

(B) The midpoint between the safe and the unsafe harbor percentages applicable to the plan.

(v) Application of average benefit percentage test. A rate group satisfies the average benefit percentage test of §1.410(b)-5 if the plan of which it is a part satisfies §1.410(b)-5 (applied without regard to §1.410(b)-5(f)). In the case of a plan that relies on §1.410(b)-5(f) to satisfy the average benefit percentage test, each rate group under the plan satisfies the average benefit percentage test (if applicable) only if the rate group separately satisfies §1.410(b)-5(f)).





(4) Examples--(i) In general. Paragraphs (c)(4)(ii) and (iii) of this section provide examples that illustrate this paragraph (c).

(ii) Example illustrating basic test. The following example illustrates the basic test in paragraph (c)(1) of this section.

Example. (a) Employer X has 110 nonexcludable employees, N1 through N100, who are nonhighly compensated employees, and H1 through H10, who are highly compensated employees. Employer X maintains Plan Y, a defined benefit plan that benefits all of these nonexcludable employees. Assume that Plan Y is not eligible to use the alternative test in paragraph (c)(2) of this section. The normal and most valuable accrual rates (determined as a percentage of testing compensation) for the employees in Plan Y for the 1994 plan year are listed in the following table.

| Employee | Normal Accrual Rate | Most Valuable Accrual Rate |
|---|---|---|
| N1 through N10 | 1.0 | 1.4 |
| N11 through N50 | 1.5 | 3.0 |
| N51 through N75 | 2.0 | 2.65 |
| N76 through N100 | 2.3 | 2.8 |
| | | |
| H1 through H5 | 1.5 | 2.0 |
| H6 through H10 | 2.0 | 2.65 |

(b) There are 10 rate groups in Plan Y because there are 10 highly compensated employees in Plan Y.

(c) Rate group 1 consists of H1 and all those employees who have a normal accrual rate greater than or equal to H1's normal accrual rate (1.5 percent) and who also have a most valuable accrual rate greater than or equal to H1's most valuable accrual rate (2.0 percent). Thus, rate group 1 consists of H1 through H10 and N11 through N100.

(d) Rate group 1 satisfies the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 90 percent, i.e., 90 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).



(e) Because H1 through H5 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 1 satisfies section 410(b), rate groups 2 through 5 also satisfy section 410(b).

(f) Rate group 6 consists of H6 and all those employees who have a normal accrual rate greater than or equal to H6's normal accrual rate (2.0 percent) and who also have a most valuable accrual rate greater than or equal to H6's most valuable accrual rate (2.65 percent). Thus, rate group 6 consists of H6 through H10 and N51 through N100. (Even though N11 through N50 have a most valuable accrual rate (3.0 percent) greater than H6's most valuable accrual rate (2.65 percent), they are not included in this rate group because their normal accrual rate (1.5 percent) is less than H6's normal accrual rate (2.0 percent).)

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(g) Rate group 6 satisfies the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 100 percent, i.e., 50 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(h) Because H6 through H10 have the same normal accrual rates and the same most valuable accrual rates, the rate group with respect to each of them is identical. Thus, because rate group 6 satisfies section 410(b), rate groups 7 through 10 also satisfy section 410(b).

(i) Plan Y satisfies the requirements of paragraph (c)(1) of this section because each rate group under the plan satisfies section 410(b).

(iii) Examples illustrating alternative test. The following examples illustrate the alternative test in paragraph (c)(2) of this section. In each example, unless otherwise provided, it is assumed that the plan satisfies paragraphs (c)(2)(ii)(A) through (C) of this section.

Example 1. Plan A provides salaried employees with a benefit equal to 1 percent of average compensation times each year of service less 1 percent of the projected primary insurance amount times each year of service. Plan A provides hourly employees with a monthly annuity of $25 times each year of service. Normal retirement age under the plan is age 65. Plan A also provides that employees who retire after age 55 but before normal retirement age and who have at least 10 years of service will receive an immediate QJSA that is reduced by 4 percent per year for each year prior to normal retirement age. In addition, employees who terminate with 10 years of service but before age 55 will receive a QJSA that is the actuarial equivalent under the terms of the plan of the normal retirement benefit.

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Under paragraphs (c)(2)(iii)(C) and (c)(2)(iv) of this section, Plan A does not fail to determine the QJSA at each age under the plan as a uniform percentage of each employee's normal retirement benefit merely because of these early retirement provisions.

Example 2. The facts are the same as in Example 1, except that the plan also provides that an employee may retire at any age after completing 30 years of service and receive an unreduced benefit. For purposes of paragraph (c)(2) of this section, Plan B does not determine the QJSA at each age under the plan as a uniform percentage of each employee's normal retirement benefit because the plan's factors for determining the QJSA at each age for employees who terminate employment after attaining the earliest retirement age under the plan vary depending on the employee's service.

Example 3. Plan B provides a benefit equal to 1 percent of average compensation times each year of service, less 1 percent of the projected primary insurance amount times each year of service. In determining an employee's early retirement benefit, one early retirement factor is applied to the gross benefit under the formula, and a different early retirement factor is applied to the offset under the formula. For purposes of paragraph (c)(2) of this section, Plan C does not determine the QJSA at each age under the plan as a uniform percentage of each employee's normal retirement benefit because the plan's factors for determining the QJSA at each age vary among employees depending on the relative sizes of their gross benefit and the offset applied to it.

Example 4. (a) Employer X has only 6 nonexcludable employees, all of whom benefit under Plan C. The nonhighly compensated employees in the plan are N1 through N4, and the highly compensated employees in the plan are H1 and H2. Assume that Plan C is eligible to use the alternative test of paragraph (c)(2) of this section. For the 1994 plan year, N1 through N4 and H1 have a most valuable accrual rate of 1.75 percent of testing compensation. For the same plan year, H2 has a most valuable accrual rate of 2.5 percent of testing compensation.

(b) There are two rate groups under Plan C. Rate group 1 consists of H1 and all those employees in the plan who have a most valuable accrual rate greater than or equal to H1's most valuable accrual rate (1.75 percent). Thus, rate group 1 consists of H1, H2, and N1 through N4. Rate group 2 consists only of H2 because no other employee in the plan has a most valuable accrual rate greater than or equal to H2's most valuable accrual rate.

(c) Rate group 2 does not satisfy the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 0 percent, i.e., 0 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

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(d) Rate group 2 also does not satisfy the nondiscriminatory classification test of §1.410(b)-4 because the ratio percentage of the rate group (0 percent) is less than the unsafe harbor percentage applicable to the plan under §1.410(b)-4(c)(4) (35.5 percent).

(e) Rate group 2 therefore does not satisfy section 410(b) and, as a result, Plan C does not satisfy the requirements of paragraph (c)(2) of this section. This is true even though rate group 1 satisfies the ratio percentage test of §1.410(b)-2(b)(2).

Example 5. (a) The facts are the same as in Example 4, except that N4 has a most valuable accrual rate of 2.5 percent.

(b) There are 2 rate groups in Plan C. Rate group 1 consists of H1 and all those employees who have a most valuable accrual rate greater than or equal to H1's most valuable accrual rate (1.75 percent). Thus, rate group 1 consists of H1, H2, and N1 through N4. Rate group 2 consists of H2 and all those employees who have a most valuable accrual rate greater than or equal to H2's most valuable accrual rate (2.5 percent). Thus, rate group 2 consists of H2 and N4.

(c) Rate group 1 satisfies the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 100 percent, i.e., 100 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 100 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(d) Rate group 2 does not satisfy the ratio percentage test of §1.410(b)-2(b)(2) because the ratio percentage of the rate group is 50 percent, i.e., 25 percent (the percentage of all nonhighly compensated nonexcludable employees who are in the rate group) divided by 50 percent (the percentage of all highly compensated nonexcludable employees who are in the rate group).

(e) However, rate group 2 does satisfy the nondiscriminatory classification test of §1.410(b)-4 because the rate group is deemed to satisfy the reasonable classification requirement of §1.410(b)-4(b) and the ratio percentage of the rate group (50 percent) is greater than the safe harbor percentage applicable to the plan under §1.410(b)-4(c)(4) (45.5 percent).

(f) If rate group 2 satisfies the average benefit percentage test of §1.410(b)-5, then rate group 2 satisfies section 410(b). In that case, Plan C satisfies the requirements of



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paragraph (c)(2) of this section because each rate group under the plan satisfies section 410(b). See paragraph (c)(3)(v) of this section for rules governing the application of the average benefit percentage test to a rate group.

Example 6. Plan D provides a normal retirement benefit of 2 percent of average annual compensation per year of service to all highly compensated employees in the plan,



and a normal retirement benefit of 1.5 percent of average annual compensation per year of service to all nonhighly compensated employees in the plan. Plan D also provides for an unreduced early retirement benefit to all employees who retire after 25 years of service. None of the highly compensated employees in the plan are projected to be eligible for the unreduced early retirement benefit before age 62. A substantial portion of the nonhighly compensated employees in the plan are projected to be eligible for the unreduced early retirement benefit before age 60. Under these facts, it would be inconsistent with the purpose of preventing discrimination in favor of highly compensated employees to apply the alternative in paragraph (c)(2) of this section to Plan D. See §1.401(a)(4)-1(c)(2).

(d) Determination of accrual rates--(1) Introduction--(i) Overview of rules. This paragraph (d) provides the rules for determining the normal and most valuable accrual rates for the employees in a plan for a plan year. Paragraphs (d)(2) through (d)(4) of this section set forth the three basic methods for determining accrual rates--the annual method, the accrued-to-date method, and the projected method, respectively. Paragraph (d)(5) of this section sets forth rules of general application that must be followed in determining accrual rates under any method in this paragraph (d). Paragraph (d)(6) of this section provides certain optional rules that may be applied in determining accrual rates under this paragraph (d). Additional rules that may affect the determination of accrual rates under this paragraph (d) are set forth in paragraph (f) of this section.

(ii) General description of accrual rates--(A) Normal accrual rate. The normal accrual rate for an employee for a plan year generally can be described as the yearly rate at which the employee's normal retirement benefit under the plan accrues. This rate is determined for the plan year under one of the methods in this paragraph (d) after normalizing the employee's normal retirement benefit to the employee's testing age.

(B) Most valuable accrual rate. The most valuable accrual rate for an employee for a plan year generally can be described as the yearly rate at which the employee's most valuable



optional form of benefit under the plan accrues. This rate is determined for the plan year under one of the methods in this paragraph (d) after normalizing the QJSA at each age under

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the plan to the employee's testing age and then comparing the normalized QJSA for each of these ages to determine which is the most valuable. The most valuable accrual rate is determined by reference to the QJSA because the QJSA must be at least as valuable as any other optional form of benefit commencing at (or deferred from) each age under the plan. See §1.401(a)-20, Q&A-16. If the plan provides a QSUPP, the most valuable accrual rate also takes into account the QSUPP payable in conjunction with the QJSA at each age under the plan, because the value of the QSUPP is not reflected in the QJSA itself, and because the QSUPP payable in conjunction with the QJSA must be at least as valuable as any other QSUPP commencing at that age. See paragraph (5) of the definition of QSUPP in §1.401(a)(4)-12. Thus, the most valuable accrual rate is designed to reflect the value of all 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.

(iii) General description of annual, accrued-to-date, and projected methods. Under the annual method, the yearly rate at which benefits accrue is determined by reference to the amount of benefits the employee has accrued during the current plan year. Under the accrued-to-date method, this determination generally is made by reference to the average amount of benefits the employee has accrued each year over all years of service under the plan, up to and including the current plan year. Under the projected method, this determination generally is made by reference to the average amount of benefits the employee



will have accrued each year over the employee's entire projected years of service under the plan, up to and including the plan year in which payment of each QJSA under the plan could commence to the employee. Paragraphs (d)(6)(vii) and (viii) of this section provide optional rules under which the accrued-to-date and projected methods may be applied solely with respect to benefits accrued and years of service in plan years beginning after a fresh-start date selected by the employer.

(2) Annual method--(i) Normal accrual rate. Under the annual method, the normal accrual rate for an employee in the plan for a plan year is the percentage amount determined

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under the following steps--

(A) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the last day of the plan year.

(B) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the last day of the prior plan year.

(C) Normalize the accrued benefit determined in paragraph (d)(2)(i)(A) of this section.

(D) Normalize the accrued benefit determined in paragraph (d)(2)(i)(B) of this section.

(E) Subtract the normalized accrued benefit determined in paragraph (d)(2)(i)(D) of this section from the normalized accrued benefit determined in paragraph (d)(2)(i)(C) of this section.

(F) Divide the difference determined in paragraph (d)(2)(i)(E) of this section by the employee's testing compensation. This rate is the employee's normal accrual rate under the plan for the plan year.



(ii) Most valuable accrual rate. Under the annual method, the most valuable accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(A) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the last day of the plan year.

(B) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the last day of the prior plan year.

(C) Normalize each QJSA and each QSUPP determined in paragraph (d)(2)(ii)(A) of this section.

(D) Normalize each QJSA and each QSUPP determined in paragraph (d)(2)(ii)(B) of this section.

(E) Subtract the normalized QJSA determined for each age in paragraph (d)(2)(ii)(D) of this section from the normalized QJSA determined for the same age in paragraph (d)(2)(ii)(C) of this section.

(F) Subtract the normalized QSUPP determined for each age in paragraph (d)(2)(ii)(D) of this section from the normalized QSUPP determined for the same age in paragraph (d)(2)(ii)(C) of this section.



(G) Add the increase in the normalized QJSA determined for each age in paragraph (d)(2)(ii)(E) of this section to the increase in the normalized QSUPP determined for the same age in paragraph (d)(2)(ii)(F) of this section.

(H) Divide the amount determined for each age in paragraph (d)(2)(ii)(G) of this section by the employee's testing compensation.

(I) Select the largest rate determined in paragraph (d)(2)(ii)(H) of this section. This rate is the employee's most valuable accrual rate under the plan for the plan year.

(iii) Example. The following example illustrates the annual method in this paragraph (d)(2).

Example. The following table illustrates the determination of the most valuable accrual rate for Employee M in Plan A for the 1994 plan year under the annual method. Employee M has a testing age under Plan A of 65 and testing compensation for the 1994 plan year of $50,000. Plan A does not provide a QSUPP. Step A lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of the last day of the 1994 plan year. Assume that as determined under paragraph (d)(5)(iii) of this section, Employee M is first eligible for a QJSA at age 55. Step B lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of the last day of the 1993 plan year. Steps C and D list the normalized value (as determined under paragraph (d)(5)(iv) of this section) of each QJSA in Steps A and B, respectively. For this purpose, an 8-percent interest rate and the UP-84 mortality table have been applied to normalize each QJSA. Step E lists the difference between steps C and D at each age. (The table skips steps F and G because Plan A does not provide a QSUPP.) Step H lists the result of dividing the difference determined in step E by Employee M's $50,000 testing compensation. Employee M's most valuable accrual rate under Plan A for the 1994 plan year is 2.05 percent, the largest rate listed in step H.

| Age | Step A<br>QJSA as if Frozen This Year | Step B<br>QJSA as if Frozen Last Year | Step C<br>Normalized QJSA from Step A | Step D<br>Normalized QJSA from Step B | Step E<br>Step C Minus Step D | Step H<br>Step E Divided by Testing Compensation |
|---|---|---|---|---|---|---|
| 55 | 4,293 | 3,927 | 12,006 | 10,983 | 1,023 | 2.05% |
| 56 | 4,569 | 4,180 | 11,681 | 10,686 | 995 | 1.99% |
| 57 | 4,845 | 4,432 | 11,313 | 10,350 | 963 | 1.93% |
| 58 | 5,118 | 4,682 | 10,910 | 9,981 | 929 | 1.86% |
| 59 | 5,390 | 4,931 | 10,481 | 9,588 | 893 | 1.79% |
| 60 | 5,662 | 5,180 | 10,034 | 9,179 | 855 | 1.71% |
| 61 | 6,214 | 5,685 | 10,027 | 9,174 | 853 | 1.71% |
| 62 | 6,765 | 6,188 | 9,931 | 9,085 | 846 | 1.69% |
| 63 | 7,312 | 6,689 | 9,759 | 8,928 | 831 | 1.66% |
| 64 | 7,857 | 7,188 | 9,524 | 8,713 | 811 | 1.62% |
| 65 | 8,400 | 7,684 | 9,240 | 8,452 | 788 | 1.58% |

-3(d)(3)

(3) Accrued-to-date method--(i) Normal accrual rate. Under the accrued-to-date method, the normal accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(A) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the last day of the plan year.

(B) Normalize the accrued benefit determined in paragraph (d)(3)(i)(A) of this section.

(C) Divide the normalized accrued benefit determined in paragraph (d)(3)(i)(B) of this section by the employee's testing service.

(D) Divide the amount determined in paragraph (d)(3)(i)(C) of this section by the employee's testing compensation. This rate is the employee's normal accrual rate under the plan for the plan year.



(ii) Most valuable accrual rate. Under the accrued-to-date method, the most valuable accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(A) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the last day of the plan year.

(B) Normalize each QJSA and each QSUPP determined in paragraph (d)(3)(ii)(A) of this section.

(C) Add the normalized QJSA determined for each age under paragraph (d)(3)(ii)(B) of this section to the normalized QSUPP determined for the same age under paragraph (d)(3)(ii)(B) of this section.

(D) Divide the amount determined for each age in paragraph (d)(3)(ii)(C) of this section by the employee's testing service.

(E) Divide the amount determined for each age in paragraph (d)(3)(ii)(D) of this section by the employee's testing compensation.

(F) Select the largest rate determined in paragraph (d)(3)(ii)(E) of this section. This rate is the employee's most valuable accrual rate under the plan for the plan year.

(iii) Section 401(a)(17) employees. The normal and most valuable accrual rates under the accrued-to-date method of all section 401(a)(17) employees in the plan may be determined under the fresh-start alternative for the accrued-to-date method in paragraph (d)(6)(vii) of this section. The preceding sentence applies only if the plan determines the



accrued benefits of section 401(a)(17) employees under a fresh-start formula that applies solely to such employees, as permitted under §1.401(a)(17)-1(e)(3)(ii).

(iv) Examples. The following examples illustrate the accrued-to-date method in this paragraph (d)(3).

Example 1. The following table illustrates the determination of the most valuable accrual rate for Employee M in Plan A for the 1994 plan year under the accrued-to-date method. Employee M has a testing age under Plan A of 65, testing compensation for the 1994 plan year of $50,000, and 10 years of testing service under Plan A. Plan A does not provide a QSUPP. Step A lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of the last day of the 1994 plan year. Assume that as determined under paragraph (d)(5)(iii) of this section, Employee M is first eligible for a QJSA at age 55. Step B lists the normalized value (as determined under paragraph (d)(5)(iv) of this section) of each QJSA in step A. For this purpose, an 8-percent interest rate and the UP-84 mortality table have been applied to normalize each QJSA. (The table skips step C because Plan A does not provide a QSUPP.) Step D divides the normalized QJSA in step B by Employee M's 10 years of testing service. Step E divides the quotient determined in step D by





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Employee M's testing compensation of $50,000. Employee M's most valuable accrual rate under Plan A for the 1994 plan year is 2.40 percent, the largest rate listed in step E.

| Age | Step A | Step B | Step D | Step E |
|---|---|---|---|---|
| | QJSA as if Frozen This Year | Normalized QJSA from Step A | Step B Divided by Testing Service | Step D Divided by Testing Compensation |
| 55 | 4,293 | 12,006 | 1,201 | 2.40% |
| 56 | 4,569 | 11,681 | 1,168 | 2.34% |
| 57 | 4,845 | 11,313 | 1,131 | 2.26% |
| 58 | 5,118 | 10,910 | 1,091 | 2.18% |
| 59 | 5,390 | 10,481 | 1,048 | 2.10% |
| 60 | 5,662 | 10,034 | 1,003 | 2.01% |
| 61 | 6,214 | 10,027 | 1,003 | 2.01% |
| 62 | 6,765 | 9,931 | 993 | 1.99% |
| 63 | 7,312 | 9,759 | 976 | 1.95% |
| 64 | 7,857 | 9,524 | 952 | 1.90% |
| 65 | 8,400 | 9,240 | 924 | 1.85% |



Example 2. The facts are the same as in Example 1, except that the plan also provides a QSUPP payable for each year until the employee is 62. Employee M's accrued QSUPP is shown in the second column under step A. Employee M's most valuable accrual rate is 3.23 percent, the largest percentage in step E.

| Age | Step A | | Step B | | Step C | Step D | Step E |
|---|---|---|---|---|---|---|---|
| | QJSA as if Frozen This Year | QSUPP as if Frozen This Year | Normalized QJSA from Step A | Normalized QSUPP from Step A | Normalized QJSA Plus Normalized QSUPP | Step C Divided by Testing Service | Step D Divided by Testing Compensation |
| 55 | 4,293 | 3,000 | 12,006 | 4,152 | 16,158 | 1,616 | 3.23% |
| 56 | 4,569 | 3,000 | 11,681 | 3,422 | 15,103 | 1,510 | 3.02% |
| 57 | 4,845 | 3,000 | 11,313 | 2,746 | 14,059 | 1,406 | 2.81% |
| 58 | 5,118 | 3,000 | 10,910 | 2,117 | 13,027 | 1,303 | 2.61% |
| 59 | 5,390 | 3,000 | 10,481 | 1,533 | 12,014 | 1,201 | 2.40% |
| 60 | 5,662 | 3,000 | 10,034 | 987 | 11,021 | 1,102 | 2.10% |
| 61 | 6,214 | 3,000 | 10,027 | 478 | 10,505 | 1,051 | 2.10% |
| 62 | 6,765 | 0 | 9,931 | 0 | 9,931 | 993 | 1.99% |
| 63 | 7,312 | 0 | 9,759 | 0 | 9,759 | 976 | 1.95% |
| 64 | 7,857 | 0 | 9,524 | 0 | 9,524 | 952 | 1.90% |
| 65 | 8,400 | 0 | 9,240 | 0 | 9,240 | 924 | 1.85% |

(4) Projected method--(i) Normal accrual rate. Under the projected method, the normal accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(A) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the employee's testing age.

(B) Normalize the accrued benefit determined in paragraph (d)(4)(i)(A) of this section.

(C) Divide the normalized accrued benefit determined in paragraph (d)(4)(i)(B) of this section by the testing service the employee would have as of the employee's testing age.



(D) Divide the amount determined in paragraph (d)(4)(i)(C) of this section by the employee's testing compensation as of the employee's testing age. This rate is the employee's normal accrual rate under the plan for the plan year.

(ii) Most valuable accrual rate. Under the projected method, the most valuable accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(A) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the age payment of the QJSA and the QSUPP (if any) to the employee would commence under the plan.

(B) Normalize each QJSA and each QSUPP determined in paragraph (d)(4)(ii)(A) of this section.

(C) Add the normalized QJSA determined for each age under paragraph (d)(4)(ii)(B) of this section to the normalized QSUPP determined for the same age under paragraph (d)(4)(ii)(B) of this section.

(D) Divide the amount determined for each age in paragraph (d)(4)(ii)(C) of this section by the testing service the employee would have as of that age.

(E) Divide the amount determined for each age in paragraph (d)(4)(ii)(D) of this section by the employee's testing compensation as of that age.

(F) Select the largest rate determined in paragraph (d)(4)(ii)(E) of this section. This rate is the employee's most valuable accrual rate under the plan for the plan year.



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(iii) Terminated employees. In the case of an employee who has terminated employment as of the last day of the current plan year, the employee's normal and most valuable accrual rates under the projected method are determined under the accrued-to-date method in paragraph (d)(3) of this section.

(iv) Section 401(a)(17) employees. The normal and most valuable accrual rates under the projected method of all section 401(a)(17) employees in the plan may be determined under the fresh-start alternative for the projected method in paragraph (d)(6)(viii) of this section. The preceding sentence applies only if the plan determines the accrued benefits of section 401(a)(17) employees under a fresh-start formula that applies solely to such employees, as permitted under §1.401(a)(17)-1(e)(3)(ii).

(v) Discriminatory pattern of accruals. The projected method may not be used for a plan year if the pattern of accruals under the plan discriminates in favor of highly compensated employees. The pattern of accruals refers to the manner in which projected benefits actually accrue over the period of accrual (i.e., whether projected benefits accrue in a level manner or in a relatively frontloaded or backloaded manner). A pattern of accruals discriminates in favor of highly compensated employees if the pattern of accruals for the highly compensated employees in the plan is frontloaded when compared to the pattern of accruals for the nonhighly compensated employees in the plan. This determination is made based on all relevant facts and circumstances.

(vi) Examples. The following examples illustrate the projected method in this paragraph (d)(4).

Example 1. Employer P maintains a plan under which headquarters employees in the plan accrue a benefit of 1.25 percent of average compensation for the first 10 years of



service and 0.75 percent of average compensation for subsequent years of service, while all other employees in the plan accrue a benefit of 1 percent of compensation for all years of service. Assume that the group of headquarters employees in the plan does not satisfy section 410(b). Under these facts, the pattern of accruals under the plan discriminates in favor of highly compensated employees, and therefore, under paragraph (d)(4)(v) of this section, accrual rates under the plan may not be determined under the projected method in this paragraph (d)(4) for the plan year.

Example 2. The following table illustrates the determination of the most valuable accrual rate for Employee M in Plan A for the 1994 plan year under the projected method. Employee M has a testing age under Plan A of 65. Plan A does not provide a QSUPP. Step A lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of each age at which payment of a QJSA would begin. Assume that as determined under paragraph (d)(5)(iii) of this section, Employee M is first eligible for a QJSA at age 60. Step B lists the normalized value (as determined under paragraph (d)(5)(iv) of this section) of each QJSA in step A. For this purpose, an 8-percent interest rate and the UP-84 mortality table have been applied to normalize each QJSA. (The table skips step C because Plan A does not provide a QSUPP.) Step D lists Employee M's projected testing service as of each age and the results of dividing the normalized QJSA in step B by Employee M's projected testing service as of that age. Step E lists Employee M's projected testing compensation as of each age and the results of dividing the quotient in step D by Employee M's projected testing compensation as of that age. Employee M's most valuable accrual rate under Plan A for the 1994 plan year is 1.56 percent, the largest rate listed in step E.

| Age | Step A | Step B | Step D | | Step E | |
|---|---|---|---|---|---|---|
| | Projected QJSA | Normalized QJSA from Step A | Projected Testing Service | Step B Divided by Testing Service | Projected Testing Compensation | Step D Divided by Testing Compensation |
| 60 | 5,096 | 9,031 | 20 | 452 | 29,000 | 1.56% |
| 61 | 5,873 | 9,476 | 21 | 451 | 32,000 | 1.41% |
| 62 | 6,697 | 9,832 | 22 | 447 | 33,000 | 1.35% |
| 63 | 7,569 | 10,101 | 23 | 439 | 33,000 | 1.33% |
| 64 | 8,486 | 10,286 | 24 | 429 | 33,000 | 1.30% |
| 65 | 9,450 | 10,395 | 25 | 416 | 33,000 | 1.26% |

(5) Rules of general application--(i) In general. This paragraph (d)(5) provides rules of general application that must be followed in determining accrual rates under this paragraph



(d), regardless of the particular method used to determine those rates. The rules in this paragraph (d)(5) are also used for purposes of determining employee benefit percentages under §1.410(b)-5(d), equivalent allocation rates under §1.401(a)(4)-8(c)(2), and whenever a benefit is required to be determined or normalized.

(ii) Uniformity required. Accrual rates must be determined in the same manner for all employees in the plan for the plan year. Thus, for example, both the normal accrual rates and the most valuable accrual rates for all employees in the plan for the plan year must be determined under the same method--that is, under either the annual method, the accrued-to-date method, the projected method, the fresh-start alternative for the accrued-to-date method, or the fresh-start alternative for the projected method. See paragraphs (d)(2), (d)(3), (d)(4),

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(d)(6)(vii), and (d)(6)(viii) of this section, respectively. Similarly, the same actuarial assumptions, as well as the same optional rules under paragraph (d)(6) of this section, must be used in determining the normal accrual rates and the most valuable accrual rates for all employees in the plan for the plan year. No exception to the uniformity requirement in this paragraph (d)(5)(ii) applies unless specifically provided for. Notwithstanding the foregoing, an employer may determine accrual rates differently for purposes of satisfying section 401(a)(4) in different plan years.

(iii) Determining plan benefits--(A) In general. A benefit payable to an employee in a particular form under a plan is determined under the rules in this paragraph (d)(5)(iii).

(B) Accrued benefit. For purposes of determining an employee's accrued benefit, the term "accrued benefit" means the employee's accrued benefit under the plan as defined in section 411(a)(7)(A)(i). If an employee's testing age is later than the employee's normal

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retirement age under the plan, the term "accrued benefit" means the benefit the employee has (or is projected to have) under the plan as of the date on which the employee's benefits under the plan are treated as frozen, expressed in the form of the benefit the employee would receive under the plan commencing at the employee's testing age. Thus, for example, if a plan with a normal retirement age of 62 has been aggregated with a plan with a normal retirement age of 65, an employee in the first plan who has a normal retirement age of 62 under that plan would nonetheless have a testing age of 65 under the aggregated plan. See paragraph (2) of the definition of testing age in §1.401(a)(4)-12. Under the rule in this paragraph (d)(5)(iii)(B), such an employee's accrued benefit must be determined based on the benefit the employee would receive under the plan at age 65, including accruals (if applicable) and actuarial increases between ages 62 and 65.

(C) Benefit accrual service. An employee's years of service for purposes of benefit accrual under a plan are taken into account through the date on which the employee's benefits under the plan are treated as frozen. If an employee's benefits under the plan are treated as frozen as of a date after the current plan year, the employee's years of service for purposes of benefit accrual under the plan are determined by assuming that the amount of service credited to the employee for that purpose for the current plan year continues to be credited to the employee in each future plan year through the date on which the employee's benefits under the plan are treated as frozen.

(D) Eligibility service. An employee's years of service for purposes of determining the employee's eligibility under a plan for a benefit commencing at (or deferred from) a particular age are taken into account through that age. If the employee would reach the age

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after the current plan year, the employee's years of service for purposes of determining eligibility for the benefit are determined by assuming that the employee earns one year of service for purposes of eligibility in each future plan year through the age.

(E) Plan compensation. An employee's compensation from the employer taken into account under the plan's compensation formula is taken into account through the date on which the employee's benefits under the plan are treated as frozen. If an employee's benefits under the plan are treated as frozen as of a date after the current plan year, the employee's compensation for purposes of benefit determination under the plan is determined by assuming that the amount of the employee's compensation for the current plan year taken into account under the plan's compensation formula continues to be earned by the employee in each future plan year through the date on which the employee's benefits under the plan are treated as frozen. Thus, for example, if after the application of section 401(a)(17), an employee's compensation for the current plan year taken into account under the plan's compensation formula is $245,000, it is assumed that the employee continues to earn $245,000 in compensation for each future plan year through the date on which the employee's benefits under the plan are treated as frozen.

(F) Marital status of employee. An employee is assumed to be married and to have a spouse of the same age as the employee.

(G) Benefit computation factors. Social security benefits and all other relevant factors used to compute benefits under the plan (other than factors described in paragraph (d)(5)(iii)(H) of this section) are assumed to remain constant as in effect on the earlier of the

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last day of the current plan year or the date on which the employee's benefits under the plan are treated as frozen.

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-3(d)(5)(iii)(G)

(H) Benefit computation factors based on variable indices. If the dollar amount of a benefit accrued or treated as accrued under section 411(d)(6) is subject to increase by reference to a variable index, the rate of increase determined by reference to the index in each future plan year is assumed to equal the rate of increase determined by reference to the index in the current plan year. Thus, for example, if an employee's normal form of benefit provides a post-retirement cost-of-living adjustment equal to the annual rate of increase in the Consumer Price Index (CPI) and the CPI increased by 4 percent in the current plan year, it is assumed that the CPI will continue to increase by 4 percent in each future plan year. Similarly, if an employee's benefit accrual for a plan year is a fixed percentage of plan year compensation indexed through normal retirement age by reference to the average yield on 30-year Treasury Constant Maturities for the week that includes the first day of each plan year, and the yield for the current plan year is 8 percent, it is assumed that the yield will continue to be 8 percent in each future plan year.

(I) Benefits commencing at certain ages disregarded. For purposes of determining an employee's most valuable accrual rate, any benefit commencing before the current plan year or after the employee's testing age is disregarded. Thus, for example, the most valuable accrual rate for an employee who is beyond the otherwise applicable testing age under the plan (i.e., the testing age determined without regard to paragraph (4) of the definition of testing age in §1.401(a)(4)-12 (current-age rule)) is determined solely by reference to the QJSA commencing in the current plan year.



-3(d)(5)(iv)

(iv) Normalizing plan benefits--(A) In general. A benefit payable to an employee in a particular form under a plan is normalized to an actuarially equivalent straight life annuity commencing at the employee's testing age under the plan as follows--

(1) Determine the actuarial present value of all payments under the benefit, as of the date payment of the benefit to the employee would commence under the plan.

(2) If the employee's testing age is after the benefit commencement date in paragraph (d)(5)(iv)(A)(1) of this section, increase the actuarial present value determined in paragraph (d)(5)(iv)(A)(1) of this section by interest for the period from the benefit commencement date in paragraph (d)(5)(iv)(A)(1) of this section to the employee's testing age. If the employee's testing age is before the benefit commencement date in paragraph (d)(5)(iv)(A)(1) of this section, discount the actuarial present value determined in paragraph (d)(5)(iv)(A)(1) of this section by interest from the benefit commencement age in paragraph (d)(5)(iv)(A)(1) of this section to the employee's testing age. The interest rate used to make these adjustments may be different from the single interest rate used to determine the actuarial present value in paragraph (d)(5)(iv)(A)(1) of this section and the straight life annuity factor in paragraph (d)(5)(iv)(A)(3) of this section.

(3) Divide the amount determined in paragraph (d)(5)(iv)(A)(2) of this section by a straight life annuity factor for the employee's testing age. The resulting quotient is the employee's normalized benefit.

(B) Actuarial assumptions. The actuarial assumptions used in normalizing a benefit must be reasonable and must be applied on a gender-neutral basis. A standard interest rate and a standard mortality table are deemed to be reasonable for this purpose. Except as



provided in paragraph (d)(5)(iv)(A)(2) of this section, the same interest rate and the same mortality table must be used for all purposes under this paragraph (d). For other assumptions (including an employee's marital status and the value of variable indices), see paragraph (d)(5)(iii) of this section.

(C) Special rule for QSUPPs. In normalizing a QSUPP, the survivor portion of the QSUPP and any amounts provided under the QSUPP after the employee's normal retirement age under the plan are disregarded.

(v) Examples. The following examples illustrate the rules in this paragraph (d)(5).

Example 1. Plan A is a defined benefit plan that includes an early retirement option on or after age 55 for employees who complete 10 years of service with the employer. Employee X currently is age 51 and has completed 5 years of service. Under paragraph (d)(5)(iii)(D) of this section, Employee X is assumed to continue to earn one year of retirement eligibility service in each future plan year. Under this assumption, Employee X will first meet the eligibility requirements for the early retirement option at age 56, when Employee X will have completed 10 years of service. Thus, in determining Employee X's most valuable accrual rate, the first QJSA payable to Employee X under Plan A would commence at age 56.

Example 2. (a) Under Plan B, benefits for unmarried employees are paid in the form of a straight life annuity commencing at a normal retirement age of 65. Plan B further provides that a married employee will be paid benefits in the form of an actuarially equivalent QJSA commencing at the same age. The conversion factor used to determine the



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QJSA is a function of the employee's age and the age of the employee's spouse. For an employee with a spouse the same age as the employee, the conversion factor is 0.92 at age 55 and decreases in a straight line to a value of 0.90 at age 65.

(b) Plan B permits an employee who has completed 10 years of service to retire on or after age 55 and to receive a reduced early retirement benefit. The amount of the reduction is 6.67 percent for each of the first 5 years that an employee's benefit commencement date precedes normal retirement age and 3.33 percent for each of the next 5 years that an employee's benefit commencement precedes age 60.

(c) Employee Y is a participant in Plan B. Employee Y is 50 years old and has 10 years of service. If Employee Y's benefits under Plan B were frozen as of the last day of the current plan year, Employee Y would have an accrued benefit of $9,333. The QJSA payable at each potential age that benefits could commence to Employee Y under the plan is

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determined under the following table. For this purpose, Employee Y is assumed under paragraph (d)(5)(iii)(F) of this section to be married and to have a spouse of the same age.

| Age | Early Retirement Factor | Joint & Survivor Factor | Frozen Accrued Benefit | QJSA Benefit Payable |
|---|---|---|---|---|
| 55 | 50.00% | 92.00% | 9,333 | 4,293 |
| 56 | 53.33% | 91.80% | 9,333 | 4,569 |
| 57 | 56.67% | 91.60% | 9,333 | 4,845 |
| 58 | 60.00% | 91.40% | 9,333 | 5,118 |
| 59 | 63.33% | 91.20% | 9,333 | 5,390 |
| 60 | 66.67% | 91.00% | 9,333 | 5,662 |
| 61 | 73.33% | 90.80% | 9,333 | 6,214 |
| 62 | 80.00% | 90.60% | 9,333 | 6,765 |
| 63 | 86.67% | 90.40% | 9,333 | 7,312 |
| 64 | 93.33% | 90.20% | 9,333 | 7,857 |
| 65 | 100.00% | 90.00% | 9,333 | 8,400 |

Example 3. A 50-percent QJSA of $1,200, payable in monthly installments of $100 each to Employee A commencing at age 62, is normalized under paragraph (d)(5)(iv) of this section to an actuarially equivalent straight life annuity commencing at Employee A's testing age of 65 by using an 8-percent interest rate and the UP-84 mortality table, under the following steps. Regardless of Employee A's marital status, under paragraphs (d)(5)(iii)(F) and (d)(5)(iv)(B) of this section, Employee A is assumed to have a spouse who is the same age as Employee A.

(a) The actuarial present value of the QJSA at age 62 is $11,462.

(b) The actuarial present value determined in paragraph (a) of this Example 3 as of age 62 is increased by interest for the period from age 62 to age 65, resulting in a value at age 65 of $14,439.

(c) The amount determined in paragraph (b) of this Example 3 is divided by a straight life annuity factor of 8.1958 for age 65. The resulting quotient (a straight life annuity of $1,762) is the employee's normalized QJSA.

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Example 4. The facts are the same as in Example 3, except that Employee A is also entitled to a $600 annual QSUPP payable in equal monthly payments of $50 beginning at age 55 and continuing until Employee A's social security retirement age. The QSUPP is normalized to an actuarially equivalent straight life annuity under the following steps.

(a) The actuarial present value of the QSUPP at age 55 is $3,996. This actuarial present value excludes the value of payments that may be made under the QSUPP to Employee A's spouse if Employee A were to die before receiving all the scheduled payments under the QSUPP and the value of any payments that extend beyond Employee A's normal retirement date under the plan.

(b) The actuarial present value determined in paragraph (a) of this Example 4 as of age 55 is increased by interest for the period from age 55 to age 65, resulting in a value at age 65 of $8,627.

(c) The amount determined in paragraph (b) of this Example 4 is divided by a straight life annuity factor of 8.1958 for age 65. The resulting quotient (a straight life annuity of $1,053) is Employee A's normalized QSUPP.

Example 5. The facts are the same as in Example 3, except that Employee A's accrued benefit is payable as a life annuity of $12,000, payable in monthly installments of $1,000 per month beginning at the plan's normal retirement age of 65, with an automatic cost-of-living adjustment after normal retirement date. In the current plan year, the index that determines the automatic cost-of-living adjustment increased by 4 percent. Employee A's life annuity is normalized to an actuarially equivalent straight life annuity beginning at age 65 under the following steps.

(a) The actuarial present value of the life annuity at age 65 is $129,260. This actuarial present value reflects future annual increases of 4 percent under the plan's automatic cost-of-living adjustment after normal retirement date.

(b) The actuarial present value determined in paragraph (a) of this Example 5 as of age 65 is neither increased nor discounted for interest, because the benefit commencement date and the employee's testing age are both age 65.

(c) The amount determined in paragraph (b) of this Example 5 is divided by a straight life annuity factor of 8.1958 for age 65. The resulting quotient (a straight life annuity of $15,772) is Employee A's normalized accrued benefit.

Example 6. A life annuity of $12,000, payable in monthly installments of $1,000 each to Employee B commencing at age 68, is normalized under paragraph (d)(5)(iv) of this section to an actuarially equivalent straight life annuity commencing at Employee B's testing age of 65 by using an 8-percent interest rate and the UP-84 mortality table, under the following steps.

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(a) The actuarial present value of the annuity at age 68 is $91,211.

(b) The actuarial present value determined in paragraph (a) of this Example 6 as of age 68 is discounted by interest for the period from age 68 to age 65, resulting in a value at age 65 of $72,406.



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(c) The amount determined in paragraph (b) of this Example 6 is divided by a straight life annuity factor of 8.1958 for age 65. The resulting quotient (a straight life annuity of $8,835) is Employee B's normalized QJSA.

Example 7. (a) Plan B is a defined benefit plan with a benefit formula of 2 percent of average annual compensation less 1.5 percent of the employee's primary social security benefit per year of service. Plan B has a calendar plan year. Average annual compensation is defined as the average of the annual compensation for the 3 consecutive plan year period over an employee's career in which the average is highest. Employee B has 5 years of testing service as of the calendar plan year 2000 and the following annual compensation: 1996-$15,000, 1997-$20,000, 1998-$24,000, 1999-$30,000, 2000-$33,000.

(b) Accrual rates for Plan B are being determined under the projected method of paragraph (d)(4) of this section for the year 2000. For purposes of projecting accrued benefits as of a date after the year 2000, the annual compensation for the year 2000 is assumed to continue into the future. See paragraph (d)(5)(iii)(E) of this section. Thus, in order to determine Employee B's QJSA as if Employee B's benefits under the plan were frozen as of the end of the year 2000, Employee B's average annual compensation is the average for the years 1998-2000, or $29,000. In order to determine Employee B's QJSA as if Employee B's benefits under the plan were frozen as of the end of the year 2001, Employee B's average annual compensation is the average for the years 1999-2001, or $32,000 (the average of $30,000, $33,000, and $33,000). In order to determine Employee B's QJSA as if Employee B's benefits under the plan were frozen as of the end of the year 2002 or a later year, Employee B's average annual compensation is $33,000.

(c) In order to determine the primary social security benefit offset in the plan formula, the factors required to determine a primary social security benefit are not assumed to change in the future. See paragraph (d)(5)(iii)(G) of this section. Thus, for example, if accrual rates are being determined in the year 2000 based on benefits determined as if frozen at a year after the year 2000, the taxable wage base for the year 2000 is assumed to remain constant.

Example 8. Employer A maintains a defined benefit plan. An employee's normal retirement benefit under the plan equals 1 percent of compensation times years of service. The plan provides for five-year cliff vesting as permitted under section 411(a)(2)(A). Because the definition of compensation under the plan does not satisfy section 414(s), the plan must be tested under the general test of paragraph (c) of this section. In anticipation of the plan's failure to satisfy the general test, Employer A amends the plan to add a minimum



benefit equal to 5 percent of compensation, so that following the amendment an employee's normal retirement benefit equals the greater of--

(A) 1 percent of compensation times years of service, or

(B) 5 percent of compensation.

Because the normal retirement benefit of a vested participant with 5 or more years of service would be at least 5 percent of compensation even without regard to the minimum benefit, the minimum benefit does not provide meaningful benefits to vested participants. It therefore would be inconsistent with the purpose of preventing discrimination in favor of highly compensated employees to take the minimum benefit into account in determining accrual rates under this paragraph (d). See §1.401(a)(4)-1(c)(2).

(6) Optional rules for calculating accrual rates--(i) In general. This paragraph (d)(6) provides optional rules that may be applied in determining accrual rates under this paragraph (d). If any optional rule is applied to a plan for a plan year, the rule must be applied to determine accrual rates for all employees in the plan for the plan year, unless otherwise provided.

(ii) Imputation of permitted disparity. The disparity permitted under section 401(*l*) may be imputed in accordance with the rules of §1.401(a)(4)-7.

(iii) Expressing accrual rates as dollar amounts. Accrual rates may be expressed as a dollar amount rather than as a percentage of testing compensation. Accrual rates that are expressed as a dollar amount are determined without taking into account any requirement in this paragraph (d) that calls for expressing any amount as a percentage of testing compensation, dividing any amount by testing compensation, or multiplying any amount by testing compensation. For example, under the annual method, an employee's normal accrual rate would be determined by subtracting the employee's normalized accrued benefit (determined as if frozen as of the last day of the prior plan year) from the employee's



normalized accrued benefit (determined as if frozen as of the last day of the plan year), without dividing the difference by the employee's testing compensation for the plan year.

(iv) Grouping of accrual rates--(A) In general. An employer may treat all employees who have accrual rates within a range of no more than 5 percent (not 5 percentage points) above and below a midpoint rate chosen by the employer as having an accrual rate equal to that midpoint rate. If accrual rates are determined as a percentage of testing compensation, an employer may, as an alternative, treat all employees who have accrual rates within a range of no more than one-twentieth of a percentage point above and below a midpoint rate chosen by the employer as having an accrual rate equal to that midpoint rate. Accrual rates within a given range may be grouped under this paragraph (d)(6)(iv) only if the accrual rates of highly and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner and the range does not overlap with any other range chosen by the employer. An employer may choose to group the accrual rates of some employees into ranges and not to group the accrual rates of other employees into ranges, provided that the accrual rates of all employees within each range chosen by the employer are grouped

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within that range. If accrual rates are determined as a percentage of testing compensation, an employer may apply either grouping method described in this paragraph (d)(6)(iv) and, in addition, may apply one method to one group of employees and the other method to another group of employees, provided that only one method is applied to any given employee or group of employees. An employer may also choose to apply these grouping rules in one manner (or not at all) for normal accrual rates and in another manner (or not at all) for most valuable accrual rates.



(B) Examples. The following examples illustrate the grouping rules in this paragraph (d)(6)(iv).

Example 1. The employees in Plan A have the following accrual rates (expressed as a percentage of testing compensation): 1.9 percent, 2.0 percent, and 2.1 percent. Because all employees have accrual rates within a range of no more than 5 percent above or below 2.0 percent (a midpoint rate chosen by the employer), the employer may treat all employees in Plan A as having an accrual rate of 2.0 percent (provided, of course, that the accrual rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner).

Example 2. The employees in Plan B have the following accrual rates (expressed as percentage of testing compensation): 0.8 percent, 0.83 percent, 0.9 percent, 1.9 percent, 2.0 percent, and 2.1 percent. Because the first three rates are within a range of no more than one-twentieth of a percentage point above or below 0.85 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 0.85 percent (provided that the accrual rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner). Because the last three rates are within a range of no more than 5 percent above or below 2.0 percent (a midpoint rate chosen by the employer), the employer may treat the employees who have those rates as having an accrual rate of 2.0 percent (provided that the accrual rates of highly compensated employees and nonhighly compensated employees are dispersed throughout the range in a reasonably comparable manner).

(v) Floor on most valuable accrual rate--(A) In general. In determining an employee's most valuable accrual rate under this paragraph (d), the employer may substitute for the employee's actual most valuable accrual rate for the current plan year, the employee's highest most valuable accrual rate determined for any plan year in a period of consecutive plan years. The period of consecutive plan years must begin with any prior plan year selected by the employer that is the same for all employees in the plan (except as otherwise provided below), and must end with and include the current plan year. This paragraph (d)(6)(v) is available to determine the most valuable accrual rate of an employee only if the following requirements are satisfied--



(1) There has been no plan amendment effective during the period that affects the determination of the most valuable accrual rate of any employee in the plan.

(2) The employee's normal accrual rates for all plan years in the period were determined in the same manner, and the employee's most valuable accrual rates for all plan years in the period were determined in the same manner. The employee's normal and most valuable accrual rates for all prior plan years may be redetermined to meet this requirement. Most valuable accrual rates do not fail to be determined in the same manner merely because the option in this paragraph (d)(6)(v) is not applied in any one or more of the prior plan years in the period.

(3) The employee's normal accrual rates for all plan years in the period fall within a range that would be permitted to be grouped at a single midpoint rate under the grouping rules of paragraph (d)(6)(iv) of this section if the employee's normal accrual rates were the only rates in the plan for a plan year. If this requirement is not satisfied for the employee, the earliest plan year in the period must be disregarded for purposes of applying this paragraph (d)(6)(v) to the employee. The rule in the preceding sentence must be applied repeatedly until the requirement in this paragraph (d)(6)(v)(A)(3) is satisfied. For purposes of this paragraph (d)(6)(v)(A)(3), an employee's normal accrual rates are determined in accordance with paragraph (d)(6)(v)(A)(2) of this section and without applying the grouping rules under paragraph (d)(6)(iv) of this section.

(B) Examples. The following examples illustrate this paragraph (d)(6)(v).

Example 1. Under Plan A, Employee X has the following normal accrual rates in the current plan year and the immediately preceding 5 plan years: 1.9 percent, 1.95 percent, 2.0 percent, 2.1 percent, 2.05 percent, and 2.05 percent. For each of those years, Employee X has the following most valuable accrual rates: 3.0 percent, 2.6 percent, 2.7 percent, 2.9



percent, 2.8 percent, and 2.8 percent. The normal and most valuable accrual rates for all plan years in the period of consecutive plan years have been determined in the same manner. In addition, the plan has not been amended during the period of consecutive years in a manner that would affect the determination of the most valuable accrual rate of any employee in the plan. The employer applies the option in this paragraph (d)(6)(v) for all employees. Employee X's normal accrual rates in the current and preceding 5 plan years are no more than 5 percent above or below 2.0 percent (a midpoint rate chosen by the employer) and thus are within a range of rates that would be permitted to be grouped at a single midpoint rate under the grouping rules of paragraph (d)(6)(iv) of this section if the employee's normal



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accrual rates were the only rates in the plan for a plan year. Therefore, the employer may treat Employee X's most valuable accrual rate as 3.0 percent for the current plan year.

Example 2. The facts are the same as in Example 1, except that Employee X's normal accrual rate in the 5th preceding plan year is 2.5 percent. Due to the greater dispersion of Employee X's normal accrual rates within the period, they may not be grouped at a single midpoint rate chosen by the employer. Under paragraph (d)(6)(v)(A)(3) of this section, the earliest plan year in the period must therefore be disregarded. As a result, only Employee X's normal and most valuable accrual rates for the current and the 4 preceding plan years are taken into account. After applying the analysis in Example 1 to this shorter period, the employer may treat Employee X's most valuable accrual rate as 2.9 percent for the current plan year.

(vi) Adjustment in most valuable accrual rate for certain disability benefits provided under the plan--(A) In general. An employer may adjust an employee's most valuable accrual rate to reflect the value of certain disability benefits that are currently available to the employee under the plan (within the meaning of §1.401(a)(4)-4(b)(2)).

(B) Includible disability benefits. A disability benefit may be taken into account under this paragraph (d)(6)(vi) only if the following requirements are satisfied--

(1) The disability benefit is equal to the maximum qualified disability benefit (within the meaning of section 411(a)(9)).

(2) The employee is treated as disabled under the plan if the employee is unable to perform the duties of the employee's usual occupation.



(3) The actual experience of the employer or the nature of the work being performed by employees covered by the disability benefit (i.e., the likelihood of employment-related disability) indicates that it is a meaningful and significant benefit.

(C) Adjustment. The value of the disability benefit is taken into account by multiplying the employee's most valuable accrual rate by 1.11. This factor is applied before imputing permitted disparity under §1.401(a)(4)-7, and before grouping accrual rates under paragraph (d)(6)(iv) of this section.

(D) Example. The following example illustrates this paragraph (d)(6)(vi).

Example. Employer A maintains Plan X. Plan X provides a disability benefit for all employees who work in Employer A's underground coal mines and who suffer an employment-related disability. Under these facts, the disability benefit is a meaningful and significant benefit.

(vii) Fresh-start alternative for accrued-to-date method--(A) In general. The accrued-to-date method may be applied solely with respect to benefits accrued and testing service in plan years beginning after a fresh-start date. This alternative may be applied only if the plan satisfies the fresh-start rules of §1.401(a)(4)-13(c) with respect to the fresh-start date.

(B) Normal accrual rate. Under the fresh-start alternative for the accrued-to-date method, the normal accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(1) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the last day of the plan year.

(2) Determine the employee's accrued benefit frozen in accordance with §1.401(a)(4)-13(c) as of the fresh-start date and adjusted, if applicable, in accordance with §1.401(a)(4)-13(c)(5)(iii) (but not §1.401(a)(4)-13(c)(6)(ii)) through the last day of the current plan year.



(3) Normalize the accrued benefit determined in paragraph (d)(6)(vii)(B)(1) of this section.

(4) Normalize the accrued benefit determined in paragraph (d)(6)(vii)(B)(2) of this section.

(5) Subtract the normalized accrued benefit determined in paragraph (d)(6)(vii)(B)(4) of this section from the normalized accrued benefit determined in paragraph (d)(6)(vii)(B)(3) of this section.

(6) Divide the amount determined in paragraph (d)(6)(vii)(B)(5) of this section by the employee's testing service since the fresh-start date.

(7) Divide the amount determined in paragraph (d)(6)(vii)(B)(6) of this section by the employee's testing compensation for the plan year. This rate is the employee's normal accrual rate under the plan for the plan year.

(C) Most valuable accrual rate. Under the fresh-start alternative for the accrued-to-date method, the most valuable accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(1) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the last day of the plan year.



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(2) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, the QJSA and the QSUPP are frozen (along with the employee's

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other benefits under the plan) in accordance with §1.401(a)(4)-13(c) as of the fresh-start date and adjusted, if applicable, in accordance with §1.401(a)(4)-13(c)(5)(iii) (but not §1.401(a)4)-13(c)(6)(ii)) through the last day of the current plan year.

(3) Normalize each QJSA and each QSUPP determined in paragraph (d)(6)(vii)(C)(1) of this section.

(4) Normalize each QJSA and each QSUPP determined in paragraph (d)(6)(vii)(C)(2) of this section.

(5) Subtract the normalized QJSA determined for each age in paragraph (d)(6)(vii)(C)(4) of this section from the normalized QJSA determined for the same age in paragraph (d)(6)(vii)(C)(3) of this section.

(6) Subtract the normalized QSUPP determined for each age under paragraph (d)(6)(vii)(C)(4) of this section from the normalized QSUPP determined for the same age under paragraph (d)(6)(vii)(C)(3) of this section.

(7) Add the increase in the normalized QJSA determined for each age in paragraph (d)(6)(vii)(C)(5) to the increase in the normalized QSUPP determined for the same age in paragraph (d)(6)(vii)(C)(6) of this section.

(8) Divide the amount determined for each age in paragraph (d)(6)(vii)(C)(7) of this section by the employee's testing service since the fresh-start date.

(9) Divide the amount determined in paragraph (d)(6)(vii)(C)(8) of this section by the employee's testing compensation.

(10) Select the largest rate determined in paragraph (d)(6)(vii)(C)(9) of this section. This rate is the employee's most valuable accrual rate under the plan for the plan year.

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(D) Examples. The following examples illustrate the fresh-start alternative for the accrued-to-date method.

Example 1. The following table illustrates the determination of the most valuable accrual rate for Employee M in Plan A for the 1994 plan year under the fresh-start alternative to the accrued-to-date method. Employee M has a testing age under Plan A of 65, testing service of 5 years since the fresh-start date, and testing compensation for the 1994 plan year of $50,000. Plan A does not provide a QSUPP. Step 1 lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of the last day of the 1994 plan year. Assume that as determined under paragraph (d)(5)(iii) of this section, Employee M is first eligible for a QJSA at age 55. Step 2 lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section, frozen in accordance with §1.401(a)(4)-13(c), and adjusted in accordance with §1.401(a)(4)-13(c)(5)(iii) through the last day of the current plan year. Steps 3 and 4 list the normalized value (as determined under paragraph (d)(5)(iv) of this section) of each QJSA in Steps 1 and 2, respectively. For this purpose, an 8-percent interest rate and the UP-84 mortality table have been applied to normalize each QJSA. Step 5 lists the difference between steps 3 and 4 at each age. (The table skips steps 6 and 7 because Plan A does not provide a QSUPP.) Step 8 divides the difference in step 5 by Employee M's 5 years of testing service since the fresh-start date. Step 9 divides the quotient determined in step 8 by Employee M's testing compensation of $50,000. Employee M's most valuable accrual rate under Plan A for the 1994 plan year is 3.36 percent, the largest rate listed in step 9.

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| | Step 1 | Step 2 | Step 3 | Step 4 | Step 5 | Step 8 | Step 9 |
|---|---|---|---|---|---|---|---|
| | QJSA as if Frozen in Current Year | Actual Frozen QJSA as of Fresh-Start Date | Normalized QJSA from Step 1 | Normalized QJSA from Step 2 | Step 3 Minus Step 4 | Step 5 Divided by Testing Service since Fresh-Start Date | Step 8 Divided by Testing Compensation |
| 55 | 4,293 | 1,288 | 12,006 | 3,602 | 8,404 | 1,681 | 3.36% |
| 56 | 4,569 | 1,371 | 11,681 | 3,504 | 8,177 | 1,635 | 3.27% |
| 57 | 4,845 | 1,453 | 11,313 | 3,394 | 7,919 | 1,584 | 3.17% |
| 58 | 5,118 | 1,535 | 10,910 | 3,273 | 7,637 | 1,527 | 3.05% |
| 59 | 5,390 | 1,617 | 10,481 | 3,144 | 7,337 | 1,467 | 2.93% |
| 60 | 5,662 | 1,699 | 10,034 | 3,010 | 7,024 | 1,405 | 2.81% |
| 61 | 6,214 | 1,864 | 10,027 | 3,008 | 7,019 | 1,404 | 2.81% |
| 62 | 6,765 | 2,029 | 9,931 | 2,979 | 6,952 | 1,390 | 2.78% |
| 63 | 7,312 | 2,194 | 9,759 | 2,928 | 6,831 | 1,366 | 2.73% |
| 64 | 7,857 | 2,357 | 9,524 | 2,857 | 6,667 | 1,333 | 2.67% |
| 65 | 8,400 | 2,520 | 9,240 | 2,772 | 6,468 | 1,294 | 2.59% |

Example 2. The facts are the same as in Example 1, except that the plan has been amended since the fresh-start date to improve the factor used to calculate the QJSA. The new factor applies to benefits accrued both before and after the fresh-start date, as permitted under §1.401(a)(4)-13(c)(6)(ii). Although this change increases the QJSA determined with respect to benefits accrued prior to the fresh-start date, the frozen QJSA determined as of the fresh-start date and adjusted through the last day of the current plan year under paragraph (d)(6)(vii)(B)(2) of this section does not include the increase in benefits attributable to the new QJSA factor and thus must be determined using the original factor provided in the plan.

(viii) Fresh-start alternative for projected method--(A) In general. The projected method may be applied solely with respect to benefits accrued and testing service in plan



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years beginning after a fresh-start date. This alternative may be applied only if the plan satisfies the fresh-start rules of §1.401(a)(4)-13(c) with respect to the fresh-start date.

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(B) Normal accrual rate. Under the fresh-start alternative for the projected method, the normal accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(1) Determine the employee's accrued benefit as if the employee's benefits under the plan had been frozen as of the employee's testing age.

(2) Determine the employee's accrued benefit frozen in accordance with §1.401(a)(4)-13(c) as of the fresh-start date and adjusted, if applicable, in accordance with §1.401(a)(4)-13(c)(5)(iii) (but not §1.401(a)4)-13(c)(6)(ii)) through the last day of the current plan year.

(3) Normalize the accrued benefit determined in paragraph (d)(6)(viii)(B)(1) of this section.

(4) Normalize the accrued benefit determined in paragraph (d)(6)(viii)(B)(2) of this section.

(5) Subtract the normalized accrued benefit determined in paragraph (d)(6)(viii)(B)(4) of this section from the normalized accrued benefit determined in paragraph (d)(6)(viii)(B)(3) of this section.

(6) Divide the amount determined in paragraph (d)(6)(viii)(B)(5) of this section by the testing service since the fresh-start date the employee would have as of the employee's testing age.

(7) Divide the amount determined in paragraph (d)(6)(viii)(B)(6) of this section by the employee's testing compensation as of the employee's testing age. This rate is the employee's normal accrual rate under the plan for the plan year.

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(C) Most valuable accrual rate. Under the fresh-start alternative for the projected method, the most valuable accrual rate for an employee in the plan for a plan year is the percentage amount determined under the following steps--

(1) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, each QJSA and each QSUPP is determined as if the employee's benefits under the plan had been frozen as of the age payment of the QJSA and the QSUPP (if any) to the employee would commence under the plan.

(2) Determine the QJSA, and the QSUPP (if any) payable in conjunction with the QJSA, at each age payment of these benefits to the employee could commence under the plan. For this purpose, the QJSA and the QSUPP are frozen (along with the employee's other benefits under the plan) in accordance with §1.401(a)(4)-13(c) as of the fresh-start date and adjusted, if applicable, in accordance with §1.401(a)(4)-13(c)(5)(iii) (but not §1.401(a)4)-13(c)(6)(ii)) through the last day of the current plan year.

(3) Normalize each QJSA and each QSUPP determined in paragraph (d)(6)(viii)(C)(1) of this section.

(4) Normalize each QJSA and each QSUPP determined in paragraph (d)(6)(viii)(C)(2) of this section.

(5) Subtract the normalized QJSA determined for each age in paragraph (d)(6)(viii)(C)(4) of this section from the normalized QJSA determined for the same age in paragraph (d)(6)(viii)(C)(3) of this section.

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(6) Subtract the normalized QSUPP determined for each age under paragraph (d)(6)(viii)(C)(4) of this section from the normalized QSUPP determined for the same age under paragraph (d)(6)(viii)(C)(3) of this section.

(7) Add the increase in the normalized QJSA determined for each age in paragraph (d)(6)(viii)(C)(5) of this section to the increase in the normalized QSUPP determined for the same age in paragraph (d)(6)(viii)(C)(6) of this section.

(8) Divide the amount determined for each age in paragraph (d)(6)(viii)(C)(7) of this section by the testing service since the fresh-start date the employee would have as of that age.

(9) Divide the amount determined for each age in paragraph (d)(6)(viii)(C)(8) of this section by the employee's testing compensation as of that age.

(10) Select the largest rate determined in paragraph (d)(6)(viii)(C)(9) of this section.

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This rate is the employee's most valuable accrual rate under the plan for the plan year.

(D) Terminated employees. Notwithstanding the foregoing, in the case of an employee who has terminated employment as of the last day of the current plan year, the employee's normal and most valuable accrual rates under the fresh-start alternative for the projected method are determined under the fresh-start alternative for the accrued-to-date method in paragraph (d)(6)(vii) of this section.

(E) Discriminatory pattern of accruals. Paragraph (d)(4)(v) of this section prohibits use of the projected method if the pattern of accruals under the plan discriminates in favor of highly compensated employees. The same prohibition applies to use of the fresh-start



alternative for the projected method, except that only the pattern of accruals under the plan after the fresh-start date is taken into account.

(F) Example. The rules in this paragraph (d)(6)(viii) are illustrated in the following example.

Example. The following table illustrates the determination of the most valuable accrual rate for Employee M in Plan A for the 1994 plan year under the fresh-start alternative for the projected method. Employee M has a testing age under Plan A of 65. Plan A does not provide a QSUPP. Step 1 lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section as if Employee M's benefits under the plan had been frozen as of each age at which payment of the QJSA would begin. Assume that, as determined under paragraph (d)(5)(iii) of this section, Employee M is first eligible for a QJSA at age 60. Step 2 lists the QJSA payable to Employee M at each age under the plan, determined under paragraph (d)(5)(iii) of this section, frozen in accordance with §1.401(a)(4)-13(c), and adjusted in accordance with §1.401(a)(4)-13(c)(5)(iii) through the last day of the current plan year. Steps 3 and 4 list the normalized value (as determined under paragraph (d)(5)(iv) of this section) of each QJSA in steps 1 and 2, respectively. For this purpose, an 8-percent interest rate and the UP-84 mortality table have been applied to normalize each QJSA. Step 5 lists the difference between steps 3 and 4 at each age. (The table skips steps 6 and 7 because Plan A does not provide a QSUPP.) Step 8 lists Employee M's projected testing service since the fresh-start date as of each age and the results of dividing the difference in step 5 by Employee M's projected testing service since the fresh-start date as of that age. Step 9 lists Employee M's projected testing compensation as of each age and the results of dividing the quotient in step 8 by Employee M's projected testing compensation as of that age. Employee M's most valuable accrual rate under Plan A for the 1994 plan year is 1.96 percent, the largest rate listed in step 9.



| | Step 1 | Step 2 | Step 3 | Step 4 | Step 5 | Step 8 | | Step 9 | |
|---|---|---|---|---|---|---|---|---|---|
| | Projected QJSA | Frozen QJSA | Normalized QJSA from Step 1 | Normalized QJSA from Step 2 | Step 3 Minus Step 4 | Projected Testing Service Since Fresh-Start Date | Step 5 Divided by Testing Service | Projected Testing Compensation | Step 8 Divided by Testing Compensation |
| 60 | 5,096 | 1,895 | 9,031 | 3,358 | 5,673 | 10 | 567 | 29,000 | 1.96% |
| 61 | 5,873 | 2,080 | 9,476 | 3,357 | 6,119 | 11 | 556 | 32,000 | 1.74% |
| 62 | 6,697 | 2,264 | 9,832 | 3,324 | 6,508 | 12 | 542 | 33,000 | 1.64% |
| 63 | 7,569 | 2,448 | 10,101 | 3,267 | 6,834 | 13 | 526 | 33,000 | 1.59% |
| 64 | 8,486 | 2,630 | 10,286 | 3,188 | 7,098 | 14 | 507 | 33,000 | 1.54% |
| 65 | 9,450 | 2,812 | 10,395 | 3,093 | 7,302 | 15 | 487 | 33,000 | 1.48% |

(e) Compensation rules--(1) In general. This paragraph (e) provides rules for determining average annual compensation and testing compensation for the employees in a plan for a plan year. Safe harbor plans that satisfy paragraph (b) of this section must determine benefits either as a dollar amount unrelated to employees' compensation or as a percentage of each employee's average annual compensation. For safe harbor plans that determine benefits as a percentage of each employee's average annual compensation, paragraph (e)(2) of this section provides the rules for determining the average annual compensation of each employee in the plan. Plans that do not satisfy one of the safe harbors in paragraph (b) of this section, and that instead satisfy this section under the general test of paragraph (c) of this section, are not required under this section to determine benefits under any particular definition of compensation or in any particular manner. However, the accrual rates used in testing these plans under the general test of paragraph (c) of this section must be expressed either as a dollar amount or as a percentage of each employee's testing



compensation for the plan year. Paragraph (e)(3) of this section provides the rules for determining the testing compensation of each employee in the plan for the plan year.

(2) Average annual compensation. "Average annual compensation" means the average of an employee's annual section 414(s) compensation determined over the averaging



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period in the employee's compensation history during which the average of the employee's annual section 414(s) compensation is the highest. For this purpose, an averaging period must consist of 3 or more consecutive 12-month periods (or, if shorter, the employee's period of employment). In addition, each employee's compensation history must end in the current plan year and must include 10 or more consecutive 12-month periods. However, an employee's compensation history need not be longer than the longer of the employee's period of testing service or the employee's averaging period. Finally, the averaging period and the compensation history for all employees in the plan must be determined in a consistent manner.

(3) Testing compensation--(i) In general. "Testing compensation" means either average annual compensation or plan year compensation, modified (if applicable) in accordance with paragraph (e)(3)(ii) or (iii) of this section. The testing compensation for all employees in the plan must be determined in a consistent manner. If accrual rates are determined by imputing permitted disparity as allowed under paragraph (d)(6)(ii) of this section, see §1.401(a)(4)-7(c)(4)(v) for limitations on testing compensation.

(ii) Certain modifications to plan year compensation. If accrual rates are being determined under any method other than the annual method in paragraph (d)(2) of this section, the following modifications to plan year compensation must be made--



(A) Plan year compensation must be determined during the period specified in paragraph (3) of the definition of plan year compensation in §1.401(a)(4)-12 (i.e., a 12-month period ending with or within the current plan year).

(B) In the case of employees who do not have section 414(s) compensation during at least 11 months within the 12-month period specified in paragraph (3) of the definition of plan year compensation in §1.401(a)(4)-12 by reason of termination of employment or absence from service, the 12-month period used to determine plan year compensation must be either--

(1) The 12-month period ending on the employee's termination of employment or absence from service, or

(2) The 12-month period immediately preceding the period used to determine the plan year compensation of all other employees in the plan.

(iii) Certain modifications to average annual compensation. If accrual rates are being determined under the projected method in §1.401(a)(4)-3(d)(4) or the fresh-start alternative for the projected method in §1.401(a)(4)-3(d)(6)(viii), the following modifications in determining average annual compensation must be made--

(A) An employee's average annual compensation must be determined as of each date (other than the fresh-start date, if applicable) that the employee's benefits under the plan are treated as frozen.

(B) If an employee's benefits under the plan are treated as frozen as of a date after the current plan year, the employee's compensation history must be projected through the future plan year in which the employee's benefits under the plan are treated as frozen, in



addition to the period of compensation history ending in the current plan year described in paragraph (e)(2) of this section.

(C) In determining the employee's projected compensation history as of any date after the 12-month period ending in the current plan year, it must be assumed that the employee continues to earn in each future 12-month period in the employee's projected compensation history the same amount of annual section 414(s) compensation that the employee earned in the 12-month period in the employee's compensation history ending in the current plan year.

(4) Examples. The rules of this paragraph (e) are illustrated by the following examples.

Example 1. Employer X maintains a defined benefit plan (Plan A). In testing whether the benefits provided under Plan A satisfy section 401(a)(4) for the plan year ending June 30, 1993, Employer X determines employees' accrual rates under the accrued-to-date method in paragraph (d)(3) of this section by using the following as the testing compensation divisor in paragraphs (d)(3)(i)(D) and (d)(3)(ii)(E) of this section: the average of each employee's annual compensation for the 5 consecutive 12-month periods (or the employee's period of employment, if shorter) during which the average of the employee's annual compensation is the highest. In determining the 5 consecutive 12-month periods during which the average of each employee's annual compensation is the highest, the last 10 consecutive 12-month periods ending on June 30, 1993, of each employee's compensation history are taken into account or, if shorter, the employee's period of testing service. In determining compensation for each 12-month period in an employee's compensation history, Employer X defines compensation using a definition that satisfies section 414(s). The amount of compensation used to determine employees' accrual rates under Plan A meets the definition of average annual compensation in paragraph (e)(2) of this section and thus is testing compensation within the meaning of paragraph (e)(3)(i) of this section.



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Example 2. (a) The facts are the same as in Example 1, except that, in determining the amount of each employee's compensation for the 12-month periods in each employee's compensation history ending in 1990 through 1993 that are taken into account in determining each employee's average annual compensation, Employer X defines compensation as wages within the meaning of section 3401(a) (wages for purposes of income tax withholding). In determining the amount of each employee's compensation for the 12-month periods in each employee's compensation history ending June 30, 1988, and June 30, 1989, that are taken into account in determining each employee's average annual compensation, Employer X defines compensation as section 415(c)(3) compensation (as defined in §1.415-2(d) without

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regard to §1.415-2(d)(10) through (12)). In determining the amount of each employee's compensation for the 12-month periods in each employee's compensation history beginning before January 1, 1988, taken into account in determining each employee's average annual compensation, Employer X defines compensation using a definition that does not satisfy section 414(s) but that was nondiscriminatory for the 1984 through 1987 plan years based on the relevant facts for those plan years.

(b) The testing compensation divisor used to determine employees' accrual rates for purposes of paragraph (d)(3) of this section is average annual compensation, and thus may be used as testing compensation, even though the underlying definition used to measure the amount of compensation for each year in an employee's compensation history is not the same. The underlying definition of compensation for each 12-month period in the employee's compensation history is section 414(s) compensation, because the definition satisfies the requirements contained in the definition of section 414(s) compensation in §1.401(a)(4)-12.

Example 3. The facts are the same as in Example 2, except the testing compensation divisor used in determining each employee's rate of accrual is the average of the employee's annual section 414(s) compensation for the consecutive 12-month periods ending on June 30, 1993, during which the employee was employed by Employer X rather the average of 5 consecutive 12-month periods as described in Examples 1 and 2. The compensation used to determine accruals is average annual compensation. The averaging period is determined consistently for each employee even though a different number of years is used to determine each employee's averaging period because the averaging period for each employee includes all the employee's years of consecutive employment. Thus, the amount of compensation used to determine employee's accrual rates under Plan A for purposes of paragraph (d)(3) of this section meets the definition of average annual compensation and may be used as testing compensation.

Example 4. The facts are the same as Example 2, except that Employer X determines the accrual rates for employees in Plan A who work at Plant S using, as the testing compensation divisor, each employee's plan year compensation as modified by paragraph (e)(3)(ii) of this section. The accrual rates for all other employees in Plan A are determined, using as the testing compensation divisor, each employee's average annual compensation as described in Examples 1 and 2. Employer X is not determining testing compensation for all employees, because the same method is not being used (either average annual compensation or plan year compensation) to determine the testing compensation for each employee in the plan. Therefore, the accrual rates determined for each employee in the plan do not satisfy paragraph (d)(3) of this section. However, Employer X may be able to restructure Plan A into two component plans in accordance with §1.401(a)(4)-9(c), one component plan including all employees in Plan A who work in Plant S and the other component plan including the employees in Plan A who do not work in Plant S.

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Example 5. The facts are the same as in Example 4, except that the testing compensation divisor used by Employer X to determine the accrual rates for employees in Plan A who work at Plant S is the average of each employee's compensation for the 3 consecutive 12-month periods during which the average of each employee's annual section 414(s) compensation is the highest, rather than the average for the 5 consecutive 12-month periods that is used for other employees in the plan. Employer X is not using average annual compensation and thus is not using testing compensation to determine each employee's accrual rates because the averaging period is not determined consistently for all employees. Therefore the accrual rates determined for each employee in the plan do not satisfy paragraph (d)(3) of this section.

Example 6. (a) The facts are the same as in Example 1, except that Employer X determines each employee's accrual rates using the projected method in paragraph (d)(4) of this section and Employer X determines compensation for each 12-month period in the employee's compensation history on the basis of the calendar year ending in the plan year. Employee Q, born on May 30, 1943, began participation in Plan A on July 1, 1973, and has benefited under the plan in every plan year since that date. Employee Q's testing age is 65. Employee Q has the following compensation history for the calendar years 1983 through 1992: 1983 - $10,000; 1984 - $12,000; 1985 - $14,000; 1986 - $15,000, 1987 - $17,000; 1988 - $17,000; 1989 - $15,000; 1990 - $15,000; 1991 - $13,000; 1992 - $12,000.

(b) In order to determine Employee Q's normal accrual rate, Employee Q's projected average annual compensation as of Employee Q's testing age of 65 must be determined. To determine Employee Q's compensation history to be used in determining Employee Q's projected average annual compensation, Employer X must assume that Employee Q's annual section 414(s) compensation for calendar years 1993 through 2007 (the calendar year ending in the plan year in which Employee Q attains the testing age of age 65) will be $12,000 for each calendar year, the same as Employee Q's annual section 414(s) compensation for the 1992 calendar year ending in the 1993 plan year. However, calendar years 1983 through 1992 must also be included in Employee Q's compensation history that is taken into account in determining Employee Q's projected average annual compensation. Employee Q's highest averaging period is calendar years 1986 through 1990 (the 5 consecutive 12-month periods out of calendar years 1983 through 2007, using projected annual section 414(s) compensation for 1993 through 2007, during which the average of Employee Q's annual section 414(s) compensation is the highest). Therefore Employee Q's projected average annual compensation for the 2007 plan year is $15,800 (($15,000 plus $17,000 plus $17,000 plus $15,000 plus $15,000) divided by 5)).

Example 7. (a) Plan M is a high average pay plan established on July 1, 1998, with a plan year ending each June 30. Plan M bases benefits for each employee on the average of the employee's annual compensation for the 36 months (or, if shorter, the employee's period of employment) during which the average of the employee's annual compensation is the highest. Compensation for purposes of determining benefits under the plan is determined using a definition that satisfies section 414(s). In determining the 36 months for each

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employee during which the average of the employee's annual compensation is the highest, the plan takes into account the 10 consecutive 12-month periods of the employee's compensation history ending on the June 30 preceding the date on which the employee terminates employment.

(b) The compensation determined under Plan M is not testing compensation, because compensation for the 12-month period ending on the June 30 during which any employee terminates employment is not included in the compensation history of that employee in determining the employee's average annual compensation. Therefore the average annual compensation determined under Plan M may not be used to determine accrual rates for purposes of paragraph (d) of this section. However, if plan M were a safe harbor plan under paragraph (b) of this section, the compensation determined under Plan M would nevertheless be treated as average annual compensation. See paragraph (b)(8)(x)(B) of this section.

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(f) Special rules--(1) In general. The special rules in this paragraph (f) apply for purposes of applying the provisions of this section to a defined benefit plan.

(2) Section 415 limits. Plan provisions that implement the limits of section 415 are disregarded. Furthermore, any plan provision that provides for increases in an employee's accrued benefit (that would have been greater but for the application of section 415) due solely to adjustments under section 415(d)(1) is also disregarded, but only if such provision applies uniformly to all employees in the plan. Thus, for example, a plan does not fail to satisfy the safe harbors in paragraph (b) of this section merely because the plan limits benefits in accordance with section 415. Similarly, for purposes of determining accrual rates under paragraph (d) of this section, plan benefits are determined without regard to plan provisions that implement the limits of section 415.

(3) Accruals after normal retirement age--(i) In general. An employee's accruals for any plan year after the plan year in which the employee attains normal retirement age are taken into account for purposes of this section. However, any plan provision may be disregarded that provides for increases in an employee's accrued benefit solely because the



employee has delayed commencing benefits beyond the normal retirement age applicable to the employee under the plan, but only if--

(A) The plan provision applies on the same terms to all employees in the plan;

(B) The same uniform normal retirement age applies to all employees in the plan; and

(C) The percentage factor used to increase the employee's accrued benefit is no greater than the largest percentage factor that could be applied to actuarially increase the employee's accrued benefit using any standard mortality table and any standard interest rate.

(ii) Examples. The following examples illustrate the rules of this paragraph (f)(3). In each example, it is assumed that the plan satisfies the requirements of paragraph (f)(3)(i)(A) through (C) of this section.

Example 1. Plan A provides a benefit of 2 percent of average annual compensation per year of service for all employees. In addition, Plan A provides an actuarial increase in an employee's accrued benefit of 6 percent for each year that an employee defers commencement of benefits beyond normal retirement age. For employees who continue in service beyond normal retirement age, the employee's 2-percent accrual for the current plan year is offset by the 6-percent actuarial increase, as permitted under section 411(b)(1)(H)(iii)(II). The employer may disregard the actuarial increase (and hence the offset) and thus may treat all employees as if they were accruing at the rate of 2 percent of average annual compensation per year.

Example 2. The facts are the same as in Example 1, except that the employee's 2-percent accrual for the current plan year is not offset by the 6-percent actuarial increase. The employer may disregard the actuarial increase and thus may treat all employees as if they were accruing at the rate of 2 percent of average annual compensation per year.

(4) Early retirement window benefits--(i) General rule. In applying the uniform subsidies requirement of paragraph (b)(2)(iv) of this section or in determining an employee's most valuable accrual rate under paragraph (d) of this section, all early retirement benefits, retirement-type subsidies, and QSUPPs for which the employee is (or is projected to be)



eligible are taken into account, regardless of whether they are permanent features under the plan or are offered only to employees who retire within a limited period of time.

(ii) Exceptions. Notwithstanding paragraph (f)(4)(i) of this section, an early retirement window benefit (as defined in paragraph (f)(4)(iii) of this section) is taken into account in accordance with the following rules--

(A) In the case of an early retirement window benefit that is available for a period that begins in one plan year and ends in the immediately succeeding plan year, the early retirement window benefit is disregarded for purposes of applying this section to the plan for the second plan year. The preceding sentence applies solely in the case of employees to whom the early retirement window benefit was treated as currently available for purposes of applying §1.401(a)(4)-4(b) to the plan for the first plan year, but who did not elect the window in that plan year.

(B) An early retirement window benefit is disregarded for purposes of applying this section to a plan for any plan year after the last plan year in which the early retirement window benefit is available. Thus, for example, in applying the option of the floor on the most valuable accrual rate in paragraph (d)(6)(v) of this section, the most valuable accrual rate in any plan year other than the current plan year is determined without regard to any early retirement window benefit offered in an earlier plan year. Similarly, in determining the most valuable accrual rate under the fresh-start alternative for the accrued-to-date method in paragraph (d)(6)(vii) of this section, the normalized amount of a QJSA frozen as of the

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fresh-start date is determined without regard to any early retirement window benefit offered in the plan year that ends on the fresh-start date.

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(iii) Early retirement window benefit defined. An early retirement window benefit is an early retirement benefit, retirement-type subsidy, or QSUPP payable under a plan only to employees who retire within a limited period of time (not to exceed 1 year). For this purpose, an amendment to an early retirement window benefit that merely extends the early retirement window benefit period is not treated as a separate early retirement window benefit, provided that the period as extended does not exceed 1 year. However, any other amendment to an early retirement window benefit creates a separate early retirement window benefit.

(5) Unpredictable contingent event benefits--(i) General rule. In applying the uniform subsidies requirement of paragraph (b)(2)(iv) of this section or in determining an employee's normal or most valuable accrual rate under paragraph (d) of this section, an unpredictable contingent event benefit is not taken into account until the occurrence of the contingent event. Upon the occurrence of the contingent event, the contingent event benefit is taken into account only for those employees who are affected by the contingent event under the terms of the plan. For purposes of this section, an unpredictable contingent event benefit is an unpredictable contingent event benefit as described in section 412(*l*)(7).

(ii) Example. The following example illustrates the rules of this paragraph (f)(5).

Example. (a) Employer X operates various manufacturing plants and maintains Plan A, a defined benefit plan that covers all its nonexcludable employees. Plan A provides an early retirement benefit under which employees who retire after age 55 but before normal retirement age and who have at least 10 years of service receive a benefit equal to their normal retirement benefit reduced by 4 percent per year for each year prior to normal retirement age. Plan A also provides a plant-closing benefit under which employees who satisfy the conditions for receiving the early retirement benefit and who work at a plant where operations have ceased and whose employment has been terminated will receive an unreduced normal retirement benefit. The plant-closing benefit is an unpredictable contingent event benefit within the meaning of section 412(*l*)(7).

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(b) During the 1993 plan year, Employer X had no plant closings. Therefore, the plant-closing benefit is not taken into account for the 1993 plan year in determining accrual rates or in applying the safe harbors in paragraph (b) of this section.

(c) During the 1994 plan year, one of Employer X's plants closes. Employees M through Z, who are employees at the plant that is closing, will satisfy the conditions for the plant-closing benefit. Therefore, in testing Plan A for compliance with this section for the 1994 plan year, the availability of the plant-closing benefit to Employees M through Z must be taken into account in determining their accrual rates or in determining whether the plan satisfies one of the safe harbors under paragraph (b) of this section.

(6) Determination of benefits on other than plan year basis. For purposes of this section, accruals are generally determined based on the plan year. Nevertheless, an employer may, but need not, determine accruals on the basis of any period ending within the plan year as long as the period is at least 12 months in duration and is applied uniformly to all employees in the plan for that plan year. For example, accruals for all employees may be determined based on accrual computation periods ending within the plan year.

(7) Adjustments for certain plan distributions. An employee's accrued benefit includes the actuarial equivalent of prior distributions from the plan to the employee, provided that the years of service taken into account in determining the prior distributions continue to be taken into account under the plan for purposes of determining the employee's current accrued benefit. For purposes of this paragraph (f)(7), actuarial equivalence must be determined in a uniform manner for all employees in the plan using reasonable actuarial assumptions. A standard interest rate and a standard mortality table are considered reasonable. Thus, for example, if an employee has commenced receipt of benefits in accordance with the minimum distribution requirements of section 401(a)(9), and the plan reduces the employee's accrued benefit to take into account the amount of the distributions,

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the employee's accrued benefit is restored to the value it would have had if the distributions had not occurred.

(8) Adjustment for certain QPSA charges. An employee's accrued benefit includes the cost of a qualified preretirement survivor annuity (QPSA) that reduces the employee's accrued benefit otherwise determined under the plan, as permitted under §1.401(a)-20, Q&A-21. Thus, an employee's accrued benefit is determined as if the cost of the QPSA had not been charged against the accrued benefit. This paragraph (f)(8) applies only if the QPSA charges apply uniformly to all employees in the plan.

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§1.401(a)(4)-4 Nondiscriminatory availability of benefits, rights, and features.

(a) Introduction--(1) General rule. The availability of benefits, rights, and features



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provided under a plan does not discriminate in favor of highly compensated employees if the plan satisfies the requirements of this section. The benefits, rights, and features subject to this requirement are all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan. In general, each benefit, right, and feature provided under a plan is separately subject to the requirements of this section regardless of whether the particular benefit, right, or feature is actuarially equivalent to any other benefit, right, or feature provided under the plan. Thus, for example, a plan may not condition or otherwise limit the availability of an optional form of benefit provided under the plan in a manner that violates the requirements of this section, even though the optional form of benefit is only one of several actuarially equivalent optional forms of benefit under the plan.

(2) Overview. A benefit, right, or feature provided under a plan is made available to employees in the plan in a nondiscriminatory manner only if the benefit, right, or feature separately satisfies the current availability requirement of paragraph (b) of this section and the effective availability requirement of paragraph (c) of this section. Paragraph (d) of this section provides special rules for mergers and acquisitions, employees with accrued benefits who are not currently benefiting under the plan, early retirement window benefits, permissive aggregation of certain benefits, rights, or features, and certain spousal benefits. Paragraph (e) of this section defines optional forms of benefit, ancillary benefits, and other rights and features. See §1.401(a)(4)-9(b)(3) for special rules regarding how this section is applied



where one or more defined contribution plans and one or more defined benefit plans are permissively aggregated and treated as a single plan pursuant to §1.410(b)-7(d).

(b) Current availability--(1) General rule. The group of employees in the plan to whom a benefit, right, or feature is currently available during the plan year must satisfy either the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory classification test of §1.410(b)-4 (without regard to the average benefit percentage test of §1.410(b)-5). In determining whether the group of employees satisfies the ratio percentage test or the nondiscriminatory classification test, an employee is treated as benefiting only if the benefit, right, or feature is currently available to the employee under the plan.

(2) Determination of current availability--(i) General rule. Whether a benefit, right, or feature that is subject to specified eligibility conditions is currently available to an employee generally is determined based on the current facts and circumstances with respect to the employee (e.g., current compensation, current accrued benefit, current position, or current net worth). Thus, the fact that an employee may, in the future, satisfy a precondition to receipt of the benefit, right, or feature generally does not cause the benefit, right, or feature to be currently available to the employee.

(ii) Certain age and service conditions disregarded--(A) General rule. Notwithstanding paragraph (b)(2)(i) of this section, any specified age or service condition with respect to an optional form of benefit or a social security supplement is disregarded in determining whether the optional form of benefit or the social security supplement is currently available to an employee. Thus, for example, an optional form of benefit that is available to all employees in the plan who terminate employment on or after age 55 with at



least 10 years of service is treated as currently available to an employee, without regard to the employee's current age or years of service and without regard to whether the employee could potentially meet the age and service conditions prior to attaining the plan's normal retirement age. The exception in this paragraph (b)(2)(ii)(A) does not apply in the case of ancillary benefits (other than social security supplements) or other rights and features.

(B) Time-limited age or service conditions not disregarded. Notwithstanding paragraph (b)(2)(ii)(A) of this section, an age or service condition is not disregarded in determining the current availability of an optional form of benefit or social security supplement if the condition must be satisfied within a limited period of time. However, in determining the current availability of an optional form of benefit or a social security supplement subject to such an age or service condition, the age and service of employees may be projected to the last date by which the age condition or service condition must be satisfied in order to be eligible for the optional form of benefit or social security supplement under the plan. Thus, for example, an optional form of benefit that is available only to employees who terminate employment between July 1, 1993, and December 31, 1993, after attainment of age 55 with at least 10 years of service is treated as currently available to an



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employee only if the employee could satisfy those age and service conditions by December 31, 1993.

(iii) Certain other conditions disregarded. Specified conditions on the availability of a benefit, right, or feature requiring termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, marital status, default on a plan loan secured by a participant's account balance, execution of a



covenant not to compete, application for benefits, election of a benefit form, or absence from service (for which imputed service or imputed compensation is granted in accordance with §1.401(a)(4)-11(d) or 1.414(s)-1(e), respectively), are disregarded in determining the employees to whom the benefit, right, or feature is currently available.

(iv) Mandatory cash-outs. In the case of a plan that provides for mandatory cash-outs of all terminated employees who have a vested accrued benefit with an actuarial present value less than or equal to a specified dollar amount (not to exceed $3,500) as permitted by sections 411(a)(11) and 417(e), any condition on a benefit, right, or feature that requires the employee to have a vested accrued benefit with an actuarial present value in excess of the specified dollar amount is disregarded.

(v) Certain conditions on plan loans. In the case of an employee's right to a loan from the plan, the condition that an employee must have an account balance sufficient to be eligible to receive a minimum loan amount specified in the plan (not to exceed $1,000) is disregarded in determining the employees to whom the right is available.

(3) Optional forms of benefit and other rights and features that are eliminated prospectively--(i) Special testing rule. Notwithstanding paragraph (b)(1) of this section, an optional form of benefit or other right or feature that is permanently eliminated with respect to benefits accrued after the later of the eliminating amendment's adoption or effective date (the "elimination date"), but is retained with respect to benefits accrued as of the elimination date, and that satisfies this paragraph (b) as of the elimination date, is treated as satisfying this paragraph (b) for all subsequent periods. This rule does not apply in the case of ancillary benefits. In addition, this rule does not apply if there are any changes in the terms



of the optional form of benefit or other right or feature (including changes in the employees to whom it is available) after the elimination date.

(ii) Treatment of earnings. For purposes of this paragraph (b)(3), in the case of a defined contribution plan, benefits accrued as of the elimination date include subsequent earnings, expenses, gains, and losses attributable to the balance in an employee's account as of the elimination date. Notwithstanding the foregoing, in the case of a right to a plan loan that is prospectively eliminated, a plan may treat, on a uniform basis, the benefits accrued as of the elimination date as consisting exclusively of the dollar amount of the balance in the employee's account as of the elimination date.

(iii) Example. The following example illustrates this paragraph (b)(3).

Example. Plan A is a defined benefit plan that provides a single sum optional form of benefit that is available to all employees on termination of employment. Plan A is amended January 1, 1993, to eliminate this single sum optional form of benefit with respect to benefits accrued after December 31, 1993. As of December 31, 1993, the single sum optional form of benefit is currently available to a group of employees that satisfies the ratio percentage test of §1.410(b)-2(b)(2). As of January 1, 2001, all nonhighly compensated employees who were entitled to the single sum optional form of benefit have terminated from employment with the employer and have taken a distribution of their benefits. The only remaining employees who have a right to take a portion of their benefits in the form of a single sum optional form of benefit on termination of employment are highly compensated employees. Because the availability of the single sum optional form of benefit satisfied the current availability requirements of this paragraph (b) on December 31, 1993 (i.e., immediately prior to the later of the date on which the amendment was adopted or effective), the optional form of benefit is deemed to continue to satisfy the current availability requirement of this paragraph (b) for subsequent plan years without further testing.

(c) Effective availability--(1) In general. Based on all the facts and circumstances, the group of employees to whom the benefit, right, or feature is effectively available must not substantially favor highly compensated employees. This requirement must be met even if the



benefit, right, or feature is, or has been, currently available to a group of employees that satisfies the current availability requirement of paragraph (b) of this section.

(2) Examples. The following examples illustrate the provisions of this paragraph (c).

Example 1. Employer X maintains Plan A, a defined benefit plan that covers both of its highly compensated nonexcludable employees and 9 of its 12 nonhighly compensated nonexcludable employees. Plan A provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Both highly compensated

employees of Employer X currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but 2 of the 9 nonhighly compensated employees of Employer X who are covered by Plan A were hired on or after age 35 and, thus, cannot qualify for the early retirement benefit. Even though the group of employees to whom the early retirement benefit is currently available satisfies the ratio percentage test of §1.410(b)-2(b)(2) when age and service are disregarded pursuant to paragraph (b)(2)(ii)(A) of this section, under these facts, the group of employees to whom the early retirement benefit is effectively available substantially favors highly compensated employees.

Example 2. Employer Y maintains Plan B, a defined benefit plan that provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65. By a plan amendment first adopted and effective December 1, 1993, Employer Y amends Plan B to provide an early retirement benefit that is available only to employees who terminate employment by December 15, 1993, and who are at least age 55 with 30 or more years of service. Assume that all employees were hired prior to attaining age 25, and that the group of employees who have, or will have attained age 55 with 30 years of service by December 15, 1993, satisfies the ratio percentage test of §1.410(b)-2(b)(2). Assume, further, that the employer takes no steps to inform all eligible employees of the early retirement option on a timely basis, and that the only employees who terminate from employment with the employer during the 2-week period in which the early retirement benefit is available are highly compensated employees. Under these facts, the group of employees to whom this early retirement window benefit is effectively available substantially favors highly compensated employees.

Example 3. Employer Z amends Plan C on June 30, 1992, to provide for a single sum optional form of benefit for employees who terminate from employment with Employer Z after June 30, 1992, and before January 1, 1993. The availability of this single sum optional form of benefit is conditioned on the employee's having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1992, is a highly compensated employee. Under paragraph (b)(2)(iii) of this section, the disability condition is disregarded in determining the current availability of the single sum



optional form of benefit. Nevertheless, under these facts, the group of employees to whom the single sum optional form of benefit is effectively available substantially favors highly compensated employees.

(d) Special rules--(1) Mergers and acquisitions--(i) Special testing rule. In the case of a transaction described in paragraph (d)(1)(ii)(A) of this section, an optional form of benefit or other right or feature available under a plan of an employer is treated as satisfying the requirements of this section for the plan year of the transaction and all subsequent plan years if all the following requirements are satisfied--

(A) The optional form of benefit or other right or feature satisfied the requirements of paragraphs (b) and (c) of this section immediately before the transaction (without taking into account section 410(b)(6)(C)). This determination is made with reference to the plan of the prior employer and its nonexcludable employees.

(B) The optional form of benefit or other right or feature satisfies the requirements of paragraphs (b) and (c) of this section immediately after the transaction (without taking into account section 410(b)(6)(C) or this paragraph (d)(1)). This determination is made with reference to the plan of the current employer and its nonexcludable employees.

(C) The optional form of benefit or other right or feature is available under the plan of the current employer after the transaction on the same terms as it was available under the plan of the prior employer before the transaction. Thus, for example, the optional form of benefit or other right or feature must continue to be available to the acquired employees to whom the optional form of benefit or other right or feature was available before the transaction, and may not be made available to any additional employees after the transaction



to whom the optional form of benefit or other right or feature was not available before the transaction.

(ii) Scope of special testing rule. This paragraph (d)(1) applies only--

(A) In the case of a transaction between the current employer and the prior employer that is a stock or asset acquisition, a merger, or other similar transaction involving a change in the employer of the employees of a trade or business.

(B) For the period that the requirements in paragraph (d)(1)(i) of this section are satisfied.

(C) To optional forms of benefit and other rights and features, but not to ancillary benefits.

(D) To optional forms of benefit and other rights and features with respect to benefits accrued under the plan of the current employer, and not to optional forms of benefit and other rights and features with respect to benefits accrued under the plan of the prior employer (unless, pursuant to the transaction, the plan of the prior employer becomes the plan of the current employer, or the assets and liabilities with respect to the acquired employees under the plan of the prior employer are transferred to the plan of the current employer in a plan merger, consolidation, or other transfer described in section 414(*l*)).

(iii) Option to extend availability to new employees. Notwithstanding paragraph (d)(1)(i)(C) of this section, the optional form of benefit or other right or feature may be extended to additional employees who are either hired by or transferred into the acquired



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trade or business during the transition period defined in section 410(b)(6)(C)(ii). The option in this paragraph (d)(1)(iii) applies only if the optional form of benefit or other right or

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feature satisfies the requirements of paragraphs (b) and (c) of this section immediately after the transition period (without taking into account this paragraph (d)(1)), in addition to the requirements in paragraph (d)(1)(i) of this section.

(iv) Example. The following example illustrates this paragraph (d)(1).

Example. Employer X maintains Plan A, a defined benefit plan with a single sum optional form of benefit for all employees in the plan. Employer Y acquires Employer X and merges Plan A into Plan B, a defined benefit plan maintained by Employer Y that does not otherwise provide a single sum optional form of benefit. Employer Y continues to provide the single sum optional form of benefit under Plan B on the same terms as it was offered under Plan A to all employees who were acquired in the transaction with Employer X (and to no other employees). The single sum optional form of benefit satisfied paragraphs (b) and (c) of this section immediately prior to the transaction (without regard to section 410(b)(6)(C)), when tested with reference to Plan A and Employer X's nonexcludable employees. The optional form of benefit satisfies paragraphs (b) and (c) of this section immediately following the transaction (determined without taking into account section 410(b)(6)(C) or this paragraph (d)(1)), when tested with reference to Plan B and Employer Y's nonexcludable employees. Under these facts, Plan B is treated as satisfying the requirements of this section with respect to the single sum optional form of benefit for the plan year of the transaction and all subsequent plan years.

(2) Frozen participants. A plan must satisfy the nondiscriminatory availability requirement of this section, not only with respect to benefits, rights, and features provided to employees who are currently benefiting under the plan, but also separately with respect to benefits, rights, and features provided to nonexcludable employees with accrued benefits who are not currently benefiting under the plan ("frozen participants"). Thus, each benefit, right, and feature available to any frozen participant under the plan is separately subject to the requirements of this section. A plan satisfies this section with respect to a benefit, right, or feature available to any frozen participant under the plan only if one or more of the following requirements is satisfied--

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(i) The benefit, right, or feature would satisfy the requirements of paragraphs (b) and (c) of this section if the benefit, right, or feature were not available to any employee currently benefiting under the plan;

(ii) The benefit, right, or feature would satisfy the requirements of paragraphs (b) and (c) of this section if all frozen participants were treated as employees currently benefiting under the plan;

(iii) No change in the availability of the benefit, right, or feature has been made that is first effective in the current plan year with respect to a frozen participant; or

(iv) Any change in the availability of the benefit, right, or feature that is first effective in the current plan year with respect to a frozen participant is made in a nondiscriminatory manner. Thus, any expansion in the availability of the benefit, right, or feature to any highly compensated frozen participant must be applied on a consistent basis to all nonhighly compensated frozen participants. Similarly, any contraction in the availability of the benefit, right, or feature that affects any nonhighly compensated frozen participant must be applied on a consistent basis to all highly compensated frozen participants.

(3) Early retirement window benefits. An early retirement benefit that is only available to employees who terminate employment within a specified time period is an optional form of benefit that must separately satisfy the requirements of this section. See paragraph (e)(1) of this section for the definition of optional form of benefit. Nonetheless, if the early retirement benefit meets the definition of an early retirement window benefit in §1.401(a)(4)-3(f)(4)(iii), and if the early retirement window benefit is available for a specified period that begins in one plan year and ends in the immediately succeeding plan

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year, the early retirement window benefit is disregarded for purposes of applying this section to the plan for the second plan year. The preceding sentence applies solely in the case of employees to whom the early retirement window benefit was treated as currently available for purposes of applying this section to the plan for the first plan year, but who did not elect the window in that plan year.

(4) Permissive aggregation of certain benefits, rights, or features--(i) General rule. In general, each optional form of benefit, ancillary benefit, and other right or feature must separately satisfy the requirements of this section. However, an optional form of benefit, ancillary benefit, or other right or feature may be aggregated with another optional form of benefit, ancillary benefit, or other right or feature, respectively, and the two may be treated as a single optional form of benefit, ancillary benefit, or other right or feature, if both of the following requirements are satisfied--

(A) One of the two optional forms of benefit, ancillary benefits, or other rights or features is in all cases of inherently equal or greater value than the other. For this purpose, one benefit, right, or feature is of inherently equal or greater value than another benefit, right, or feature only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount under the first benefit, right, or feature than under the second benefit, right, or feature.

(B) The optional form of benefit, ancillary benefit, or other right or feature of inherently equal or greater value separately satisfies the requirements of this section (without regard to this paragraph (d)(4)).

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(ii) Aggregation may be applied more than once. The aggregation rule in this paragraph (d)(4) may be applied more than once. Thus, for example, an optional form of benefit may be aggregated with another optional form of benefit that itself constitutes two separate optional forms of benefit that are aggregated and treated as a single optional form of benefit under this paragraph (d)(4).

(iii) Examples. The following examples illustrate the permissive aggregation rule in this paragraph (d)(4).

Example 1. Plan A is a defined benefit plan that provides a single sum optional form of benefit to all employees in the plan. The single sum optional form of benefit is available on the same terms to all employees in the plan, except that for employees in Division A, a 5-percent discount factor is applied, and for employees of Division B, a 7-percent discount factor is applied. Under paragraph (e)(1) of this section, the single sum optional form of benefit constitutes two separate optional forms of benefit. Assume that the single sum optional form of benefit available to employees of Division A separately satisfies the requirements of this section without taking into account this paragraph (d)(4). Because a lower discount factor is applied in determining the single sum optional form of benefit available to employees of Division A than is applied in determining the single sum optional form of benefit available to employees of Division B, the first single sum optional form of benefit is inherently more valuable than the second single sum optional form of benefit. Under these facts, these two single sum optional forms of benefit may be aggregated and treated as a single optional form of benefit for purposes of this section.

Example 2. The facts are the same as in Example 1, except that in order to receive the single sum optional form of benefit, employees of Division A (but not employees of Division B) must have completed at least 20 years of service. The single sum optional form of benefit available to employees of Division A is not of inherently equal or greater value than the single sum optional form of benefit available to employees of Division B, because an employee of Division A who terminates employment with less than 20 years of service would receive a smaller amount (i.e., zero) than a similarly situated employee of Division B who terminates employment with less than 20 years of service. Under these facts, the two single sum optional forms of benefit may not be aggregated and treated as a single optional form of benefit for purposes of this section.

(5) Certain spousal benefits. In the case of a plan that includes two or more plans that have been permissively aggregated under §1.410(b)-7(d), the aggregated plan satisfies

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the requirements of this section with respect to the availability of any nonsubsidized qualified joint and survivor annuities, qualified preretirement survivor annuities, or spousal death benefits described in section 401(a)(11), if each plan that is part of the aggregated plan satisfies section 401(a)(11). If any subsidized qualified joint and survivor annuities, qualified preretirement survivor annuities, or spousal death benefits described in section 401(a)(11) are provided, the availability of these subsidized benefits under the aggregated plan must satisfy either the requirements of this section or the special rule of §1.401(a)(4)-9(b)(3)(i) (regarding non-core benefits, rights, and features under a DB/DC plan), whichever is applicable. Whether a benefit is considered subsidized for this purpose may be determined using the interest rate, mortality, and other actuarial assumptions specified in the plan, provided those assumptions are reasonable. Whether those assumptions are reasonable is determined taking into account any other assumptions used under the plan. In addition, for purposes of this paragraph (d)(5), a qualified joint and survivor annuity, qualified preretirement survivor annuity, or spousal death benefit is deemed to be nonsubsidized if it is provided under a defined contribution plan.

(e) Definitions--(1) Optional form of benefit--(i) General rule. For purposes of this section, the term "optional form of benefit" means a distribution alternative (including the normal form of benefit) that is available under a plan with respect to benefits described in section 411(d)(6)(A) or early retirement benefits and retirement-type subsidies described in section 411(d)(6)(B)(i), including QSUPPs. Except as provided in paragraph (e)(1)(ii) of this section, different optional forms of benefit exist if the distribution alternative is not payable on substantially the same terms. The relevant terms include all terms affecting the value of

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the optional form, such as the method of benefit calculation and the actuarial assumptions used to determine the amount distributed. Different optional forms of benefit may result from differences in payment schedule, timing, commencement, medium of distribution (e.g., in cash or in kind), election rights, or the portion of the benefit to which the distribution



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alternative applies.

(ii) Exceptions--(A) Differences in benefit formula or accrual method. An optional form of benefit available under a defined benefit plan does not fail to be a single optional form of benefit merely because the benefit formula or accrual method (or both) underlying the optional form of benefit are different for different employees to whom the optional form of benefit is available. Notwithstanding the foregoing, differences in the normal retirement ages of employees or in the form in which the accrued benefit of employees is payable at normal retirement age under a plan are taken into account in determining whether an optional form of benefit constitutes one or more optional forms of benefit.

(B) Differences in allocation formula. An optional form of benefit available under a defined contribution plan does not fail to be a single optional form of benefit merely because the method of determining allocations (including allocations of earnings, expenses, gains, and losses described in §1.401(a)(4)-2(c)(2)(iii)) to account balances are different for different employees to whom the optional form of benefit is available.

(C) Distributions subject to section 417(e). An optional form of benefit available under a defined benefit plan does not fail to be a single optional form of benefit merely because, in determining the amount of a distribution, the plan applies a lower interest rate to



determine the distribution for employees with a vested accrued benefit having an actuarial present value not in excess of $25,000, as required by section 417(e) and §1.417(e)-1.

(iii) Examples. The following examples illustrate the definition of optional form of benefit in this paragraph (e)(1).

Example 1. Plan A is a defined benefit plan that benefits all employees of Divisions M and N. The plan offers a qualified joint and 50-percent survivor annuity at normal retirement age, calculated by multiplying an employee's single life annuity payment by a factor. For an employee of Division M whose benefit commences at age 65, the plan provides a factor of 0.90, but for a similarly situated employee of Division N the plan provides a factor of 0.85. The qualified joint and survivor annuity is not available to employees of Division M and N on substantially the same terms.

Example 2. Plan B is a defined benefit plan that benefits all employees of Divisions R and S. The plan offers a single sum optional form of benefit which, for employees of Division R, is determined using a fixed interest rate assumption and, for employees of Division S, is determined using a different fixed interest rate assumption. The single sum optional form of benefit is not available to employees of Divisions R and S on substantially the same terms.

Example 3. Plan C is a defined benefit plan that benefits all employees of Divisions T and U. The plan offers a single sum optional form of benefit, available on the same terms and determined using the same actuarial assumptions, to all employees. However, different benefit formulas are provided to each division. Despite that fact, under the exception provided in paragraph (e)(1)(ii)(A) of this section, the single sum optional form of benefit available to employees of Division T is not a separate optional form of benefit from the single sum optional form available to employees of Division U.

(2) Ancillary benefit. For purposes of this section, the term "ancillary benefit" includes social security supplements (other than QSUPPs), disability benefits not in excess of a qualified disability benefit described in section 411(a)(9), ancillary life insurance and health insurance benefits, death benefits under a defined contribution plan, preretirement death benefits under a defined benefit plan, shut-down benefits not protected under section 411(d)(6), and other similar benefits. Different ancillary benefits exist with respect to each benefit that is not available on substantially the same terms.



(3) Other right or feature. For purposes of this section, the term "other right or feature" means any right or feature applicable to employees under the plan, other than a right or feature taken into account under paragraph (e)(1) or (e)(2) of this section as part of an optional form of benefit or an ancillary benefit under the plan, and other than a right or feature that cannot reasonably be expected to be of more than insignificant value to an employee (e.g., administrative details). Different rights or features exist if the right or feature is not available on substantially the same terms. Other rights and features include, but are not limited to, the following--

(i) Plan loan provisions (other than those relating to a distribution of an employee's accrued benefit upon default under a loan);

(ii) The right to direct investments;

(iii) The right to a particular form of investment;

(iv) The right to a particular class or type of employer securities (taking into account any difference in conversion, dividend, voting, liquidation preference, or other rights conferred under the security);

(v) The right to make each rate of elective contributions described in §1.401(k)-1(g)(3) (taking into account the definition of compensation under the plan out of which elective contributions are made);



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(vi) The right to make after-tax employee contributions to a defined benefit plan that are not allocated to separate accounts;

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(vii) The right to make each rate of employee contributions described in §1.401(m)-1(f)(6) (taking into account the definition of compensation under the plan out of which employee contributions are made);

(viii) The right to an allocation of each rate of matching contributions described in §1.401(m)-1(f)(12) and the formulas and requirements for matching contributions (taking into account, if applicable, the definition of compensation under the plan by reference to which matching contributions are made, and any corrective distributions of excess deferrals, excess contributions, or excess aggregate contributions);

(ix) The right to purchase additional retirement or ancillary benefits under the plan; and

(x) The right to make rollover contributions and transfers to and from the plan.

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§1.401(a)(4)-5 Plan amendments and plan terminations.

(a) Plan amendments--(1) General rule. A plan does not satisfy section 401(a)(4) if a plan amendment or series of plan amendments discriminates significantly in favor of highly compensated employees. For this purpose, a plan amendment includes the establishment or termination of a plan and any change in the benefits, rights, or features under a plan.

(2) Facts-and-circumstances determination. Whether a plan amendment or series of plan amendments discriminates significantly in favor of highly compensated employees is determined based on all relevant facts and circumstances. These include, for example, the relative numbers of highly and nonhighly compensated employees affected by the plan amendment, the relative accrued benefits of highly and nonhighly compensated employees before and after the plan amendment, any additional benefits provided to highly and nonhighly compensated employees under other plans, the relative length of service of highly and nonhighly compensated employees, the length of time the plan and the benefit, right, or feature being amended have been in effect, and the turnover of employees prior to the plan amendment. In the case of a plan amendment that grants past service credits, the relevant facts and circumstances also include the benefits former employees would have received had the plan, as amended, been in effect throughout the period for which past service credits are granted. For this purpose, past service credits include benefits attributable to an employee's service prior to the time a new plan is in effect, increases in existing benefits resulting from an employee's service prior to the effective date of a plan amendment, and benefits attributable to an employee's service with another employer.

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(3) Time at which determination made. The requirements of this paragraph (a) are generally applied at the time a plan amendment first becomes effective for purposes of section 401(a). Thus, whether a plan amendment with a delayed effective date discriminates significantly in favor of highly compensated employees is generally determined when the amendment actually becomes effective, and not when it is adopted. In the case of an unpredictable contingent event benefit (within the meaning of section 412(*l*)(7)), the determination as to whether the amendment discriminates significantly in favor of highly compensated employees is generally made at the time the contingency occurs.

(4) Treatment of certain prospective plan amendments. A plan amendment increasing future benefits for highly compensated employees or reducing future benefits for nonhighly compensated employees does not necessarily discriminate significantly in favor of highly compensated employees. For example, an amendment instituting use of the disparity permitted under section 401(*l*) for the first time does not necessarily discriminate significantly in favor of highly compensated employees.

(5) Safe harbor for certain grants of past service. A plan amendment that credits past service is deemed not to discriminate significantly in favor of highly compensated employees if the period for which the credit is granted does not exceed the 5 years immediately preceding the year in which the amendment first becomes effective, the past service credit is granted on a reasonably uniform basis to current employees under the plan, the amount of the credit is determined by applying the current plan formula to the number of years being credited, and the period for which past service credit is granted represents actual service (or imputed service within the meaning of §1.401(a)(4)-11(d)) with the employer or a previous



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employer. However, this safe harbor is not available if a plan amendment granting past service credit for 5 years is part of a pattern of amendments that significantly discriminates in favor of highly compensated employees.

(6) Examples. The following examples illustrate the plan amendment rules in this paragraph (a).

Example 1. Plan A is a defined benefit plan that covered both highly and nonhighly compensated employees for most of its existence. The employer decides to wind up its business. In the process of ceasing operations, but at a time when the plan covers only highly compensated employees, Plan A is amended to increase benefits and thereafter is terminated. Plan A does not satisfy this paragraph (a).

Example 2. Plan B is a defined benefit plan that provides a social security supplement that is not a QSUPP. After substantially all of the highly compensated employees of the employer have benefited from the supplement, but before a substantial number of nonhighly compensated employees have become eligible for the supplement, Plan B is amended to significantly reduce the amount of the supplement. Plan B does not satisfy this paragraph (a).

Example 3. Plan C is a defined benefit plan that contains an ancillary life insurance benefit available to all employees. The plan is amended to eliminate this benefit at a time when life insurance payments have been made only to beneficiaries of highly compensated employees. Because all employees received the benefit of life insurance coverage before Plan C was amended, Plan C does not fail to satisfy this paragraph (a) merely as a result of the amendment.

Example 4. Plan D provides for a benefit of 1 percent of average annual compensation per year of service. Ten years after Plan D is adopted, it is amended to provide a benefit of 2 percent of average annual compensation per year of service, including years of service prior to the amendment. The amendment is effective only for employees currently employed at the time of the amendment. The ratio of highly compensated employees to highly compensated former employees is significantly higher than the ratio of nonhighly compensated employees to nonhighly compensated former employees. Plan D does not satisfy this paragraph (a).

Example 5. The facts are the same as in Example 4, except that the years of prior service are equivalent between highly and nonhighly compensated employees who are current employees, and the group of current employees with prior service would satisfy the nondiscriminatory classification test of §1.410(b)-4 in the current and all prior plan years for



which past service credit is granted. Plan D does not fail to satisfy this paragraph (a) merely as a result of the amendment.

Example 6. Employer V maintains Plan E, an accumulation plan. In 1993, Employer V amends Plan E to provide that the compensation used to determine an employee's benefit for all preceding plan years shall not be less than the employee's average annual compensation as of the close of the 1993 plan year. The years of service and percentage increases in compensation for highly compensated employees are reasonably comparable to those of nonhighly compensated employees. In addition, the ratio of highly compensated employees to highly compensated former employees is proportional to the ratio of nonhighly compensated employees to nonhighly compensated former employees. Plan E does not fail to satisfy this paragraph (a) merely as a result of the amendment.

Example 7. Employer W currently has six nonexcludable employees, two of whom, H1 and H2, are highly compensated employees, and the remaining four of whom, N1 through N4, are nonhighly compensated employees. The ratio of highly compensated employees to highly compensated former employees is significantly higher than the ratio of nonhighly compensated employees to nonhighly compensated former employees. Employer W establishes Plan F, a defined benefit plan providing a benefit of 1 percent of average annual compensation per year of service, including years of service prior to the establishment of the plan. H1 and H2 each have 15 years of prior service, N1 has 9 years of past service, N2 has 5 years, N3 has 3 years, and N4 has 1 year. Plan E does not satisfy this paragraph (a).

Example 8. Assume the same facts as in Example 7, except that N1 through N4 were hired in the current year, and Employer W never employed any nonhighly compensated employees prior to the current year. Thus, no nonhighly compensated employees would have received additional benefits had Plan F been in existence during the preceding 15 years. Plan F does not fail to satisfy this paragraph (a) merely as a result of the grant of past service.

Example 9. The facts are the same as in Example 7, except that the Plan F limits the grant of past service credit to 5 years, and the grant of past service otherwise satisfies the safe harbor in paragraph (a)(5) of this section. Plan F does not fail to satisfy this paragraph (a) merely as a result of the grant of past service.

Example 10. The facts are the same as in Example 9, except that 5 years after the establishment of Plan F, Employer W amends the plan to provide a benefit equal to 2 percent of average annual compensation per year of service, taking into account all years of service since the establishment of the plan. The ratio of highly compensated employees to highly compensated former employees who terminated employment during the 5-year period since the establishment of the plan is significantly higher than the ratio of nonhighly compensated employees to nonhighly compensated former employees who terminated employment during the 5-year period since the establishment of the plan. Although the amendment described in



this example might separately satisfy the safe harbor in paragraph (a)(5) of this section, the safe harbor is not available with respect to the amendment because, under these facts, the amendment is part of a pattern of amendments that significantly discriminates in favor of highly compensated employees.

Example 11. Employer Y established Plan G, a defined benefit plan, covering all its employees in 1971. No past service credit was granted to Employer Y's employees at the time Plan G was established. In 1990, Employer Y acquires Division B from Employer Z. Employees of Division B had been covered under a defined benefit plan maintained by Employer Z. Employer Y amends Plan G to cover all employees of Division B and grants past service credit to all employees of Division B for each year of service with Employer Z beginning with 1971. Employer Y further amends its plan to provide that benefits for employees of Division B under its plan will be offset by benefits paid under the plan maintained by Employer Z. Under these facts, Plan G does not fail to satisfy this paragraph (a) merely as a result of these amendments.

Example 12. Plan H is an insurance contract plan within the meaning of section 412(i). For all plan years before 1999, Plan H purchases insurance contracts from Insurance Company J. In 1999, Plan H shifts future purchases of insurance contracts to Insurance Company K. The shift in insurance companies is a plan amendment subject to the requirements of this paragraph (a).

(b) Pre-termination restrictions--(1) Required provisions in defined benefit plans. A defined benefit plan must incorporate provisions restricting benefits and distributions as

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described in paragraphs (b)(2) and (b)(3) of this section at the time the plan is established or, if later, the effective date of these regulations, unless the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of an early termination of the plan. For this purpose, the restrictions apply to a plan within the meaning of section 414(*l*). Any plan containing a provision described in this paragraph (b) satisfies section 411(d)(2) and does not fail to satisfy section 411(a) or (d)(3) merely because of the provision.

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(2) Restriction of benefits. A plan must provide that, in the event of plan termination, the benefit of any highly compensated employee (and any highly compensated former employee) is limited to a benefit that is nondiscriminatory under section 401(a)(4).

(3) Restrictions on distributions--(i) Limit on annual payments. A plan must provide that the annual payments to an employee described in paragraph (b)(3)(ii) of this section are restricted to an amount equal in each year to the payments that would be made on behalf of the employee under--

(A) A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the employee is entitled under the plan (other than a social security supplement), and

(B) The amount of the payments that the employee is entitled to receive under a social security supplement. The restrictions in this paragraph (b)(3) do not apply, however, if any one of the following requirements is satisfied--

(1) After payment to an employee described in paragraph (b)(3)(ii) of this section of all benefits payable to the employee under the plan, the value of plan assets equals or exceeds 110 percent of the value of current liabilities, as defined in section 412(*l*)(7),

(2) The value of the benefits payable to the employee under the plan for an employee described in paragraph (b)(3)(ii) of this section is less than 1 percent of the value of current liabilities before distribution, or

(3) The value of the benefits payable to the employee under the plan for an employee described in paragraph (b)(3)(ii) of this section does not exceed the amount described in section 411(a)(11)(A) (restrictions on certain mandatory distributions).

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(ii) Employees whose benefits are restricted. The employees whose benefits are restricted on distribution include all highly compensated employees and highly compensated former employees. In any one year, the total number of employees whose benefits are subject to restriction under this section can be limited by the plan to a group of not less than 25 highly compensated employees and highly compensated former employees. If the group of affected employees is so limited by the plan, the group must consist of those highly compensated employees and highly compensated former employees with the greatest compensation in the current or any prior year. Plan provisions defining or altering the group of employees whose benefits are restricted under this paragraph (b) may be amended at any time without violating section 411(d)(6).

(iii) "Benefit" defined. For purposes of this paragraph (b), the term "benefit" includes, among other benefits, loans in excess of the amounts set forth in section 72(p)(2)(A), any periodic income, any withdrawal values payable to a living employee, and any death benefits not provided for by insurance on the employee's life.

(iv) Determination of current liabilities. For purposes of this paragraph (b), an employer required to file Form 5500 (Annual Return/Report of Employee Benefit Plan (with more than 100 participants)) or Form 5500-C/R (Annual Return/Report of Employee Benefit Plan (with less than 100 participants)) may use the value of current liabilities as reported on Schedule B of the employer's most recent, timely filed Form 5500 or Form 5500 C/R. Alternatively, an employer is permitted to determine current liabilities as of a later date. Employers that are not required to file Schedule B of the Form 5500 or Form 5500 C/R may

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apply rules similar to those applicable to employers who do file Schedule B to determine the value of current liabilities.

(v) Determination date for assets and liabilities. For purposes of this paragraph (b), the value of plan assets and the value of current liabilities must be determined as of the same date.

(4) Operational restrictions on certain money purchase pension plans. A money purchase pension plan that has an accumulated funding deficiency, within the meaning of



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section 412(a), must comply in operation with the restrictions on benefits and distributions as described in paragraphs (b)(2) and (b)(3) of this section. Restrictions imposed by the requirements of this paragraph (b)(4) are treated as not violating section 411(d)(6).

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§1.401(a)(4)-6 Contributory defined benefit plans.

(a) Overview--(1) Contributions not allocated to separate accounts. This section contains rules necessary for determining whether a contributory DB plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2). A contributory DB plan must satisfy that requirement separately with respect to benefits derived from employer contributions (employer-provided benefits) and benefits derived from employee contributions not allocated to separate accounts (employee-provided benefits). See §1.401(a)(4)-1(c)(4). The general rules for determining whether a defined benefit plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) with respect to the amount of employer-provided benefits are set forth in §§1.401(a)(4)-3 and 1.401(a)(4)-8(c) and (d). Paragraph (b) of this section provides rules for determining the amount of employer-provided benefits under a contributory DB plan for purposes of section 401(a)(4). Paragraph (c) of this section provides the exclusive rules for determining whether a contributory DB plan satisfies §1.401(a)(4)-1(b)(2) with respect to the amount of employee-provided benefits.

(2) Contributions allocated to separate accounts. The portion of a plan that consists of employee contributions allocated to separate accounts is treated as a separate plan under the mandatory disaggregation rules of §1.410(b)-7(c)(1). See §1.401(a)(4)-2(d)(2) for the exclusive rules for determining whether a plan consisting of contributions of this type satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2).

(b) Determination of employer-provided benefit--(1) General rule. An employee's employer-provided benefit under a contributory DB plan as of a plan year for purposes of section 401(a)(4) equals the difference between the employee's total benefit under the plan as

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of the plan year and the employee's employee-provided benefit under the plan as of the plan year. The rules of section 411(c) generally must be used to determine an employee's employer-provided benefit for this purpose. However, paragraphs (b)(2) through (b)(6) of this section provide alternative methods for determining an employee's employer-provided benefit. If one of these alternatives is applied with respect to an employee in the plan for a plan year, it must be applied to all employees in the plan for the plan year. Contributory DB plans that satisfy paragraph (b)(2) or (b)(3) of this section may be eligible to use the safe harbor described in §1.401(a)(4)-3(b)(3) (safe harbor for unit credit plans). Contributory DB plans that satisfy paragraph (b)(4), (b)(5) or (b)(6) of this section may be eligible to use any of the safe harbors in §1.401(a)(4)-3(b)(3) through (b)(7) (the safe harbors for unit credit plans, unit credit plans using fractional accrual rule, and flat benefit plans, the alternative safe harbor for flat benefit plans, and the safe harbor for insurance contract plans, respectively). See §1.401(a)(4)-3(b)(8)(ix).

(2) Composition-of-workforce method--(i) In general. A contributory DB plan that satisfies paragraphs (b)(2)(ii)(A) and (B) of this section may apply the requirements of §1.401(a)(4)-3 to the plan by substituting employees' employer-provided benefit rates determined under paragraph (b)(2)(iii) of this section for the accrual rates otherwise applicable under that section.

(ii) Eligibility requirements--(A) Uniform rate of employee contributions. A contributory DB plan satisfies this paragraph (b)(2)(ii)(A) if it requires all employees in the plan to make employee contributions at the same rate (expressed as a percentage of plan year compensation). A plan does not fail to satisfy this paragraph (b)(2)(ii)(A) merely because it

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eliminates the requirement of employee contributions for all employees with plan year compensation below a stated dollar amount. Alternatively, a plan does not fail to satisfy this paragraph (b)(2)(ii)(A) merely because it requires all employees in the plan to make employee contributions at the same rate (expressed as a percentage of plan year compensation) with respect to plan year compensation up to a stated dollar amount, and at a higher rate (expressed as a percentage of plan year compensation) that is the same for all employees in the plan with respect to plan year compensation at or above the stated dollar amount.

(B) Demographic requirements--(1) In general. A contributory DB plan satisfies this

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paragraph (b)(2)(ii)(B) if it satisfies one of the demographic tests in paragraph (b)(2)(ii)(B)(2) or (3) of this section.

(2) Minimum percentage test. This test is satisfied only if more than 40 percent of the nonhighly compensated employees in the plan have attained ages at least equal to the plan's target age, and more than 20 percent (rounded up to the next whole number) of the nonhighly compensated employees in the plan have attained ages at least equal to the average attained age of the highly compensated employees in the plan. For this purpose, a plan's target age is the lesser of age 50, or the average attained age of the highly compensated employees in the plan minus X years, where X equals 20 minus the number that is equal to 5 times the employee contribution rate under the plan (expressed as a percentage of plan year compensation). In no case, however, may X years be fewer than zero (0) years. Thus, for example, if the average attained age of the highly compensated employees in the plan is 53



and the employee contribution rate is 2 percent of plan year compensation, the plan's target age is 43 years (i.e., 53 minus (20 minus (5 times 2))).

(3) Ratio test. This test is satisfied only if the percentage of all nonhighly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the highly compensated employees in the plan, is at least 70 percent of the percentage of all highly compensated nonexcludable employees, who are in the plan and who have attained ages at least equal to the average attained age of the highly compensated employees in the plan. Attained ages must be determined as of the beginning of the plan year. In lieu of determining the actual distribution of the attained ages of the highly compensated employees, an employer may assume that 50 percent of all highly compensated employees in the plan have attained ages at least equal to the average attained age of the highly compensated employees in the plan.

(iii) Determination of employer-provided benefit--(A) Application of factors to determine employee-provided benefit rate. The rate at which employee-provided benefits are provided under a contributory DB plan (the employee-provided benefit rate) may be determined for purposes of this paragraph (b)(2) by multiplying the rate at which employee contributions (expressed as a percentage of plan year compensation) are required to be made under the plan by the factor determined under paragraph (b)(2)(iv) of this section. In the case of a contributory DB plan described in the second or third sentences of paragraph (b)(2)(ii)(A) of this section (e.g., a plan requiring different rates of employee contributions at different levels of plan year compensation), the employee-provided benefit rate is determined



for all employees in the plan using the highest required rate of employee contributions applicable to any level of plan year compensation for that plan year.

(B) Employer-provided benefits under a unit credit safe harbor plan. For purposes of applying the safe harbor in §1.401(a)(4)-3(b)(3) with respect to employer-provided benefits under a section 401(*l*) plan, an employee's gross benefit percentage, or an employee's excess benefit percentage and base benefit percentage, are reduced by subtracting the employee-provided benefit rate determined under paragraph (b)(2)(iii)(A) of this section from the respective percentages for the plan year. For purposes of applying the safe harbor in §1.401(a)(4)-3(b)(3) with respect to employer-provided benefits under a plan other than a section 401(*l*) plan, the employee's entire accrued benefit is treated as employer-provided.

(C) Employer-provided benefits under the general test. For purposes of applying the general test of §1.401(a)(4)-3(c) with respect to employer-provided benefits, an employee's normal and most valuable accrual rates otherwise determined under §1.401(a)(4)-3(d) are reduced by subtracting the employee-provided benefit rate determined under paragraph (b)(2)(iii)(A) of this section from the respective accrual rates. This adjustment is made before applying the optional rules in §1.401(a)(4)-3(d)(6)(ii), (iv), (v), and (vi) (regarding imputation of permitted disparity, grouping of accrual rates, floor on most valuable accrual rates, and adjustment for certain disability benefits, respectively). If employee contributions were not required, or were required at a different rate (or rates), in prior plan years than in the current plan year, a plan may not use the accrued-to-date or projected method in §1.401(a)(4)-3(d)(3) and (4). The plan may, however, use one of the fresh-start alternatives to these methods in §1.401(a)(4)-3(d)(6)(vii) or (viii), provided that the plan uses a fresh-start



date that is no earlier than the last day of the last plan year in which employee contributions were not required at the rate (or rates) applicable for the current plan year.

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(iv) Determination of plan factor. The factor for a plan is determined under the following table based on the average entry age of the employees in the plan and on whether or not the plan determines benefits based on average compensation. For this purpose, average entry age equals the average attained age of all employees in the plan, minus the average years of participation of all employees in the plan. A plan is treated as determining benefits based on average compensation if it determines benefits based on compensation averaged over a specified period not exceeding 5 consecutive years (or the employee's entire period of employment with the employer, if shorter).

TABLE OF FACTORS

| Average Entry Age | Factor | |
|---|---|---|
| | Average Compensation Benefit Formula | Other Formulas |
| Less than 30 | 0.5 | 0.75 |
| 30 to 40 | 0.4 | 0.6 |
| Over 40 | 0.2 | 0.3 |

(v) Examples. The following examples illustrate the rules of this paragraph (b)(2).

Example 1. Plan A is a contributory DB plan that is a defined benefit excess plan providing a benefit equal to 2.0 percent of the employee's average annual compensation at or below covered compensation, plus 2.5 percent of average annual compensation above covered compensation, times years of service up to 35. Under the plan, average annual compensation is determined using a 5-consecutive-year period for purposes of §1.401(a)(4)-3(e)(2). The plan requires employee contributions at a rate of 4 percent of plan year compensation for all employees. Assume that the plan satisfies the demographic requirements of paragraph (b)(2)(ii)(B) of this section. Under these facts, the plan satisfies



the eligibility requirements of paragraph (b)(2)(ii) of this section. Assume, further, that the average attained age for all employees in the plan is 55, and that the average years of participation of all employees in the plan is 10. The average entry age for the plan is therefore 45, and, accordingly, the appropriate factor under the table is 0.2. Thus, for a plan year, an employee's employee-provided benefit rate is 0.8 percent (4 percent x 0.2). In applying the safe harbor requirements of §1.401(a)(4)-3(b)(3) to this plan (including the requirements of §1.401(*l*)-3), the employee's base benefit percentage is 1.2 percent, and the employee's excess benefit percentage is 1.7.

Example 2. The facts are the same as in Example 1, except that the employee contribution rate is 2 percent of plan year compensation for the first $20,000, and 4 percent for plan year compensation at or above that amount. In determining the employee-provided benefit rate under the plan using the table in paragraph (b)(2)(iv) of this section, all employees are assumed to make employee contributions at the 4 percent rate. Thus, for a plan year, an employee's employee-provided benefit rate is 0.8 percent (4 percent x 0.2). In applying the safe harbor requirements of §1.401(a)(4)-3(b)(3) to this plan (including the requirements of §1.401(*l*)-3), the employee's base benefit percentage is 1.2 percent, and the employee's excess benefit percentage is 1.7.

Example 3. The facts are the same as in Example 1, except that the plan is tested using the general test in §1.401(a)(4)-3(c). Assume Employee X participates in Plan A and has a normal accrual rate for the plan year (calculated with respect to Employee X's total accrued benefit) of 2.2 percent of testing compensation before applying any of the optional rules in §1.401(a)(4)-3(d)(6)(ii), (iv), (v), and (vi). In applying the general test in §1.401(a)(4)-3(c) with respect to employer-provided benefits, this rate is reduced by 0.8 to yield a normal accrual rate of 1.4 percent. This rate may then be adjusted using any of the optional rules in §1.401(a)(4)-3(d)(6)(ii), (iv), (v), and (vi).

(3) Minimum benefit method--(i) Application of uniform factors. A contributory DB plan that satisfies the uniform rate requirement of paragraph (b)(2)(ii)(A) of this section and the minimum benefit requirement of paragraph (b)(3)(ii) of this section may apply the adjustments provided in paragraph (b)(2)(iii) of this section as if the average entry age of employees in the plan were between 30 and 40. Thus, if this minimum benefit requirement is satisfied, a plan need not satisfy the demographic requirements of paragraph (b)(2)(ii)(B) of this section or actually determine the average entry age of the employees in the plan.



(ii) Minimum benefit requirement. This requirement is satisfied if the plan provides that, in plan years beginning after December 31, 1991, each employee will accrue a benefit that equals or exceeds the sum of--

(A) The accrued benefit derived from employee contributions made for plan years beginning after December 31, 1991, determined in accordance with section 411(c), and

(B) Fifty percent of the total benefit accrued in plan years beginning after December 31, 1991, as determined under the plan benefit formula without regard to that portion of the formula designed to satisfy the minimum benefit requirement of this paragraph (b)(3)(ii).

(iii) Example. The following example illustrates the minimum benefit method of this paragraph (b)(3).

Example. Plan A is contributory DB plan. For the plan year beginning in 1992, Employee X participates in Plan A and accrues a benefit under the terms of the plan (without regard to the minimum benefit requirement of paragraph (b)(3)(ii) of this section) of $3,000. The portion of Employee X's benefit accrual for the plan year beginning in 1992 derived from employee contributions is $2,000, determined by applying the rules of section 411(c) to such contributions. The requirement of paragraph (b)(3)(ii) of this section is not satisfied for the plan year beginning in 1992 unless the plan provides that Employee A's benefit accrual for the plan year beginning in 1992 is equal to $3,500 ($2,000 plus 50 percent of $3,000).

(4) Grandfather rule for plans in existence on May 14, 1990. A contributory DB plan



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that satisfies the requirements of paragraph (c)(4) of this section may determine an employee's employer-provided benefit by subtracting from the employee's total benefit the employee-provided benefits determined using any reasonable method set forth in the plan, provided that it is the same method used in determining whether the plan satisfies paragraph (c)(4)(iv) of this section.

(5) Government plan method. A contributory DB plan that is established and maintained for its employees by the government of any state or political subdivision or by



any agency or instrumentality thereof may treat an employee's total benefit as entirely employer-provided.

(6) Cessation of employee contributions method. If a contributory DB plan provides that no employee contributions may be made to the plan for plan years beginning after December 31, 1991, the plan may treat an employee's total benefit as entirely employer-provided.

(c) Rules applicable in determining whether employee-provided benefits are nondiscriminatory in amount--(1) In general. A contributory DB plan satisfies §1.401(a)(4)-1(b)(2) with respect to the amount of employee-provided benefits for a plan year only if the plan satisfies the requirements of paragraph (c)(2), (c)(3), or (c)(4) of this section for the plan year. This requirement applies regardless of the method used to determine the amount of employer-provided benefits under paragraph (b) of this section.

(2) Same rate of contributions. This requirement is satisfied for a plan year if the plan requires all employees in the plan to make employee contributions at the same rate (expressed as a percentage of plan year compensation) for the plan year.

(3) Total benefits method. This requirement is satisfied for a plan year if--

(i) The total benefits (i.e., the sum of employer-provided and employee-provided benefits) under the plan would satisfy §1.401(a)(4)-3 if all benefits were treated as employer-provided benefits, and

(ii) The plan either--

(A) Requires all employees in the plan with plan year compensation at or above a stated dollar amount to make employee contributions at the same rate (expressed as a



percentage of plan year compensation), and does not require employees with plan year compensation below that amount to make employee contributions, or

(B) Requires all employees in the plan to make employee contributions at the same rate (expressed as a percentage of plan year compensation) with respect to plan year compensation up to a stated dollar amount, and at a higher rate (expressed as a percentage of plan year compensation) that is the same for all employees in the plan with respect to plan year compensation at or above that amount.

(4) Grandfather rule for plans in existence on May 14, 1990. This requirement is satisfied for a plan year if all the following requirements are met--

(i) On May 14, 1990, the plan required employee contributions at a greater rate (expressed as a percentage of compensation) at higher levels of compensation than at lower levels of compensation;

(ii) The required rate of employee contributions is not increased after May 14, 1990, although the level of compensation at which employee contributions are required may be increased or decreased;

(iii) For plan years beginning after December 31, 1991, all employees in the plan are permitted to make employee contributions under the plan at a uniform rate with respect to all compensation; and

(iv) 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.



§1.401(a)(4)-7 Imputation of permitted disparity.

(a) Introduction--(1) In general. In determining whether a plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits, section 401(a)(5)(C) allows the disparities permitted under section 401(*l*) to be taken into account. For purposes of satisfying the safe harbors of §§1.401(a)(4)-2(b)(3) and 1.401(a)(4)-3(b), permitted disparity may be taken into account only by satisfying section 401(*l*) in form in accordance with §1.401(*l*)-2 or 1.401(*l*)-3, respectively. Alternatively, for purposes of the general tests of



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§§1.401(a)(4)-2(c) and 1.401(a)(4)-3(c), permitted disparity may be taken into account only in accordance with the rules of this section. In general, this section allows permitted disparity to be arithmetically imputed with respect to employer-provided contributions or benefits by determining an adjusted allocation or accrual rate that appropriately accounts for the permitted disparity with respect to each employee. This section contains the exclusive rules for imputing permitted disparity. See §§1.401(a)(4)-8(b)(2)(i)(D) and (c)(2)(i)(E) and 1.401(a)(4)-9(b)(2)(iv) for special rules applying the rules of this section with respect to equivalent allocation rates and equivalent accrual rates.

(2) Overview. Paragraph (b) of this section provides rules for imputing permitted disparity with respect to employer-provided contributions by adjusting each employee's unadjusted allocation rate. Paragraph (c) of this section provides rules for imputing permitted disparity with respect to employer-provided benefits by adjusting each employee's unadjusted accrual rate. Paragraph (d) of this section contains rules of general application.

(b) Adjusting allocation rates--(1) In general. This paragraph (b) provides rules for adjusting unadjusted allocation rates to take into account permitted disparity. These rules



produce an adjusted allocation rate for each employee by determining the excess contribution percentage under the 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. This adjusted allocation rate is used to determine whether the amount of contributions under the plan satisfies the general test of §1.401(a)(4)-2(c) and to apply the average benefit percentage test on the basis of contributions under §1.410(b)-5(d)(5) or (e)(2). Paragraph (b)(2) of this section applies to employees whose plan year compensation does not exceed the taxable wage base, and paragraph (b)(3) of this section applies to employees whose plan year compensation exceeds the taxable wage base. Paragraph (b)(4) of this section provides definitions, and paragraph (b)(5) of this section provides an example.

(2) Employees whose plan year compensation does not exceed taxable wage base. If an employee's plan year compensation does not exceed the taxable wage base, the employee's adjusted allocation rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity rate and the unadjusted allocation rate are determined under paragraphs (b)(4)(ii) and (iv) of this section, respectively.

A Rate = 2 x unadjusted allocation rate

B Rate = unadjusted allocation rate + permitted disparity rate

(3) Employees whose plan year compensation exceeds taxable wage base. If an employee's plan year compensation exceeds the taxable wage base, the employee's adjusted allocation rate is the lesser of the C rate and the D rate determined under the formulas



below, where allocations and the permitted disparity rate are determined under paragraphs (b)(4)(i) and (ii), respectively.

$$\text{C Rate} = \frac{\text{allocations}}{\text{plan year compensation - 1/2 taxable wage base}}$$

$$\text{D Rate} = \frac{\text{allocations + (permitted disparity rate x taxable wage base)}}{\text{plan year compensation}}$$

(4) Definitions. In applying this paragraph (b), the following definitions govern.

(i) Allocations. "Allocations" means the amount determined by multiplying the employee's plan year compensation by the employee's unadjusted allocation rate.

(ii) Permitted disparity rate--(A) In general. "Permitted disparity rate" means the rate in effect as of the beginning of the plan year under section 401(*l*)(2)(A)(ii) (e.g., 5.7 percent for plan years beginning in 1990).

(B) Cumulative permitted disparity limit. Notwithstanding paragraph (b)(4)(ii)(A) of this section, the permitted disparity rate is zero for an employee who has benefited under a defined benefit plan taken into account under §1.401(*l*)-5(a)(3) for any plan year beginning after December 31, 1991, if imputing permitted disparity would result in a cumulative disparity fraction for the employee, as defined in §1.401(*l*)-5(c)(2), that exceeds 35. An employee is not treated as benefiting under a defined benefit plan for a plan year beginning after December 31, 1991, if the employer can establish that for that plan year the defined benefit plan was not a section 401(*l*) plan and did not impute permitted disparity under this section. For purposes of this paragraph (b)(4)(ii)(B), a DB/DC plan (as described in §1.401(a)(4)-9(a)) and a target benefit plan (that satisfies §1.401(a)(4)-8(b)(3)) are treated as defined benefit plans, but a cash balance plan (that satisfies §1.401(a)(4)-8(c)(3)) is treated as

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a defined contribution plan. Thus, for example, if, for any plan year beginning after December 31, 1991, an employee benefits under a defined contribution plan that is included in a DB/DC plan that imputes permitted disparity under this section, the employee is treated as benefiting under a defined benefit plan.

(iii) Taxable wage base. "Taxable wage base" means the taxable wage base, as defined in §1.401(*l*)-1(c)(32), in effect at the beginning of the plan year.

(iv) Unadjusted allocation rate. "Unadjusted allocation rate" means the employee's allocation rate determined under §1.401(a)(4)-2(c)(2)(i) for the plan year (expressed as a percentage of plan year compensation), without imputing permitted disparity under this section.

(5) Example. (a) Employees M and N participate in a profit-sharing plan maintained by Employer X. Employee M has plan year compensation of $30,000 in the 1990 plan year and has an unadjusted allocation rate of 5 percent. Employee N has plan year compensation of $100,000 in the 1990 plan year and has an unadjusted allocation rate of 8 percent. The taxable wage base in 1990 is $51,300.

(b) Because Employee M's plan year compensation does not exceed the taxable wage base, Employee M's A rate is 10 percent (2 x 5 percent), and Employee M's B rate is 10.7 percent (5 percent + 5.7 percent). Thus, Employee M's adjusted allocation rate is 10 percent, the lesser of the A rate and the B rate.

(c) Employee N's allocations are $8,000 (8 percent x $100,000). Because Employee N's plan year compensation exceeds the taxable wage base, Employee N's C rate is 10.76 percent ($8,000 divided by ($100,000 - (1/2 x $51,300))), and Employee N's D rate is 10.92 percent (($8,000 + (5.7 percent x $51,300)) divided by $100,000). Thus, Employee N's adjusted allocation rate is 10.76 percent, the lesser of the C rate and the D rate.

(c) Adjusting accrual rates--(1) In general. This paragraph (c) provides rules for adjusting unadjusted accrual rates to take into account permitted disparity. These rules produce an adjusted accrual rate for each employee by determining the excess benefit percentage under the hypothetical plan formula that would yield the employer-provided



accrual actually received by the employee, if the plan took into account the full permitted disparity under section 401(*l*)(3)(A) in each of the first 35 years of an employee's testing service under the plan and used the employee's covered compensation as the integration level. This adjusted accrual rate is used to determine whether the amount of employer-provided benefits under the plan satisfies the alternative safe harbor for flat benefit plans under §1.401(a)(4)-3(b)(6) or the general test of §1.401(a)(4)-3(c), and to apply the average benefit percentage test on the basis of benefits under §1.410(b)-5(d)(6) or (e)(2). Paragraph (c)(2) of this section applies to employees whose testing compensation does not exceed covered compensation, and paragraph (c)(3) of this section applies to employees whose testing compensation exceeds covered compensation. Paragraph (c)(4) of this section provides definitions, and paragraph (c)(5) of this section provides an example.

(2) Employees whose testing compensation does not exceed covered compensation. If an employee's testing compensation does not exceed the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the A rate and the B rate determined under the formulas below, where the permitted disparity factor and the unadjusted accrual rate are determined under paragraph (c)(4)(iii) and (vi) of this section, respectively.

A Rate = 2 x unadjusted accrual rate

B Rate = unadjusted accrual rate + permitted disparity factor

(3) Employees whose testing compensation exceeds covered compensation. If an employee's testing compensation exceeds the employee's covered compensation, the employee's adjusted accrual rate is the lesser of the C rate and D rate determined under the



formulas below, where the employer-provided accrual and the permitted disparity factor are determined under paragraph (c)(4)(ii) and (iii) of this section respectively.

$$\text{C Rate} = \frac{\text{employer-provided accrual}}{\text{testing compensation - 1/2 covered compensation}}$$

$$\text{D Rate} = \frac{\text{employer-provided accrual}}{\text{testing compensation}} + \frac{\text{(permitted disparity factor x covered compensation)}}{\text{testing compensation}}$$

(4) Definitions. For purposes of this paragraph (c), the following definitions apply.

(i) Covered compensation. "Covered compensation" means covered compensation as defined in §1.401(*l*)-1(c)(7). Notwithstanding §1.401(*l*)-1(c)(7)(iii), an employee's covered compensation must be automatically adjusted each plan year for purposes of applying this paragraph (c).

(ii) Employer-provided accrual. "Employer-provided accrual" means the amount

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determined by multiplying the employee's testing compensation by the employee's unadjusted accrual rate.

(iii) Permitted disparity factor--(A) In general. "Permitted disparity factor" for an employee means the employee's annual permitted disparity factor determined under paragraph (c)(4)(iii)(B) of this section, adjusted as provided in paragraph (c)(4)(iii)(C), (D), or (E) of this section for the annual method, the accrued-to-date method, or the projected method, whichever is applicable. Paragraph (c)(4)(iii)(F) of this section contains rules for satisfying the overall permitted disparity limits under section 401(*l*). The permitted disparity factor must be determined under the same method for all employees in the plan, unless

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otherwise provided (see, e.g., the special rules for terminated employees and section 401(a)(17) employees in §1.401(a)(4)-3(d)(3)(iii), (d)(4)(iii), (d)(4)(iv), (d)(6)(viii)(D)).

(B) Annual permitted disparity factor. An employee's annual permitted disparity factor is 0.75 percent adjusted, pursuant to §1.401(*l*)-3(e), using as the age at which benefits commence the lesser of age 65 or the employee's testing age. For example, if the employee's testing age is 62, the annual permitted disparity factor is 0.6 percent for an employee whose social security retirement age is 65. Generally, if the employee's testing age is 65, the annual permitted disparity factor is 0.75 percent for an employee whose social security retirement age is 65, 0.70 percent for an employee whose social security retirement age is 66, and 0.65 percent for an employee whose social security retirement age is 67. For this purpose, a plan is permitted to treat all employees (of whatever age) as having a social security retirement age of 67. Thus, the plan may use an annual permitted disparity factor of 0.65 percent for all employees in the plan whose testing age is 65. No adjustments are made in the annual permitted disparity factor unless an employee's testing age is different from the employee's social security retirement age.

(C) Annual method. If unadjusted accrual rates are determined under the annual method of §1.401(a)(4)-3(d)(2), the permitted disparity factor for an employee is generally the annual disparity factor. In the case of an employee with more than 35 years of testing service, the permitted disparity factor for the current plan year is zero.

(D) Accrued-to-date method. If unadjusted accrual rates are determined under the accrued-to-date method of §1.401(a)(4)-3(d)(3), an employee's permitted disparity factor is determined as follows--

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(1) General rule. The permitted disparity factor is equal to the annual permitted disparity factor for the employee multiplied by the employee's testing service (not to exceed 35), and then divided by the employee's testing service.

(2) Fresh-start alternative. If a plan uses the fresh-start alternative for the accrued-to-date method under §1.401(a)(4)-3(d)(6)(vii), the permitted disparity factor is equal to the annual permitted disparity factor for the employee multiplied by the employee's testing service since the fresh-start date (not to exceed 35 minus the employee's testing service as of the fresh-start date), and then divided by the employee's testing service since the fresh-start date.

(E) Projected method. If unadjusted accrual rates are determined under the projected method of §1.401(a)(4)-3(d)(4), an employee's permitted disparity factor is determined as follows--

(1) General rule. The permitted disparity factor is equal to the annual permitted disparity factor for the employee multiplied by the employee's projected testing service (not to exceed 35), and then divided by the employee's projected testing service.

(2) Fresh-start alternative. If a plan uses the fresh-start alternative for the projected method under §1.401(a)(4)-3(d)(6)(viii), the permitted disparity factor is equal to the annual permitted disparity factor for the employee multiplied by the employee's projected testing service since the fresh-start date (not to exceed 35 minus the employee's testing service as of the fresh-start date), and then divided by the employee's projected testing service since the fresh-start date.

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(3) Projected testing service. For purposes of this paragraph (c)(4)(iv)(E), an employee's projected testing service is the testing service used in determining the employee's unadjusted accrual rate.

(F) Cumulative permitted disparity limit. The 35 years used in paragraph



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(c)(4)(iii)(C), (D)(1), and (E)(1) of this section must be reduced by the employee's cumulative disparity fraction, as defined in §1.401(*l*)-5(c)(2), determined solely with respect to the employee's total years of service under all other plans taken into account under §1.401(*l*)-5(a)(3). The 35 years used in paragraph (c)(4)(iii)(D)(2) and (E)(2) of this section must be reduced by the employee's cumulative disparity fraction, as defined in §1.401(*l*)-5(c)(2), determined solely with respect to the employee's total years of service under all other plans taken into account under §1.401(*l*)-5(a)(3) for plan years of those other plans ending after the fresh-start date.

(iv) Social security retirement age. "Social security retirement age" means social security retirement age as defined in section 415(b)(8).

(v) Testing compensation. "Testing compensation" means average annual compensation as defined in §1.401(a)(4)-3(e)(2), modified (if applicable) in accordance with §1.401(a)(4)-3(e)(3)(iii). However, if unadjusted accrual rates are determined under the annual method of §1.401(a)(4)-3(d)(2), testing compensation may be determined using plan year compensation.

(vi) Unadjusted accrual rate. "Unadjusted accrual rate" means the normal or most valuable accrual rate, whichever is being determined for the employee under §1.401(a)(4)-



3(d), expressed as a percentage of testing compensation, without imputing permitted disparity under this section.

(5) Example. The following example illustrates the application of this definition.

Example. (a) Employees M and N participate in a defined benefit plan that uses a normal retirement age of 65. The plan is being tested for the plan year under §1.401(a)(4)-3(c), using unadjusted accrual rates determined under the annual method of §1.401(a)(4)-3(d)(2). Employee M has an unadjusted normal accrual rate of 1.48 percent, testing compensation of $21,000, and an employer-provided accrual of $311 (1.48 percent x $21,000). Employee N has an unadjusted normal accrual rate of 1.7 percent, testing compensation of $106,000, and an employer-provided accrual of $1,802 (1.7 percent x $106,000). The covered compensation of both Employees M and N is $25,000, and social security retirement age for both employees is 65. Neither employee has testing service of more than 35 years and neither has ever participated in another plan.

(b) Because Employee M's testing compensation does not exceeds covered compensation, Employee M's A rate is 2.96 percent (2 x 1.48 percent), and Employee M's B rate is 2.23 percent (1.48 percent + 0.75 percent). Thus, Employee M's adjusted accrual rate is 2.23 percent, the lesser of the A rate and the B rate.

(c) Because Employee N's testing compensation exceeds covered compensation, Employee N's C rate is 1.93 percent ($1,802/($106,000 minus (0.5 X $25,000))), and Employee N's D rate is 1.88 percent (($1,802 + (0.75 percent X $25,000))/$106,000). Thus Employee N's adjusted accrual rate is 1.88 percent, the lesser of the C rate and the D rate.

(d) Rules of general application--(1) Eligible plans. The rules in this section may be used only for those plans to which the permitted disparity rules of section 401(*l*) are available. Therefore, these rules may generally not be used, for example, by an employer (determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act) not subject to the tax under section 3111(a) or 3221. See §1.401(*l*)-1(a)(3) for other arrangements to which section 401(*l*) is not available.

(2) Consistency. In general, if the rules of this section are applied to a plan, permitted disparity must be imputed for all employees in the plan. However, permitted



disparity need not be imputed for employees, including self-employed individuals within the meaning of section 401(c)(1), not covered by the any of the taxes under section 3111(a), section 3221, or section 1401, provided that permitted disparity is not imputed for any of those employees. In addition, permitted disparity may not be imputed for an employee if imputation would violate the overall permitted disparity rules of §1.401(*l*)-5. See paragraph (d)(3) of this section.

(3) Overall permitted disparity. The annual overall permitted disparity limits of §1.401(*l*)-5(b) apply to the employer-provided contributions and benefits for an employee under all plans taken into account under §1.401(*l*)-5(a)(3). Thus, if an employee who benefits under the plan for the current plan year also benefits under a section 401(*l*) plan for the plan year ending with or within the current plan year, permitted disparity may not be imputed for that employee for the plan year. Similarly, if an employee who benefits under the plan for the current plan year also benefits under another plan of the employer for the plan year ending with or within the current plan year, disparity may be imputed for that employee under only one of the plans. See §1.401(*l*)-5(b)(9), Example 4.

(4) Relationship to other adjustments. Permitted disparity is imputed under this section after taking into account the value of any includible disability benefits under

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§1.401(a)(4)-3(d)(6)(vi) and before grouping allocation or accrual rates under §1.401(a)(4)-2(c)(2)(v) or 1.401(a)(4)-3(d)(6)(iv).

(5) Compensation used for amounts testing. In applying §§1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-8, 1.401(a)(4)-9, and 1.410(b)-5 to the amount of contributions or benefits under the plan, a plan that imputes permitted disparity must use the same amount of

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plan year compensation that is used in adjusting allocation rates under paragraph (b) of this section or the same amount of testing compensation that is used in adjusting accrual rates under paragraph (c) of this section, as applicable. Thus, for example, if an employee's unadjusted accrual rates are determined based on testing compensation of $26,512, that same amount of testing compensation must be used to compute the employees' adjusted accrual rates under paragraph (c) of this section.

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§1.401(a)(4)-8 Cross-testing.

(a) Introduction--(1) Overview. In order to satisfy section 401(a)(4), either the contributions or the benefits provided under a plan must be nondiscriminatory in amount. See §1.401(a)(4)-1(b)(2). Whether a defined contribution plan satisfies this requirement is generally determined on a contributions basis under §1.401(a)(4)-2. As an alternative, however, a defined contribution plan may be tested with respect to the equivalent amount of benefits under the rules provided in paragraph (b) of this section. This alternative is not available to an ESOP, a section 401(k) plan, or a section 401(m) plan. Similarly, whether a defined benefit plan discriminates in favor of highly compensated employees with respect to the amount of employer-provided contributions or benefits is generally determined on a benefits basis under §1.401(a)(4)-3. As an alternative, however, a defined benefit plan may be tested with respect to the equivalent amount of contributions under the rules provided in paragraph (c) of this section. Paragraphs (b) and (c) of this section generally require the determination of individual equivalent accrual or allocation rates. Paragraphs (b)(3), (c)(3), and (d) of this section, however, contain additional safe harbor testing methods for target benefit plans, cash balance plans, and defined benefit plans that are part of floor-offset arrangements, respectively, that generally may be satisfied on a design basis.

(2) Separate testing of employer-provided and employee-provided benefits. This section applies solely for purposes of determining whether a plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) with respect to the amount of employer-provided benefits or contributions. In the case of a contributory DB plan tested under paragraph (c)(1) of this section, the rules in §1.401(a)(4)-6(b)(1) (section 411(c)

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method), (b)(5) (government plan method), or (b)(6) (cessation-of-employee-contributions method) must be used to determine the amount of each employee's employer-provided benefit. See §1.401(a)(4)-2(d)(2) for the exclusive rules for determining whether a plan consisting of employee contributions allocated to separate accounts satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2).

(b) Nondiscrimination in amount of benefits provided under a defined contribution plan--(1) General rule. A defined contribution plan satisfies section 401(a)(4) with respect to an equivalent amount of benefits for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (b)(1), a rate group exists under the plan for each highly compensated employee in the plan and consists of the highly compensated employee and all other employees (both highly and nonhighly compensated) in the plan who have an equivalent accrual rate greater than or equal to the highly compensated employee's equivalent accrual rate. Thus, an employee is in the rate group for each highly compensated employee in the plan who has an equivalent accrual rate less than or equal to the employee's equivalent accrual rate. Whether a rate group satisfies section 410(b) is determined by applying the rules in §1.401(a)(4)-3(c)(3). Allocations under a defined contribution plan are converted into equivalent accrual rates for this purpose using either the annual or the accrued-to-date method in paragraph (b)(2) of this section. Paragraph (b)(3) of this section contains an optional design-based testing method for target benefit plans.

(2) Determination of equivalent accrual rates--(i) Annual method. Amounts allocated to employees' accounts under a defined contribution plan for a plan year are converted into equivalent accrual rates under the annual method as follows--

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(A) Determine the dollar amount of the allocations under the plan taken into account under §1.401(a)(4)-2(c)(2)(ii) for the plan year with respect to each employee.

(B) Normalize each amount determined under paragraph (b)(2)(i)(A) of this section. For this purpose, the amount determined in paragraph (b)(2)(i)(A) of this section is treated as a single-sum benefit that is immediately and unconditionally payable to the employee. The interest rate used for this purpose must be a standard interest rate, and the straight life annuity factor must be based on the same or a different standard interest rate and a standard mortality table. The straight life annuity factor must be based on the employee's testing age determined without regard to paragraph (4) of the definition of testing age in §1.401(a)(4)-12 (current-age rule). All actuarial assumptions used for this purpose must be applied on a consistent basis to all employees in the plan.

(C) Express the annual payment under each normalized annuity determined under paragraph (b)(2)(i)(B) of this section either as a dollar amount or as a percentage of the employee's testing compensation for the plan year. If testing compensation is defined as plan year compensation, the modifications in §1.401(a)(4)-3(e)(3)(ii) do not apply.

(D) The employer may impute permitted disparity to the extent allowed under the rules of §1.401(a)(4)-7 using the annual method in §1.401(a)(4)-7(c)(4)(iv)(C). In determining each employee's adjusted accrual rate for purposes of that section, the amount determined under paragraph (b)(2)(i)(C) of this section is substituted for the employee's unadjusted accrual rate.



(E) The employer may apply the grouping rules of §1.401(a)(4)-3(d)(6)(iv) to the equivalent accrual rates determined under paragraph (b)(2)(i)(C) of this section (or, if permitted disparity is taken into account, paragraph (b)(2)(i)(D) of this section.

(ii) Accrued-to-date method--(A) General rule. A method analogous to the accrued-to-date method in §1.401(a)(4)-3(d)(3) may be used instead of the annual method in paragraph (b)(2)(i) of this section to determine employees' equivalent accrual rates under a defined contribution plan for a plan year. If this method is used, each employee's equivalent accrual rate is determined by substituting the employee's adjusted account balance (within the meaning of paragraph (b)(2)(ii)(C) of this section) for the plan year, divided by the employee's testing service for the plan year, for the amount determined under paragraph (b)(2)(i)(A) of this section. In addition, in applying the normalization requirement in paragraph (b)(2)(i)(B) of this section, the employee's testing age is determined without regard to paragraph (4) of the definition of testing age in §1.401(a)(4)-12 (current-age rule) for all purposes, and not merely for purposes of determining the straight life annuity factor that must be applied. If testing compensation is defined as plan year compensation, the modifications in §1.401(a)(4)-3(e)(3)(ii)(A) and (B) must be made. In addition, if permitted disparity is taken into account under paragraph (b)(2)(i)(D) of this section, the accrued-to-date method in §1.401(a)(4)-7(c)(4)(iv)(D) must be applied.

(B) Fresh-start alternative. The accrued-to-date method provided in this paragraph (b)(2)(ii) may be applied solely with respect to testing service during, and adjusted account balances attributable to allocations made for, plan years beginning after a fresh-start date.



(C) Determination of adjusted account balance. For purposes of this paragraph (b)(2)(ii), an employee's adjusted account balance is the employee's actual account balance attributable to allocations taken into account under §1.401(a)(4)-2(c)(2)(ii) for all plan years taken into account under this paragraph (b)(2)(ii), plus any additional amounts that would have been included in that portion of the account balance but for the fact that they were previously distributed (including an adjustment for interest that would have been earned with respect to such prior distributions calculated at a rate of interest that is reasonably consistent with the investment performance of the plan). For purposes of the foregoing, an employer may disregard distributions made to a nonhighly compensated employee, as well as distributions made to any employee in plan years beginning before a selected date no later than January 1, 1986, that is the same for all employees in the plan.

(3) Safe harbor testing method for target benefit plans--(i) General rule. A target benefit plan is a money purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated

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benefit under the plan. Whether a target benefit plan satisfies section 401(a)(4) with respect to an equivalent amount of benefits is generally determined under paragraphs (b)(1) and (b)(2) of this section. A target benefit plan is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of benefits, however, if each of the following requirements is satisfied--

(A) Form of plan. The plan satisfies the uniformity requirements of §1.401(a)(4)-2(b)(2) (regarding a plan's normal retirement age, allocation formula, and vesting and



service-crediting rules), taking into account the relevant exceptions provided in §1.401(a)(4)-2(b)(5).

(B) Stated benefit formula. Each employee's stated benefit is determined under a unit credit fractional rule or flat benefit formula that would satisfy the requirements of §1.401(a)(4)-3(b)(4) or (b)(5), respectively, and that would satisfy each of the uniformity requirements in §1.401(a)(4)-3(b)(2) (taking into account the relevant exceptions provided in §1.401(a)(4)-3(b)(8)), if the plan were a defined benefit plan with the same benefit formula. In determining whether these requirements are satisfied, the stated benefit at normal retirement age is assumed to accrue ratably over each employee's period of plan participation through normal retirement age for which the employee was covered by the stated benefit formula in accordance with §1.401(a)(4)-3(b)(4)(i)(B) or (b)(5)(i)(B). In addition, the rules of §1.401(a)(4)-3(f) do not apply. An employee's stated benefit may not take into account years in which the employee did not participate in the plan or in which the plan did not satisfy this paragraph (b)(3). See §1.401(a)(4)-13(e)(1) for a special rule treating certain plans as satisfying this paragraph (b)(3) in years prior to the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b).

(C) Employer contributions. Employer contributions with respect to each employee are based exclusively on the employee's stated benefit using the method provided in paragraph (b)(3)(iv) of this section, and forfeitures and any other amounts under the plan taken into account under §1.401(a)(4)-2(c)(2)(ii) are used exclusively to reduce employer contributions.



(D) Employee contributions. Employee contributions (if any) are not used to fund the stated benefit.

(E) Permitted disparity. If permitted disparity is taken into account, the stated benefit formula satisfies §1.401(*l*)-3. For this purpose, the 0.75-percent factor in the maximum excess or offset allowance in §1.401(*l*)-3(b)(2)(i) or (b)(3)(i), respectively, as reduced in accordance with §1.401(*l*)-3(d)(9) and (e), is further reduced by multiplying the factor by 0.80.

(ii) Fresh-start rules--(A) In general. A target benefit plan does not fail to satisfy this paragraph (b)(3) merely because an employee's stated benefit includes benefits attributable to plan years beginning before a fresh-start date that were determined under a benefit formula that differs from the benefit formula used to determine stated benefits in plan years beginning after the fresh-start date, provided the stated benefit formula satisfies §1.401(a)(4)-13(c) with respect to benefits attributable to plan years beginning after the fresh-start date.

(B) Additional requirements for plans that did not satisfy safe harbor in prior years. If a plan was not a target benefit plan or did not satisfy this paragraph (b)(3) in the immediately preceding plan year, the stated benefit formula must satisfy §1.401(a)(4)-13(c) by applying the formula in §1.401(a)(4)-13(c)(2) (formula without wear-away) with respect to benefits attributable to the current and subsequent plan years. For this purpose, each employee's frozen accrued stated benefit under such a plan for purposes of §1.401(a)(4)-13(c)(2) must be treated as zero. Thus, an employee's stated benefit generally may not take into account service prior to the current plan year if the plan did not satisfy this paragraph (b)(3) in the preceding plan year. See §1.401(a)(4)-13(e)(1) for a special rule treating certain



target benefit plans as satisfying this paragraph (b)(3) in years prior to the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b).

(iii) Benefits and contributions after normal retirement age. A target benefit plan may limit increases in the stated benefit (and contributions to fund those increases) after normal retirement age consistent with the requirements applicable to defined benefit plans under

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section 411(b)(1)(H) (without regard to section 411(b)(1)(H)(iii)), provided that the limitation applies on the same terms to all employees in the plan. Thus, post-normal retirement benefits required under §1.401(a)(4)-3(b)(2)(iii) must be provided under the stated benefit formula, subject to any uniformly applicable service cap under the formula. In addition, actuarial increases in the stated benefit for delayed retirement may not be provided. See paragraph (b)(3)(i)(B) of this section (prohibiting application of §1.401(a)(4)-3(f)(3)).

(iv) Method for determining required employer contributions--(A) General rule. An employer's required contribution to the account of an employee for a plan year is determined based on the employee's stated benefit and the amount of the employee's theoretical reserve as of the date the employer's required contribution is determined for the plan year (the "determination date"). Paragraph (b)(3)(iv)(B) of this section provides rules for determining an employee's theoretical reserve. Paragraphs (b)(3)(iv)(C) and (D) of this section provides rules for determining an employer's required contributions.

(B) Theoretical reserve--(1) Initial theoretical reserve. An employee's theoretical reserve as of the determination date for the first plan year in which the employee participates in the plan, and for the first plan year after any plan year in which the plan did not satisfy this paragraph (b)(3), is zero. See §1.401(a)(4)-13(e)(2), however, for transition rules used



in determining an employee's initial theoretical reserve under a plan that satisfied this paragraph (b)(3) or other applicable nondiscrimination requirements prior to the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b).

(2) Theoretical reserve in subsequent plan years. An employee's theoretical reserve as of the determination date for a plan year (other than a plan year described in paragraph (b)(3)(iv)(B)(1) of this section) is the employee's theoretical reserve as of the determination date for the prior plan year, plus the employer's required contribution for the prior plan year (as limited by section 415), both increased by interest from the determination date for the prior plan year through the determination date for the current plan year, but not beyond the determination date for the plan year that includes the employee's normal retirement date. (Thus, an employee's theoretical reserve as of the determination date for a plan year does not include the amount of the employer's required contribution for the plan year.) The interest rate for determining employer contributions that was in effect on the determination date in the prior plan year must be applied to determine the required interest adjustment for this period. For plan years beginning after the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b), a standard interest rate must be used, and may not be changed except on the determination date for a plan year.

(C) Required contributions for employees under normal retirement age. The employer contributions required for purposes of paragraph (b)(3)(i)(C) of this section with respect to an employee whose attained age is less than the employee's normal retirement age must be determined for each plan year as follows--



(1) Determine the employee's fractional rule benefit under the plan's stated benefit formula in accordance with §1.401(a)(4)-3(b)(4)(i)(B) or (b)(5)(i)(B).

(2) Determine the actuarial present value of the fractional rule benefit determined in paragraph (b)(3)(iv)(C)(1) of this section as of the determination date for the current plan year, using a standard interest rate and a standard mortality table that are set forth in the plan and that are the same for all employees in the plan, and assuming no mortality before the employee's normal retirement age.

(3) Determine the excess, if any, of the amount determined in paragraph (b)(3)(iv)(C)(2) of this section over the employee's theoretical reserve for the current plan year determined under paragraph (b)(3)(iv)(B) of this section.

(4) Determine the required employer contribution for the current plan year by amortizing on a level basis the result in paragraph (b)(3)(iv)(C)(3) of this section over the period beginning with the determination date for the current plan year and ending with the determination date for the plan year in which the employee is projected to reach normal retirement age.

(D) Required contributions for employees over normal retirement age. The required employer contributions for purposes of paragraph (b)(3)(i)(C) of this section with respect to an employee whose attained age equals or exceeds the employee's normal retirement age is



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the excess of the actuarial present value, as of the determination date for the current plan year, of the employee's stated benefit for the current plan year, (determined using a straight life annuity factor based on the employee's normal retirement age, even though the

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employee's stated benefit commences as of the employee's current age) over the employee's theoretical reserve as of the determination date.

(v) Effect of section 415 and 416 requirements. A target benefit plan does not fail to satisfy this paragraph (b)(3) merely because required contributions under the plan are limited by section 415 in a plan year or merely because additional contributions are made consistent with the requirements of section 416(c)(2) (regardless of whether the plan is top-heavy).

(vi) Examples. The following examples illustrate this paragraph (b)(3).

Example 1. (a) Employer X maintains a target benefit plan with a calendar plan year that bases contributions on a stated benefit equal to 40 percent of each employee's average annual compensation, reduced pro rata for years of service less than 25, payable annually as a straight life annuity commencing at normal retirement age. The UP-84 mortality table and an interest rate of 7.5 percent are used to calculate the contributions necessary to fund the stated benefit. Required contributions are determined on the last day of each plan year. The normal retirement age under the plan is 65. Employee A is 39 years old in 1992, has participated in the plan for 5 years, and has average annual compensation equal to $60,000 for the 1992 plan year. Assume that Employee A's theoretical reserve as of the last day of the 1991 plan year is $13,909, determined under §1.401(a)(4)-13(e).

(b) Under these facts, Employer X's 1992 required contribution to fund Employee A's stated benefit is $1,318, calculated as follows--

(1) Employee A's fractional rule benefit is $24,000 (40 percent of Employee A's average annual compensation of $60,000).

(2) The actuarial present value of Employee A's fractional rule benefit as of the last day of the 1992 plan year is $30,960 (Employee A's fractional rule benefit of $24,000 multiplied by 1.290, the actuarial present value factor for an annuity commencing at age 65 applicable to a 39-year-old employee, determined using the stated interest rate of 7.5 percent and the UP-84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee A's fractional rule benefit ($30,960) is reduced by Employee A's theoretical reserve as of the last day of the 1992 plan year. The theoretical reserve on that day is $14,744--the $13,909 theoretical reserve as of the last day of the 1991 plan year, increased by interest for one year at the rate of 6 percent. Because the required contribution for the 1991 plan year is taken into account under §1.401(a)(4)-13(e)(2) in determining the theoretical reserve as of the last day of the 1991 plan year, it is

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not added to the theoretical reserve again in this paragraph (b)(3) of this Example. The resulting difference is $16,216 ($30,960 minus $14,744).

(4) The $16,216 excess of the actuarial present value of Employee A's fractional rule benefit over Employee A's theoretical reserve is multiplied by 0.0813, the amortization factor applicable to a 39-year-old employee determined using the stated interest rate of 7.5 percent. The product of $1,318 is the amount of the required employer contribution for Employee A for the 1992 plan year.

Example 2. (a) The facts are the same as in Example 1, except that as of January 1, 1993, the plan's stated benefit formula is amended to provide for a stated benefit equal to 45 percent of average annual compensation, reduced pro rata for years of service less than 25, payable annually as a straight life annuity commencing at normal retirement age. The plan provides that, if the stated benefit formula is amended, an employee's stated benefit under the plan is equal to the greater of the employee's frozen accrued stated benefit as of the last day of the plan year preceding the year in which such amendment first becomes effective, or the employee's stated benefit determined under the amended benefit formula applied for all years of service (i.e., the plan uses the fresh-start rule in §1.401(a)(4)-13(c)(3) with respect to the stated benefit formula). For the 1993 plan year, Employee A's average annual compensation continues to be $60,000. The mortality table used for the calculation of the employer's required contributions remains the same as in the prior plan year, but the plan's stated interest rate is changed to 8 percent effective as of December 31, 1993.

(b) Under these facts, Employer X's required contribution for Employee A is $1,290, calculated as follows:

(1) Employee A's fractional rule benefit is $27,000 (45 percent of $60,000).

(2) The actuarial present value of Employee A's fractional rule benefit as of the last day of the 1993 plan year is $32,319 ($27,000 multiplied by 1.197, the actuarial present value factor for an annuity commencing at age 65 applicable to a 40-year-old employee, determined using the stated interest rate of 8 percent and the UP-84 mortality table, and assuming no mortality before normal retirement age).

(3) The actuarial present value of Employee A's fractional rule benefit ($32,319) is reduced by Employee A's theoretical reserve as of the last day of the 1993 plan year. The theoretical reserve as of that day is $17,267--the $14,744 theoretical reserve as of the last day of the 1992 plan year plus the $1,318 required contribution for the 1992 plan year, both increased by interest for one year at the rate of 7.5 percent. The resulting difference is $15,052 ($32,319 minus $17,267).

(4) The result in paragraph (b)(3) of this Example is multiplied by 0.0857, the amortization factor applicable to a 40-year-old employee determined using the stated interest

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rate of 8 percent. The product, $1,290, is the amount of the required employer contribution for Employee A for the 1993 plan year.

(c) Nondiscrimination in amount of contributions under a defined benefit plan--(1) General rule. A defined benefit plan satisfies section 401(a)(4) with respect to an equivalent amount of contributions for a plan year if each rate group under the plan satisfies section 410(b). For purposes of this paragraph (c)(1), a rate group exists under a plan for each highly compensated employee in the plan and consists of the highly compensated employee

and all other employees (both highly and nonhighly compensated) in the plan who have an equivalent normal allocation rate greater than or equal to the highly compensated employee's equivalent normal allocation rate, and who also have an equivalent most valuable allocation rate greater than or equal to the highly compensated employee's equivalent most valuable allocation rate. In the case of a defined benefit plan that satisfies the requirements necessary to use the alternative test in §1.401(a)(4)-3(c)(2), however, a rate group consists of the highly compensated employee and all other employees (both highly and nonhighly compensated) in the plan who have an equivalent most valuable allocation rate greater than or equal to the highly compensated employee's equivalent most valuable allocation rate. Whether a rate group satisfies section 410(b) is determined by applying the rules in §1.401(a)(4)-3(c)(3). Normal and most valuable benefits under a defined benefit plan are converted into equivalent normal and most valuable allocation rates using the methods in paragraph (c)(2) of this section. Paragraph (c)(3) of this section provides a safe harbor testing method for cash balance plans.

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(2) Determination of equivalent allocation rates--(i) Equivalent normal allocation rate. Employees' accrued benefits under a defined benefit plan for a plan year are converted into equivalent normal allocation rates as follows--

(A) Determine the increase in each employee's normalized accrued benefit under §1.401(a)(4)-3(d)(2)(i)(A) through (E) for the plan year.

(B) Determine the actuarial present value of the increase in the employee's normalized accrued benefit determined under paragraph (c)(2)(i)(A) of this section as of the employee's testing age, using a standard interest rate and a standard mortality table that are applied uniformly to all employees in the plan.

(C) Determine the present value, as of the close of the plan year, of the amount determined under paragraph (c)(2)(i)(B) of this section using a standard interest rate that is the same for all employees in the plan. The interest rate used for this purpose may be different from the interest rate used in paragraph (c)(2)(i)(B) of this section.

(D) Express the amount determined under paragraph (c)(2)(i)(C) of this section as a dollar amount or as a percentage of the employee's plan year compensation for the plan year.

(E) Permitted disparity may be imputed to the extent allowed under the rules of §1.401(a)(4)-7 using the method in §1.401(a)(4)-7(b). In determining an employee's adjusted allocation rate under that section, the percentage amount determined under paragraph (c)(2)(i)(D) of this section is substituted for the employee's unadjusted allocation rate. If permitted disparity is taken into account, it must be taken into account for all employees in the plan.

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(F) The employer may apply the grouping rules of §1.401(a)(4)-2(c)(2)(v) to the equivalent normal allocation rates determined under paragraph (c)(2)(i)(D) of this section (or, if permitted disparity is taken into account, paragraph (c)(2)(i)(E) of this section.

(ii) Equivalent most valuable allocation rate. An employee's benefits under a defined benefit plan are converted into an equivalent most valuable allocation rate using the method set forth in paragraph (c)(2)(i) of this section, and substituting the largest normalized annuity determined under §1.401(a)(4)-3(d)(2)(ii)(A) through (G) for each employee for the increase in the employee's normalized accrued benefit in paragraph (c)(2)(i)(A) of this section. An employer may use the rule in §1.401(a)(4)-3(d)(6)(vi) to take the value of disability benefits provided under a plan into account in determining employees' equivalent most valuable allocation rates. If this option is used, the largest annuity described in this paragraph (c)(2)(ii) is multiplied by 1.11 before the employee's equivalent most valuable allocation rate is determined.

(iii) Use of optional calculation methods. Except as otherwise provided in this section, none of the optional methods available under §1.401(a)(4)-3(d) for determining the amount of benefits used to determine an employee's normal and most valuable accrual rates, or for adjusting an employee's normal or most valuable accrual rates, are available in determining the employee's equivalent normal and most valuable allocation rates under this paragraph (c)(2). Thus, for example, a defined benefit plan that is being tested on the basis of equivalent contributions may take the value of disability benefits provided under a plan



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into account in determining employees' equivalent most valuable allocation rates as provided in paragraph (c)(2)(ii) of this section, but may not disregard plan provisions described in

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§1.401(a)(4)-3(f)(3) that provide for increases in an employee's accrued benefit because the employee has delayed commencement of benefits after normal retirement age.

(3) Safe harbor testing method for cash balance plans--(i) General rule. A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan. Because a cash balance plan is a defined benefit plan, whether it satisfies section 401(a)(4) with respect to the equivalent amount of contributions is generally determined under paragraphs (c)(1) and (c)(2) of this section. However, a cash balance plan that satisfies each of the requirements in paragraphs (c)(3)(ii) through (xi) of this section is deemed to satisfy section 401(a)(4) with respect to an equivalent amount of contributions.

(ii) Plan requirements in general. The plan must be an accumulation plan. The benefit formula under the plan must provide for hypothetical allocations for each employee in the plan that satisfy paragraph (c)(3)(iii) of this section, and interest adjustments to these hypothetical allocations that satisfy paragraph (c)(3)(iv) of this section. The benefit formula under the plan must provide that these hypothetical allocations and interest adjustments are accumulated as a hypothetical account for each employee, determined in accordance with paragraph (c)(3)(v) of this section. The plan must provide that an employee's accrued benefit under the plan as of any date is an annuity that is the actuarial equivalent of the employee's projected hypothetical account as of normal retirement age, determined in accordance with paragraph (c)(3)(vi) of this section. In addition, the plan must satisfy

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paragraphs (c)(3)(vii) through (xi) of this section (to the extent applicable) regarding optional forms of benefit, past service credits, post-normal retirement age benefits, certain uniformity requirements, and changes in the plan's benefit formula, respectively.

(iii) Hypothetical allocations--(A) In general. The hypothetical allocations provided under the plan's benefit formula must satisfy either paragraph (c)(3)(iii)(B) or (C) of this section. Paragraph (c)(3)(iii)(B) of this section provides a design-based safe harbor that does not require the annual comparison of hypothetical allocations under the plan. Paragraph (c)(3)(iii)(C) of this section requires the annual comparison of hypothetical allocations.

(B) Uniform hypothetical allocation formula. To satisfy this paragraph (c)(3)(iii)(B), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years of amounts that would satisfy §1.401(a)(4)-2(b)(3) for each such plan year if the hypothetical allocations were the only allocations under a defined contribution plan for the employees for those plan years. Thus, the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for all plan years that are the same percentage of plan year compensation or the same dollar amount. In determining whether the hypothetical allocations satisfy §1.401(a)(4)-2(b)(3), the only provisions of §1.401(a)(4)-2(b)(5) that apply are §1.401(a)(4)-2(b)(5)(ii) (section 401(*l*) permitted disparity), (iii) (entry dates), (vi) (certain limits on allocations), and (vii) (dollar allocation per uniform unit of service). Thus, for example, the plan's benefit formula may take permitted disparity into account in a manner allowed under §1.401(*l*)-2 for defined contribution plans.

(C) Modified general test. To satisfy this paragraph (c)(3)(iii)(C), the plan's benefit formula must provide for hypothetical allocations for all employees in the plan for the plan

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year that would satisfy the general test in §1.401(a)(4)-2(c) for the plan year, if the hypothetical allocations were the only allocations for the employees taken into account under §1.401(a)(4)-2(c)(2)(ii) under a defined contribution plan for the plan year. In determining whether the hypothetical allocations satisfy §1.401(a)(4)-2(c), the provisions of §1.401(a)(4)-2(c)(2)(iii) through (v) apply. Thus, for example, permitted disparity may be imputed under §1.401(a)(4)-2(c)(2)(iv) in accordance with the rules of §1.401(a)(4)-7(b) applicable to defined contribution plans.

(iv) Interest adjustments to hypothetical allocations--(A) General rule. The plan benefit formula must provide that the dollar amount of the hypothetical allocation for each

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employee for a plan year is automatically adjusted using an interest rate that satisfies paragraph (c)(3)(iv)(B) of this section, compounded no less frequently than annually, for the period that begins with a date in the plan year and that ends at normal retirement age. This requirement is not satisfied if any portion of the interest adjustments to a hypothetical allocation are contingent on the employee's satisfaction of any requirement. Thus, for example, the interest adjustments to a hypothetical allocation must be provided through normal retirement age, even though the employee terminates employment or commences benefits before that age.

(B) Requirements with respect to interest rates. The interest rate must be a single interest rate specified in the plan that is the same for all employees in the plan for all plan years. The interest rate must be either a standard interest rate or a variable interest rate. If the interest rate is a variable interest rate, it must satisfy paragraph (c)(3)(iv)(C) of this section.

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(C) Variable interest rates--(1) General rule. The plan must specify the variable interest rate, the method for determining the current value of the variable interest rate, and the period (not to exceed 1 year) for which the current value of the variable interest rate applies. Permissible variable interest rates are listed in paragraph (c)(3)(iv)(C)(2) of this section. Permissible methods for determining the current value of the variable interest rate are provided in paragraph (c)(3)(iv)(C)(3) of this section.

(2) Permissible variable interest rates. The variable interest rate specified in the plan must be one of the following--

(i) The rate on 3-month Treasury Bills,

(ii) The rate on 6-month Treasury Bills,

(iii) The rate on 1-year Treasury Bills,

(iv) The yield on 1-year Treasury Constant Maturities,

(v) The yield on 2-year Treasury Constant Maturities,

(vi) The yield on 5-year Treasury Constant Maturities,

(vii) The yield on 10-year Treasury Constant Maturities,

(viii) The yield on 30-year Treasury Constant Maturities, or

(ix) The single interest rate such that, as of a single age specified in the plan, the actuarial present value of a deferred straight life annuity of an amount commencing at the normal retirement age under the plan, calculated using that interest rate and a standard mortality table but assuming no mortality before normal retirement age, is equal to the actuarial present value, as of the single age specified in the plan, of the same annuity

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calculated using the section 417(e) rates applicable to distributions in excess of $25,000 (determined under §1.417(e)-1(d)), and the same mortality assumptions.

(3) Current value of variable interest rate. The current value of the variable interest rate that applies for a period must be either the value of the variable interest rate determined as of a specified date in the period or the immediately preceding period, or the average of the values of the variable interest rate as of two or more specified dates during the current period or the immediately preceding period. The value as of a date of the rate on a Treasury Bill is the average auction rate for the week or month in which the date falls, as reported in the Federal Reserve Bulletin. The value as of a date of the yield on a Treasury Constant Maturity is the average yield for the week, month, or year in which the date falls, as reported in the Federal Reserve Bulletin. (The Federal Reserve Bulletin is published by the Board of Governors of the Federal Reserve System and is available from Publication Services, Mail Stop 138, Board of Governors of the Federal Reserve System, Washington D.C. 20551.) The plan may limit the current value of the variable interest rate to a maximum (not less than the highest standard interest rate), or a minimum (not more than the lowest standard interest rate), or both.

(v) Hypothetical account--(A) Current value of hypothetical account. As of any date, the current value of an employee's hypothetical account must equal the sum of all hypothetical allocations and the respective interest adjustments to each such hypothetical allocation provided through that date for the employee under the plan's benefit formula (without regard to any interest adjustments provided under the plan's benefit formula for periods after that date).

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(B) Value of hypothetical account as of normal retirement age. Under paragraph (c)(3)(vi) of this section, the value of an employee's hypothetical account must be determined as of normal retirement age in order to determine the employee's accrued benefit as of any date at or before normal retirement age. As of any date at or before normal retirement age, the value of an employee's hypothetical account as of normal retirement age must equal the sum of each hypothetical allocation provided through that date for the employee under the plan's benefit formula, plus the interest adjustments provided through normal retirement age on each of those hypothetical allocations for the employee under the plan's benefit formula (without regard to any hypothetical allocations that might be provided after that date under the plan's benefit formula). If the interest rate specified in the plan is a variable interest rate, the plan must specify that the determination in the preceding sentence is made by assuming that the current value of the variable interest rate for all future periods is either the current value of the variable interest rate for the current period or the average of the current values of the variable interest rate for the current period and one or more periods immediately preceding the current period (not to exceed 5 years in the aggregate).

(vi) Determination of accrued benefit--(A) Definition of accrued benefit. The plan must provide that at any date at or before normal retirement age the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) of each employee in the plan is an annuity commencing at normal retirement age that is the actuarial equivalent of the employee's hypothetical account as of normal retirement age (as determined under paragraph (c)(3)(v)(B) of this section). The separate benefit that each employee accrues for a plan year is an annuity that is the actuarial equivalent of the employee's hypothetical allocation for that plan



year, including the automatic adjustments for interest through normal retirement age required under paragraph (c)(3)(iv) of this section.

(B) Normal form of benefit. The annuity specified in paragraph (c)(3)(vi)(A) of this section must provide an annual benefit payable in the same form at the same uniform normal retirement age for all employees in the plan. The annual benefit must be the normal retirement benefit under the plan (within the meaning of section 411(a)(9)) under the plan.

(C) Determination of actuarial equivalence. For purposes of this paragraph (c)(3)(vi) and paragraph (c)(3)(ix) of this section, actuarial equivalence must be determined using a standard mortality table and either a standard interest rate or the interest rate specified in the plan for making interest adjustments to hypothetical allocations. If the interest rate used is the interest rate specified in the plan, and that rate is a variable interest rate, the assumed value of the variable interest rate for all future periods must be the same value that would be assumed for purposes of paragraph (c)(3)(v)(B) of this section. The same actuarial assumptions must be used for all employees in the plan.

(D) Effect of section 415 and 416 requirements. A plan does not fail to satisfy this paragraph (c)(3)(vi) merely because the accrued benefits under the plan are limited by section 415, or merely because the accrued benefits under the plan are the greater of the accrued benefits otherwise determined under the plan and the minimum benefit described in section 416(c)(1) (regardless of whether the plan is top-heavy).

(vii) Optional forms of benefit--(A) In general. The plan must satisfy the uniform subsidies requirement of §1.401(a)(4)-3(b)(2)(iv) with respect to all subsidized optional forms of benefit.



(B) Limitation on subsidies. Unless hypothetical allocations are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section, the actuarial present value of any QJSA provided under the plan must not be greater than the single sum distribution to the employee that would satisfy paragraph (c)(3)(vii)(C) of this section assuming that it was distributed to the employee on the date of commencement of the QJSA.

(C) Distributions subject to section 417(e). Except as otherwise required under section 415(b), if the plan provides for a distribution alternative that is subject to the interest rate restrictions under section 417(e), the actuarial present value of the benefit paid to an employee under the distribution alternative must equal the nonforfeitable percentage (determined under the plan's vesting schedule) of the greater of the following two amounts--

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(1) The current value of the employee's hypothetical account as of the date the distribution commences, calculated in accordance with paragraph (c)(3)(v)(A) of this section.

(2) The actuarial present value (calculated in accordance with §1.417(e)-1(d)) of the employee's accrued benefit.

(D) Determination of actuarial present value. For purposes of this paragraph (c)(3)(vii), actuarial present value must be determined using a reasonable interest rate and mortality table. A standard interest rate and a standard mortality table are considered reasonable for this purpose.

(viii) Past service credit. The benefit formula under the plan may not provide for hypothetical allocations in the current plan year that are attributable to years of service before the current plan year, unless each of the following requirements is satisfied--



(A) The years of past service credit are granted on a uniform basis to all current employees in the plan.

(B) Hypothetical allocations for the current plan year are determined under a uniform hypothetical allocation formula that satisfies paragraph (c)(3)(iii)(B) of this section.

(C) The hypothetical allocations attributable to the years of past service would have satisfied the uniform hypothetical allocation formula requirement of paragraph (c)(3)(iii)(B) of this section, and the interest adjustments to those hypothetical allocations would have satisfied paragraph (c)(3)(iv)(A) of this section, if the plan provision granting past service had been in effect for the entire period for which years of past service are granted to any employee. In order to satisfy this requirement, the hypothetical allocation attributable to a year of past service must be adjusted for interest in accordance with paragraph (c)(3)(iv) of this section for the period (including the retroactive period) beginning with the year of past service to which the hypothetical allocation is attributable and ending at normal retirement age. If the interest rate specified in the plan is a variable interest rate, the interest adjustments for the period prior to the current plan year either must be based on the current value of the variable interest rate for the period in which the grant of past service first becomes effective or must be reconstructed based on the then current value of the variable interest rate that would have applied during each prior period.

(ix) Employees beyond normal retirement age. In the case of an employee who commences receipt of benefits after normal retirement age, the plan must provide that interest adjustments continue to be made to an employee's hypothetical account until the employee's benefit commencement date. In the case of an employee described in the



previous sentence, the employee's accrued benefit is defined as an annuity that is the actuarial equivalent of the employee's hypothetical account determined in accordance with paragraph (c)(3)(v)(A) of this section as of the date of benefit commencement.

(x) Additional uniformity requirements. In addition to any uniformity requirements provided elsewhere in this paragraph (c)(3), the plan must satisfy the uniformity requirements in §1.401(a)(4)-3(b)(2)(v) (uniform vesting and service requirements) and (vi) (no employee contributions). A plan does not fail to satisfy the uniformity requirements of this paragraph (c)(3)(x) or any other uniformity requirement provided in this paragraph (c)(3) merely because the plan contains one or more of the provisions described in §1.401(a)(4)-3(b)(8)(iv) (prior vesting schedules), (v) (certain conditions on accruals), or (x) (multiple definitions of service).

(xi) Changes in benefit formula, allocation formula, or interest rates. A plan does not fail to satisfy this paragraph (c)(3) merely because the plan is amended to change the benefit formula, hypothetical allocation formula, or the interest rate used to adjust hypothetical allocations for plan years after a fresh-start date, provided that the accrued benefits for plan years beginning after the fresh-start date are determined in accordance with §1.401(a)(4)-13(c), as modified by §1.401(a)(4)-13(f).

(d) Safe harbor testing method for defined benefit plans that are part of a floor-offset arrangement--(1) General rule. A floor-offset arrangement is an arrangement pursuant to which benefits under a defined benefit plan are reduced by reference to an employee's account balance under a defined contribution plan. Generally, a defined benefit plan that is part of a floor-offset arrangement satisfies the nondiscriminatory amount requirement of

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§1.401(a)(4)-1(b)(2) only if the amount of the net benefit provided under the plan (i.e., the nominal benefit minus the offset) can be shown to be nondiscriminatory on either a contributions or a benefits basis. A defined benefit plan that is part of a floor-offset arrangement is deemed to satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2), however, if--

(i) Pursuant to the floor-offset arrangement, the vested portion of the accrued benefit (as defined in section 411(a)(7)(A)(i)) that would otherwise be provided to an employee under the defined benefit plan is reduced solely by the actuarial equivalent of all or part of the vested portion of the employee's account balance attributable to employer contributions under a defined contribution plan maintained by the same employer (plus the actuarial equivalent of all or part of any prior distributions from that portion of the account balance). In determining the actuarial equivalent of amounts provided under the defined contribution plan, an interest rate no higher than the highest standard interest rate must be used, and no mortality may be assumed in determining the actuarial equivalent of any prior distributions from the defined contribution plan or for periods prior to the benefit commencement date under the defined benefit plan.

(ii) The defined benefit plan is not a contributory DB plan (unless it satisfies §1.401(a)(4)-6(b)(6) (the cessation-of-employee-contributions method)), and benefits under the defined benefit plan are not reduced by any portion of the employee's account balance under the defined contribution plan (or prior distributions from that account) that are attributable to employee contributions.



(iii) The defined benefit plan and the defined contribution plan benefit the same employees.

(iv) The offset under the defined benefit plan is applied to all employees in the plan on the same terms. Thus, for example, uniform interest and other actuarial assumptions must be used.

(v) All employees have available to them under the defined contribution plan the same investment options and the same options with respect to the timing of preretirement distributions.

(vi) The defined benefit plan satisfies the uniformity requirements of §1.401(a)(4)-3(b)(2) and the unit credit safe harbor in §1.401(a)(4)-3(b)(3) without taking into account the offset described in paragraph (d)(1)(i) of this section, and the defined contribution plan satisfies any of the tests in §1.401(a)(4)-2(b) or (c). Alternatively, the defined benefit plan satisfies any of the tests in §1.401(a)(4)-3(b) or (c) without taking into account the offset described in paragraph (d)(1)(i) of this section, and the defined contribution plan satisfies the uniform allocation safe harbor in §1.401(a)(4)-2(b)(3) (including the uniformity requirements of §1.401(a)(4)-2(b)(2)).

(vii) The defined contribution plan is not an ESOP, a section 401(k) plan, or a section 401(m) plan.

(2) Application of safe harbor testing method to qualified offset arrangements. A defined benefit plan that is part of a qualified offset arrangement as defined in section 1116(f)(5) of the Tax Reform Act of 1986, Pub. L. No. 99-514, is deemed to satisfy the requirements of paragraphs (d)(1)(vi) and (d)(1)(vii) of this section, if the only defined



contribution plans included in the qualified offset arrangement are section 401(k) plans, section 401(m) plans, or both, and the defined benefit plan would satisfy the requirements of paragraph (d)(1)(vi) of this section assuming the elective contributions for each employee under the defined contribution plan were the same (either as a dollar amount or as a percentage of compensation) for all plan years since the establishment of the plan.



§1.401(a)(4)-9 Plan aggregation and restructuring.

(a) Introduction. Two or more plans that are permissively aggregated and treated as a single plan for purposes of the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory classification test of §1.410(b)-4 must also be treated as a single plan for purposes of section 401(a)(4). See §1.401(a)(4)-12 (definition of plan). Thus, for example, if an employee benefits under each of two defined benefit plans that have been aggregated

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and treated as a single plan for purposes of the ratio percentage test of §1.410(b)-2(b)(2), the employee's benefits under both plans must be taken into account in determining the employee's normal and most valuable accrual rates for purposes of the general test in §1.401(a)(3)-3(c)(1). In some cases, an aggregated plan may consist of one or more defined benefit plans and one or more defined contribution plans. Such aggregated plans are referred to in this section as DB/DC plans. Paragraph (b) of this section provides special rules for determining whether a DB/DC plan satisfies section 401(a)(4) with respect to the amount of employer-provided benefits and the availability of benefits, rights and features. Paragraph (c) of this section provides rules allowing a plan to be treated as consisting of separate component plans and allowing the component plans to be tested separately under section 401(a)(4).

(b) Application of nondiscrimination requirements to DB/DC plans--(1) General rule. Except as provided in paragraphs (b)(2) and (b)(3) of this section, whether a DB/DC plan satisfies section 401(a)(4) is determined using the same rules applicable to a single plan.

(2) Special rules for demonstrating nondiscrimination in amount of contributions or benefits--(i) Application of general tests. Because a DB/DC plan contains both a defined



benefit and a defined contribution plan, it cannot rely on any of the design-based safe harbors or optional testing methods provided in §1.401(a)(4)-2, 1.401(a)(4)-3, or 1.401(a)(4)-8. Furthermore, because a DB/DC plan contains a defined benefit plan, it must be tested on the basis of employees' aggregate normal as well as most valuable allocation or accrual rates, unless all of the defined benefit plans in the DB/DC plan satisfy the requirements to use the alternative test in §1.401(a)(4)-3(c)(2). Thus, a DB/DC plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits only if it satisfies §1.401(a)(4)-8(c)(1) with respect to the aggregate normal and most valuable allocation rates of the employees in the plan, or if it satisfies §1.401(a)(4)-3(c)(1) (or §1.401(a)(4)-3(c)(2), if applicable) with respect to the aggregate normal and most valuable accrual rates of the employees in the plan. Paragraph (b)(2)(ii) of this section provides the exclusive rules for determining employees' aggregate normal and most valuable allocation rates under a DB/DC plan. Paragraph (b)(2)(iii) of this section provides the exclusive rules for determining employees' aggregate normal and most valuable accrual rates under a DB/DC plan. Paragraphs (b)(2)(iv) and (b)(2)(v) of this section provide additional special rules applicable in determining whether a DB/DC plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits.

(ii) Determination of aggregate allocation rates. An employee's aggregate normal allocation rate for a plan year under a DB/DC plan is the sum of the employee's allocation rate for the plan year under all defined contribution plans included in the DB/DC plan, determined under §1.401(a)(4)-2(c)(2) by treating the defined contribution plans as a single plan, and the employee's equivalent normal allocation rate for the plan year under all defined



benefit plans included in the DB/DC plan, determined under §1.401(a)(4)-8(c)(2)(i) by treating the defined benefit plans as a single plan. An employee's aggregate most valuable allocation rate for the plan year under the DB/DC plan is the sum of the employee's allocation rate for the plan year under all defined contribution plans included in the DB/DC plan, determined under §1.401(a)(4)-2(c)(2) by treating the defined contribution plans as a single plan, and the employee's equivalent most valuable allocation rate for the plan year under all defined benefit plans included in the DB/DC plan, determined under §1.401(a)(4)-8(c)(2)(ii) by treating the defined benefit plans as a single plan.

(iii) Determination of aggregate accrual rates--(A) Annual method. If the annual method is used, an employee's aggregate normal accrual rate for a plan year under a DB/DC plan is the sum of the employee's normal accrual rate for the plan year under all defined benefit plans included in the DB/DC plan, determined under the annual method of §1.401(a)(4)-3(d)(2)(i) by treating the defined benefit plans as a single plan, and the employee's equivalent normal accrual rate for the plan year under all defined contribution plans included in the DB/DC plan, determined under the annual method of §1.401(a)(4)-8(b)(2)(i) by treating the defined contribution plans as a single plan. An employee's aggregate most valuable accrual rate for the plan year under the DB/DC plan is the sum of the employee's most valuable accrual rate for the plan year under all defined benefit plans



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included in the DB/DC plan, determined under the annual method of §1.401(a)(4)-3(d)(2)(ii) by treating the defined benefit plans as a single plan, and the employee's equivalent most valuable accrual rate for the plan year under all defined contribution plans included in the

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DB/DC plan, determined under the annual method of §1.401(a)(4)-8(b)(2)(i) by treating the defined contribution plans as a single plan.

(B) Accrued-to-date method. If the accrued-to-date method is used, an employee's aggregate normal accrual rate for a plan year under a DB/DC plan is the sum of the employee's normal accrual rate for the plan year under all defined benefit plans included in the DB/DC plan, determined under the accrued-to-date method of §1.401(a)(4)-3(d)(3)(i) by treating the defined benefit plans as a single plan, and the employee's equivalent normal accrual rate for the plan year under all defined contribution plans included in the DB/DC plan, determined under the accrued-to-date method of §1.401(a)(4)-8(b)(2)(ii) by treating the defined contribution plans as a single plan. An employee's aggregate most valuable accrual rate for the plan year under the DB/DC plan is the sum of the employee's most valuable accrual rate for the plan year under all defined benefit plans included in the DB/DC plan, determined under the accrued-to-date method of §1.401(a)(4)-3(d)(3)(ii) by treating the defined benefit plans as a single plan, and the employee's equivalent most valuable accrual rate for the plan year under all defined contribution plans included in the DB/DC plan, determined under the accrued-to-date method of §1.401(a)(4)-8(b)(2)(ii) by treating the defined contribution plans as a single plan.

(C) Projected method. Neither the projected method in §1.401(a)(4)-3(d)(4) nor the fresh-start alternative for the projected method in §1.401(a)(4)-3(d)(6)(viii) may be used to determine aggregate accrual or allocation rates under a DB/DC plan.

(iv) Treatment of permitted disparity. A DB/DC plan may impute permitted disparity under the rules of §1.401(a)(4)-7 only after calculating employees' aggregate accrual or

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equivalent allocation rates under paragraphs (b)(2)(ii) or (iii) of this section. In the case of a DB/DC plan being tested on a benefits basis, the rules of §1.401(a)(4)-7(c) must be applied. Thus, each employee's aggregate normal and most valuable accrual rates determined in paragraph (b)(2)(iii) of this section must be substituted respectively for the employee's unadjusted accrual rate as defined in §1.401(a)(4)-7(c)(4)(vi). In the case of a DB/DC plan being tested on the basis of equivalent contributions, the rules of §1.401(a)(4)-7(b) must be applied. Thus, each employee's aggregate normal and most valuable allocation rates determined in paragraph (b)(2)(ii) of this section must be substituted respectively for the employee's unadjusted allocation rate as defined in §1.401(a)(4)-7(b)(4)(iv).

(v) Consistency requirements—(A) In general. Notwithstanding the fact that aggregate normal and most valuable accrual and allocation rates under a DB/DC plan must be separately determined with respect to the defined benefit plans and defined contribution plans in the DB/DC plan, each separately-determined rate must be determined on a consistent basis as if the DB/DC plan were a single plan. Thus, for example, the same definition of testing compensation and the same actuarial assumptions must be used.

(B) Use of optional calculation methods. Except as otherwise provided in this paragraph (b), any optional methods for determining allocation or accrual rates that would be available to a single plan may generally be used in determining allocation or accrual rates under a DB/DC plan, provided that the optional methods selected are applied on a consistent basis to all employees in the DB/DC plan. Examples of options that may be used on a consistent basis under this rule include alternative methods of determining testing compensation under §1.401(a)(4)-3(e) or plan year compensation under §1.401(a)(4)-12, and

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options to determine accrual or equivalent accrual rates based on benefits accrued or allocations made for plan years after a fresh-start date as provided in §1.401(a)(4)-3(d)(6)(vii) or 1.401(a)(4)-8(b)(2)(ii)(B). Options that may not be used in testing a defined benefit plan on the basis of equivalent contributions under §1.401(a)(4)-8 may not be used in testing a DB/DC plan, however, regardless of whether the plan is being tested on a contributions or benefits basis. Thus, for example, a DB/DC plan may not use any actuarial assumptions available under §1.401(a)(4)-3(d)(5)(iii)(B) other than a standard interest rate and a standard

mortality table, may not disregard plan provisions providing for actuarial increases after normal retirement age under §1.401(a)(4)-3(f)(3), and may not compute benefits other than on a plan-year basis under §1.401(a)(4)-3(f)(6). Further, a DB/DC plan must determine the amount of employer-provided benefits using the rules in §1.401(a)(4)-6(b)(1) (section 411(c) method), (b)(5) (government plan method) or (b)(6) (cessation-of-employee-contributions method). In addition, if a DB/DC plan is using one of the fresh-start options in §1.401(a)(4)-3(d)(6)(vii) or (viii), the method provided in §1.401(a)(4)-13(d) for adjusting an employee's frozen accrued benefit is not available under the plan.

(3) Special rules for demonstrating nondiscrimination in availability of non-core benefits, rights, and features--(i) In general. Non-core benefits, rights, and features provided under a DB/DC plan are permitted to satisfy the nondiscriminatory availability requirements of §1.401(a)(4)-4 under the special rules in this paragraph (b)(3). For this purpose, non-core benefits, rights and features are benefits, rights, and features other than single sum benefits, loans, ancillary benefits, and benefit commencement dates (including the availability of in-service withdrawals).



(ii) Current availability. A DB/DC plan satisfies §1.401(a)(4)-4(b)(1) with respect to the current availability of non-core benefits, rights, and features if--

(A) Each of the non-core benefits, rights, and features that is currently available to any highly compensated employee under any defined contribution plan included in the DB/DC plan is also currently available either to a group of employees that satisfies the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory classification test of §1.410(b)-4 (without regard to the average benefit percentage test in §1.410(b)-5), or to all nonhighly compensated employees in all defined contribution plans included in the DB/DC plan; and

(B) Each of the non-core benefits, rights, and features that is currently available to any highly compensated employee under any defined benefit plan included in the DB/DC plan is also currently available either to a group of employees that satisfies the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory classification test of §1.410(b)-4 (without regard to the average benefit percentage test in §1.410(b)-5), or to all nonhighly compensated employees in all defined benefit plans included in the DB/DC plan.

(iii) Effective availability. The fact that a non-core benefit, right, or feature is provided under one type of plan included in a DB/DC plan (i.e., defined benefit or defined contribution), and therefore may be difficult or impossible to provide under the other type of plan included in the DB/DC plan, is one of the facts that is considered in determining whether the plan satisfies the effective availability requirement of §1.401(a)(4)-4(c)(1).

(c) Plan restructuring--(1) General rule. A plan may be treated, in accordance with this paragraph (c), as consisting of two or more component plans for purposes of determining whether the plan satisfies section 401(a)(4). If each of the component plans of a plan



satisfies all of the requirements of sections 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying section 401(a)(4). Paragraph (c)(2) of this section describes how component plans are identified. Paragraphs (c)(3) and (c)(4) of this section provide special rules for determining whether a component plan satisfies sections 401(a)(4) and 410(b), respectively. Additional rules and examples are contained in paragraphs (c)(5) and (c)(6) of this section, respectively.

(2) Identification of component plans. A plan may be restructured into component plans, each consisting of all the allocations, accruals, and other benefits, rights, and features provided to a selected group of employees in the plan. Any criteria may be used to select the group of employees used for this purpose, and these criteria may be changed from plan year to plan year. Thus, for example, employees may be grouped together based on employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method (e.g., salaried or hourly), coverage under the same allocation or benefit formula, or any other attribute or method of classification, regardless of whether the classification would be considered reasonable under the nondiscriminatory classification test of §1.410(b)-4. Every employee in the plan must be included in one and only one component plan under the same plan for a plan year.

(3) Satisfaction of section 401(a)(4) by a component plan--(i) General rule. The rules



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applicable in determining whether a component plan satisfies section 401(a)(4) are the same as those applicable to a plan. Thus, for this purpose, any reference to a "plan" in section 401(a)(4) and the regulations thereunder (other than this paragraph (c)) is interpreted as a

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reference to a "component plan." For example, any rules relevant to the determination of allocation or accrual rates for testing purposes, including the rules for determining an employee's normal and most valuable accrual rates in §1.401(a)(4)-3(d), the grouping rules in §§1.401(a)(4)-2(c)(5) and 1.401(a)(4)-3(d)(6)(iv), and the cross-testing rules in §1.401(a)(4)-8, are applied only after restructuring. Whether a component plan satisfies the uniformity and other requirements applicable to safe harbor plans under §§1.401(a)(4)-2(b) and 1.401(a)(4)-3(b) is determined taking into account the entire benefit formula and any other plan provisions actually or potentially applicable to employees in a component plan, regardless of whether all of these provisions actually apply to the employees in the component plan for the current plan year (e.g., in the case of a component plan covering only short-service employees under a benefit formula providing higher accrual rates for employees with longer service).

(ii) Certain testing rules involving averaging. The safe harbor in §1.401(a)(4)-2(b)(4) for plans with uniform points allocation formulas, and the special nondiscrimination tests in sections 401(k)(3) and 401(m)(2) for elective, employee, and matching contributions, are not available in testing contributions under a component plan. Thus, for example, elective contributions under a cash or deferred arrangement may not be tested under section 401(k)(3) if the plan of which it is a part is restructured into component plans. Under §1.401(k)-1(a)(4)(i), a cash or deferred arrangement that does not satisfy section 401(k)(3) is not a qualified cash or deferred arrangement. See also §1.401(k)-1(b)(3)(iii). Further, since section 401(m)(2) provides the exclusive means for a plan to satisfy section 401(a)(4) with respect to the amount of employee contributions allocated to separate accounts and matching

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contributions, a plan that is restructured into component plans cannot satisfy section 401(a)(4) if such contributions are made to it.

(4) Satisfaction of section 410(b) by a component plan--(i) General rule. The rules applicable in determining whether a component plan satisfies section 410(b) are the same as those applicable to a plan, with the following modifications--

(A) The permissive aggregation rules of §1.410(b)-7(d) are not available to a component plan. Thus, for example, two or more component plans may not be permissively aggregated for purposes of section 401(a)(4), or for purposes of the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory classification test of §1.410(b)-4, even though they may be formed from a plan that consists of two or more plans that were permissively aggregated under §1.410(b)-7(d).

(B) A component plan satisfies the average benefit percentage test of §1.410(b)-5 if the plan of which it is a part satisfies §1.410(b)-5 (applied without regard to §1.410(b)-5(f)). In the case of a component plan that is part of a plan that relies on §1.410(b)-5(f) to satisfy the average benefit percentage test, the component plan satisfies the average benefit percentage test (if applicable) only if the component plan separately satisfies §1.410(b)-5(f)).

(ii) Relationship to satisfaction of section 410(b) by the plan. Satisfaction of section 410(b) by a component plan is relevant solely for purposes of determining whether the plan of which it is a part satisfies section 401(a)(4). The plan must still independently satisfy section 410(b) in order to be a qualified plan. Similarly, satisfaction of section 410(b) by a plan is relevant solely for purposes of determining whether the plan satisfies section 410(b). Thus, for example, a component plan that does not satisfy the ratio percentage test of

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§1.410(b)-2(b)(2) must still satisfy the average benefit test of §1.410(b)-2(b)(3) (including the nondiscriminatory classification test of §1.410(b)-4 and the average benefit percentage test of §1.410(b)-5), even though the plan of which it is a part satisfies the ratio percentage test.

(5) Effect of restructuring under other sections. The restructuring rules provided in this paragraph (c) apply solely for purposes of sections 401(a)(4) and 401(*l*), and those portions of sections 410(b), 414(s), and any other provisions that are specifically applicable in determining whether the requirements of section 401(a)(4) are satisfied. Thus, for example, a component plan is not treated as a separate plan under section 401(a)(26).



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(6) Examples. The following examples illustrate the rules of this paragraph (c).

Example 1. Employer X maintains a defined benefit plan. The plan provides a normal retirement benefit equal to 1 percent of average annual compensation times years of service to employees at Plant M, and 1.5 percent of average annual compensation times years of service to employees at Plant N. Under paragraph (c)(2)(i) of this section, the plan may be treated as consisting of two component defined benefit plans, one providing retirement benefits equal to 1 percent of average annual compensation times years of service to the employees at Plant M, and another providing benefits equal to 1.5 percent of average annual compensation times years of service to employees at Plant N. If each component plan satisfies sections 401(a)(4) and section 410(b) as if it were a separate plan under the rules of this paragraph (c), then the entire plan satisfies section 401(a)(4).

Example 2. The facts are the same as in Example 1, except that Employer X also maintains another defined benefit plan providing a normal retirement benefit equal to 2 percent of career average compensation times years of service to employees at Plant O. If the plan covering employees at Plants M and N were aggregated with the plan covering employees at Plant O under section 410(b), the aggregated plan could then be restructured into component plans. For example, the aggregated plan could be treated as consisting of two plans, one providing a normal retirement benefit equal to 1 percent of average annual compensation times years of service to employees at Plant M and 2 percent of career average compensation times years of service at Plant O, and another providing a normal retirement benefit equal to 1.5 percent of average annual compensation to employees at Plant N. If each component plan satisfied sections 401(a)(4) and section 410(b) as if it were a separate plan under the rules of this paragraph (c), then the entire aggregated plan would satisfy section 401(a)(4).

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Example 3. Employer Y maintains Plan P, a defined benefit plan, for its Employees A, B, C, D, E and F. Plan P provides benefits under a uniform formula that satisfies the requirements of §1.401(a)(4)-3(b)(2) and (b)(3) before it is amended on February 14, 1994. The amendment provides an early retirement window benefit that is a subsidized optional form of benefit under §1.401(a)(4)-3(b)(2)(iv) and that is available on the same terms to all employees who satisfy the eligibility requirements for the window. The early retirement window benefit is available only to employees who retire between June 1, 1994, and December 31, 1994. Assume that Employees A, B, and C will be eligible to receive the window benefit by the end of the window period and Employees D, E, and F will not. Because substantially all employees in the plan will not satisfy the eligibility requirements for the early retirement window benefit by the close of the early retirement window benefit period, Plan P fails to satisfy the uniform subsidies requirement of §1.401(a)(4)-3(b)(2)(iv). See §1.401(a)(4)-3(b)(2)(vii), Example 7. Under paragraph (c)(2)(i) of this section, Employees A, B, C, D, E, and F may be grouped into two component plans, one consisting of employees A, B, and C and all their accruals and other benefits, rights, and features under the plan (including the early retirement window benefit), and another consisting of employees D, E, and F, and all their accruals and other benefits, rights, and features under the plan. Each of the component plans identified in this manner satisfies the uniform subsidies requirement of §1.401(a)(4)-3(b)(2)(iv), and thus satisfies the requirements of §1.401(a)(4)-3(b). If each of these component plans also satisfies section 410(b) (including, if applicable, the reasonable classification requirement of §1.410(b)-4(b)) as if it were a separate plan under the rules of this paragraph (c), then the entire plan satisfies section 401(a)(4).

Example 4. Employer Z maintains Plan Q, a defined benefit plan with a benefit formula that provides 2 percent of average annual compensation for each year of service up to 20 to each employee in the plan. Assume that Plan Q would satisfy the unit credit fractional rule safe harbor in §1.401(a)(4)-3(b)(4), except that some employees in the plan accrue a portion of their normal retirement benefit in the current plan year that is more than 1/3 larger than the portion of the same benefit accrued by other employees in the plan for the current plan year, and the plan therefore fails to satisfy the 1/3-larger requirement of §1.401(a)(4)-3(b)(4)(i)(C). Employer Z restructures Plan Q into two plans, one covering employees with 30 years or less of service at normal retirement age, and the other covering all other employees in the plan. Each component plan would separately satisfy the 1/3-larger requirement of §1.401(a)(4)-3(b)(4)(i)(C) if the only employees taken into account were those employees included in the component plan in the current plan year. Under paragraph (c)(3)(i) of this section, however, the component plans do not satisfy the 1/3-larger requirement, and hence fail to satisfy the unit credit fractional rule safe harbor in §1.401(a)(4)-3(b)(4), because the safe harbor determination is made taking into account the effect of the plan benefit formula on any potential employee, and not just those employees in the component plan in the current plan year.

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§1.401(a)(4)-10 Testing of former employees.

(a) Introduction--(1) General rule. The requirements of section 401(a)(4) with respect to the amount of contributions and benefits and the availability of benefits, rights, and features under a plan apply separately to employees and former employees. See §1.401(a)(4)-1(c)(3). This section contains rules for applying those requirements to former employees. None of the other requirements of section 401(a)(4) applies separately to employees and former employees.

(2) Overview. Rules for determining whether a plan satisfies section 401(a)(4) with respect to the amount of contributions or benefits provided to former employees under the plan are set forth in paragraph (b) of this section. Rules for determining whether a plan satisfies section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees under the plan are set forth in paragraph (c) of this section. A plan may satisfy any of the tests in paragraphs (b) or (c) of this section on a restructured basis, pursuant to §1.401(a)(4)-9(c).

(b) Nondiscrimination in amount of contributions or benefits--(1) General rule. A plan must separately satisfy §1.401(a)(4)-1(b)(2) with respect to the amount of contributions or benefits provided to former employees. A plan under which no former employee currently benefits is deemed to satisfy this requirement. Whether a former employee currently benefits under a plan is determined under §1.410(b)-3(b).

(2) Defined contribution plans. Because of the application of the limitations of section 415, a defined contribution plan generally cannot provide an allocation to a former employee, except under section 415(c)(3)(C) (regarding permanent and total disability). Because

allocations under section 415(c)(3)(C) may not be provided to highly compensated former employees, allocations made under that section automatically satisfy §1.401(a)(4)-1(b)(2).

(3) Defined benefit plans--(i) General rule. A defined benefit plan satisfies §1.401(a)(4)-1(b)(2) with respect to the amount of contributions or benefits provided to former employees if the plan satisfies the unit credit safe harbor requirements of §1.401(a)(4)-3(b)(3) (including the uniformity requirements of §1.401(a)(4)-3(b)(2)), the general test of §1.401(a)(4)-3(c) (using the annual method in §1.401(a)(4)-3(d)(2) to determine accrual rates), or the general test of §1.401(a)(4)-8(c)(1), with respect to these contributions or benefits. Only benefit accruals arising out of a former employee's status as a former employee are taken into account in determining whether these requirements are satisfied. In applying §§1.401(a)(4)-3 and 1.401(a)(4)-8 for purposes of this paragraph (b), the terms "highly compensated former employee" and "nonhighly compensated former employee" are substituted for the terms "highly compensated employee" and "nonhighly compensated employee" where those terms appear in those sections. Paragraphs (b)(3)(ii) through (iv) of this section provide certain special rules for applying the safe harbor tests, the general tests, and permitted disparity provisions to former employees.

(ii) Special rules for applying safe harbor tests--(A) Compensation requirements. In order to satisfy the unit credit safe harbor in §1.401(a)(4)-3(b)(3) with respect to benefits that are determined as a percentage of average annual compensation, the average annual compensation of a former employee must be determined as of the date the individual most recently became a former employee.



(B) Option to apply safe harbors on aggregate basis. Notwithstanding the rules of §1.401(a)(4)-1(c)(3) (requiring separate testing of former employees), a plan satisfies the requirements of §1.401(a)(4)-1(b)(2) with respect to accruals provided to former employees in a plan year if the accruals provided to the former employees, when added to their previously accrued benefits (including accruals attributable to their status as employees), satisfy the unit credit safe harbor requirements of §1.401(a)(4)-3(b)(3) (including the uniformity requirements of §1.401(a)(4)-3(b)(2)).

(iii) Special rules for applying general tests--(A) In general. A former employee's accrual rate for purposes of the general tests of §1.401(a)(4)-3(c) or 1.401(a)(4)-8(c)(1) must be determined subject to the modifications described in paragraphs (b)(3)(iii)(B) through (D) of this section.

(B) Compensation for former employees. A former employee's testing compensation for purposes of §1.401(a)(4)-3(d)(2), or plan year compensation for purposes of §1.401(a)(4)-8(c)(2), is generally determined in the same manner as it would be if the former employee were an employee, except that it is determined as of the date the individual most recently became a former employee. In applying the rules for determining accrual and equivalent allocation rates in §§1.401(a)(4)-3(d)(2) and 1.401(a)(4)-8(c)(2), however, the modifications to plan year compensation provided in §1.401(a)(4)-3(e)(3)(ii)(A) and (B) must be applied. In addition, an employer may use the former employee's compensation as determined under the plan as of the plan year in which the individual most recently became a former employee in lieu of the testing compensation or plan year compensation otherwise required under §§1.401(a)(4)-3(d)(2) and 1.401(a)(4)-8(c)(2), provided that any compensation used to



determine the employee's compensation under the plan as of that plan year is section 414(s) compensation. If the option in the preceding sentence is used to determine any former employee's accrual or equivalent allocation rates for a plan year, it must be applied consistently to determine the accrual or equivalent allocation rates of all former employees in the plan for that plan year.

(C) Testing service for former employees. A former employee's accrual rate determined under §§1.401(a)(4)-3(d)(2) and 1.401(a)(4)-8(c)(2) may be adjusted by dividing the rate by the former employee's testing service (or the former employee's testing service after a fresh-start date), determined as of the date the former employee most recently became a former employee.

(D) Special section 410(b) test for former employees. In determining whether a rate group (within the meaning of §1.401(a)(4)-3(c) or 1.401(a)(4)-8(c)(1)) consisting of former

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employees satisfies section 410(b), the special rule in §1.410(b)-2(c)(2)(ii) may be applied.

(iv) Permitted disparity. The provisions of section 401(*l*) and §1.401(a)(4)-7 generally apply to benefits provided to former employees in the same manner as those provisions apply to employees. Thus, for example, for purposes of determining a former employee's cumulative permitted disparity limit, the sum of the former employee's total annual disparity fractions (within the meaning of §1.401(*l*)-5) as an employee continue to be taken into account. However, the permitted disparity rate applicable to a former employee is determined under §1.401(*l*)-3(e) as of the age the former employee commenced receipt of benefits, not as of the date the employee receives the accrual for the current plan year.

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(4) Safe harbor for ad hoc cost-of-living adjustments--(i) General rule. A defined benefit plan satisfies section 401(a)(4) with respect to the amount of any ad hoc cost-of-living adjustment (an "ad hoc COLA") provided to former employees if the ad hoc COLA increases the benefits of each former employee in the plan on a consistent basis. For purposes of this paragraph (b)(4), an ad hoc COLA may not provide for additional increases in benefits in plan years after the plan year in which the ad hoc COLA is provided. The percentage increase in a former employee's benefits under the ad hoc COLA may not exceed the social security increase. For this purpose, "social security increase" means the percentage increase in social security benefits under section 215(i)(2)(A) of the Social Security Act for the period that begins with the date the former employee commenced receipt of benefits and that ends on the date in the current plan year on which the ad hoc COLA first applies, less the percentage increase provided to the former employee under any automatic COLA or any prior ad hoc COLA under the plan. An ad hoc COLA that exceeds the social security increase for the applicable period is tested under the general rule of paragraph (b)(1) of this section.

(ii) Uniformity requirements. An ad hoc COLA increases benefits on a consistent basis for purposes of this paragraph (b)(4) if it applies the social security increase to the periodic benefit of all former employees in the plan. An ad hoc COLA may provide a percentage increase that is less than the social security increase, if the method of determining the percentage increase is consistent for all former employees in the plan, and if the ad hoc COLA provides the same percentage increase to all former employees in the plan who commenced receipt of benefits in the same calendar or plan year. Thus, for example, an

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employer may provide an ad hoc COLA based on any of the following percentages: the annual rate of social security increase minus a percentage point, the annual rate of social security increase capped at a given percentage, a specified percentage (less than 100 percent) of the social security increase, or a fixed percentage increase for each year in the period. Similarly, the ad hoc COLA may be limited to the social security increase otherwise allowed under this paragraph (b)(4)(ii) for the period since a date or an age specified in the plan.

(iii) Banding options. In determining the year in which a former employee commenced receipt of benefits for purposes of this paragraph (b)(4), former employees may be grouped into bands (not to exceed 5 consecutive calendar years each) based on the years in which the former employees in the band commenced receipt of benefits. If this option is used, all former employees in each band may be treated as if they commenced receipt of benefits in the most recent year in the band. Thus, for example, all former employees who commenced receipt of benefits under the plan in calendar years 1975-1979 may be grouped into a band, may be treated as if they had commenced receipt of benefits in 1979, and thus may be provided the same percentage increase in their benefits. In addition, the average annual rate of social security increase during the years within a band may be treated as the annual social security increase for each year within the band.

(iv) Examples. The following examples illustrate the safe harbors in this paragraph (b)(4). In each example, the plan does not contain an automatic COLA, and it has never before granted an ad hoc COLA for former employees.

Example 1. Plan A provides an ad hoc COLA for all former employees in the amount of 3 percent per year since commencement of benefits. The annual rate of social security increase since each year that a former employee commenced receipt of benefits was at least 3 percent. Plan A satisfies the safe harbor of this paragraph (b)(4).

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Example 2. The facts are the same as in Example 1, except that the plan bands all former employees into 3-year bands for purposes of determining former employee's benefit commencement dates. Thus, for example, all former employees who commenced benefits 7-



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9 years prior to the amendment are treated as commencing benefits 7 years prior to the amendment and are then entitled to a benefit increase of 21 percent. Plan A satisfies the safe harbor of this paragraph (b)(4).

Example 3. Plan B provides an ad hoc COLA for all former employees in the following amounts: 3 percent per year for each of the first 5 years preceding the date of the amendment granting the ad hoc COLA (the "amendment date"); 6 percent per year for the sixth through tenth years preceding the amendment date; and 9 percent per year for the eleventh through fifteenth years preceding the amendment date. Thus, for example, a former employee who commenced receipt of benefits 2 years before the amendment date will receive an increase of 6 percent (3 percent x 2 years); and a former employee who commenced receipt of benefits 15 years before the amendment date will receive an increase of 90 percent ((3 percent x 5 years) + (6 percent x 5 years) + (9 percent x 5 years)). Assume that the average annual rate of social security increase during the 5 years prior to the amendment date was 3 percent, the average annual rate of social security increase during the 6-10 years prior to the amendment date was 6 percent, and the average annual rate of social security increase during the 11-15 years prior to the amendment date was 9 percent. In determining the social security increase for former employees, former employees are grouped into bands of 5 years each, and the average annual rate of social security increase for all years within the band is treated as the annual rate of social security increase for each year in the band. Because the ad hoc COLA provides for percentage increases equal to the social security increase to all former employees, Plan B satisfies the safe harbor of this paragraph (b)(4).

Example 4. The facts are the same as in Example 3, except that the ad hoc COLA increases benefits for all former employees in the amount of 5 percent per year since benefit commencement. Plan B does not satisfy the safe harbor of this paragraph (b)(4), because the ad hoc COLA exceeds the social security increase for those former employees who commenced receipt of benefits less than 5 years before the amendment date.

(c) Nondiscrimination in availability of benefits, rights, or features--(1) General rule. A plan satisfies section 401(a)(4) with respect to the availability of benefits, rights, and features provided to former employees if the plan satisfies §1.401(a)(4)-4 with respect to those benefits, rights, or features. In determining whether a group of former employees to whom a benefit, right, or feature is currently available satisfies section 410(b), the safe harbor testing method in §1.410(b)-2(c)(2)(ii) may be applied.

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(2) No change in availability. A plan satisfies section 401(a)(4) with respect to the availability of a benefit, right, or feature provided to any former employee in the plan if no change in the availability of the benefit, right, or feature has been made that is first effective in the current plan year with respect to a former employee.

(3) Changes in availability. A plan satisfies section 401(a)(4) with respect to the availability of a benefit, right, or feature provided to any former employee if any change in the availability of the benefit, right, or feature that is first effective in the current plan year with respect to a former employee is made in a nondiscriminatory manner. Thus, any expansion in the availability of the benefit, right, or feature to any highly compensated former employee in the plan must be applied on a consistent basis to all nonhighly compensated former employees in the plan. Similarly, any contraction in the availability of the benefit, right, or feature that affects any nonhighly compensated former employee in the plan must be applied on a consistent basis to all highly compensated former employees in the plan.

(4) Plan loans. For purposes of demonstrating that a plan satisfies section 401(a)(4) with respect to the availability of loans provided to former employees, an employer may test as employees those former employees who are parties in interest within the meaning of section 3(14) of the Employee Retirement Income Security Act of 1974.

(5) Employees terminated before a specified date. In applying the rule of §1.410(b)-6(h)(2) (permitting certain former employees who became former employees before 1984 or more than 10 years before the current year to be excluded) for purposes of this paragraph (c), a former employee is treated as currently benefiting under the plan only if there has been

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a change in the current plan year in the availability of any benefit, right, or feature provided to the former employee.

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§1.401(a)(4)-11 Additional rules.

(a) Introduction. This section contains additional rules for determining whether a plan satisfies section 401(a)(4). Paragraph (b) of this section contains rules for the treatment of the portion of an employee's accrued benefit or account balance that is attributable to rollovers and transfers between plans. Paragraph (c) of this section contains rules relating to vesting. Paragraph (d) of this section contains rules relating to crediting service. Paragraph (e) of this section, regarding family aggregation, is reserved. Paragraph (f) of this section, regarding governmental plans, is reserved. Paragraph (g) of this section provides rules regarding the extent to which retroactive amendments may be made for purposes of section 401(a).

(b) Rollovers and transfers--(1) Rollovers and elective transfers. The portion of an



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employee's accrued benefit or account balance that is attributable to rollover contributions described in section 402(a)(5), 403(a)(4), or 408(d)(3), or to elective transfers described in §1.411(d)-4, Q&A-3(b), are not taken into account in determining whether the transferee plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2).

(2) Other transfers. [Reserved]

(c) Vesting--(1) In general. A plan does not satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) if the manner in which employees vest in their accrued benefits discriminates in favor of highly compensated employees. This determination is made after taking into account any relevant provisions of sections 401(a)(5)(E), 411(d)(1), 411(d)(2), and 411(e). For purposes of this paragraph (c), the manner in which employees vest in their accrued benefits also is determined taking into account any plan provision that



directly effects the nonforfeitability of employees' accrued benefits (e.g., plan provisions regarding suspension of benefits permitted under section 411(a)(3)(B)).

(2) Deemed equivalence of statutory vesting schedules. For purposes of this paragraph (c), when two or more plans with different vesting schedules are permissively aggregated under §1.410(b)-7(d), the minimum vesting rates required under the vesting schedules in section 411(a)(2)(A) and (B) are treated as equivalent to one another, and the minimum vesting rates required under the vesting schedules in section 416(b)(1)(A) and (B) are treated as equivalent to one another. Thus, for example, Plan A, covering an employer's nonhighly compensated employees and providing full vesting after completion of 5 years of service, and Plan B, covering the same employer's highly compensated employees and providing graded vesting according to the schedule in section 411(a)(2)(B), do not fail to satisfy section 401(a)(4) when treated as a single plan merely because of this difference in vesting schedules.

(d) Crediting service--(1) In general. A plan does not satisfy the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) if the manner in which employees' service is credited for any purpose under the plan discriminates in favor of highly compensated employees.

(2) Absence from service--(i) General rule. A plan does not fail to satisfy this paragraph (d) merely because it credits service during a period of absence from service if the service ("imputed service") satisfies the requirements specified in paragraph (d)(2)(ii) of this section.



(ii) Requirements for crediting service during absence from service--(A) Definition of absence from service. For the period during which imputed service is credited to an employee, the employee must be absent from service for a reason other than termination from employment with the employer maintaining the plan. For this purpose, if an employee continues to perform services for the employer during the period, the employee is not absent from service.

(B) Uniformity. Any provision in the plan for crediting imputed service while an employee is absent from service must be applied uniformly to all employees in the plan.

(C) Effective availability. For purposes of applying the effective availability requirement of §1.401(a)(4)-4(c) to the right to imputed service credits under the plan, the manner in which the employer grants absences from service that give rise to imputed service is taken into account.

(D) Period of credited service. In the case of imputed service credited for a period during which an employee is absent from service for any reason other than military duty or jury duty, the maximum period for which imputed service may be credited is the shorter of 6 months or the duration of the absence. If an employee is absent from service for military duty or jury duty, imputed service may be credited to the employee for up to the entire period of the military duty or jury duty even if the period exceeds 6 months.

(E) Amount of imputed service. The amount of imputed service credited during a period of absence from service is not greater than the service with which the employee would reasonably have been expected to have been credited during the period if the employee had continued to perform services.

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(iii) Elapsed time. Notwithstanding paragraphs (d)(2)(i) and (ii) of this section, if the plan is crediting service using elapsed time in accordance with §1.410(a)-7, the amount of service credited for an employee's absence from service must not be less than the amount of service required to be credited under §1.410(a)-7.

(e) Family aggregation rules. [Reserved]

(f) Governmental plans. [Reserved]

(g) Retroactive correction--(1) In general. Section 401(a)(4)-1(c)(9)(i) provides that the requirements for determining whether a plan satisfies section 401(a)(4) are generally applied on a plan year basis, taking into account the terms of the plan in effect and the employer's employee demographics during the plan year. Notwithstanding this requirement, this paragraph (g) provides rules for retroactively amending a plan after the close of the plan year for purposes of satisfying section 401(a) for the plan year. These rules apply in addition to the rules of section 401(b). Paragraph (g)(2) of this section describes the scope of the retroactive amendments that are permitted to be made. Paragraph (g)(3) of this section specifies the conditions under which a retroactive amendment may be made. Paragraph (g)(4) of this section provides a rule prohibiting retroactive amendments that benefit terminated nonvested employees from being taken into account for certain purposes. Paragraph (g)(5) of this section discusses the effect of the retroactive amendments permitted under this paragraph (g) under provisions other than section 401(a).

(2) Scope of retroactive amendments--(i) Minimum coverage and nondiscrimination in amount of contributions or benefits. For purposes of satisfying the minimum coverage requirements of section 410(b) or the nondiscriminatory amount requirement of §1.401(a)(4)-



1(b)(2), a plan may be retroactively amended to increase accruals or allocations for employees who benefited under the plan during the preceding plan year, or to grant accruals or allocations to employees who did not benefit under the plan during the preceding plan year. For purposes of this paragraph (g), the term "employee" means an individual who was an employee within the meaning of §1.410(b)-9 in the preceding plan year.

(ii) Nondiscriminatory availability of benefits, rights, and features. A plan may not be retroactively amended to make available to an employee a benefit, right, or feature under the plan that previously was not available to the employee solely to meet the nondiscriminatory availability requirements of §1.401(a)(4)-4. An employer may, however, make available to an employee a benefit, right, or feature that is directly related to an increase in the amount of an employee's accrual or allocation (including a grant of accruals or allocations to an employee who otherwise would not be treated as benefiting under the plan).

(iii) Nondiscriminatory effect of plan amendments and terminations. A plan may be retroactively amended to correct a discriminatory plan amendment so that the plan satisfies the requirements of §1.401(a)(4)-5(a). A plan may not, however, be retroactively amended to correct for a failure to incorporate the pre-termination restrictions of §1.401(a)(4)-5(b).

(iv) Special rules for section 401(k) and 401(m) plans. A plan may not be retroactively amended under this paragraph (g) to correct for a failure to satisfy the actual deferral percentage test of section 401(k)(3) or the actual contribution percentage test of section 401(m)(2). See §§1.401(k)-1(f) and 1.401(m)-1(e) for rules on correcting a violation of these tests. In addition, neither a section 401(k) plan nor a section 401(m) plan may be



retroactively amended under this paragraph (g) to extend eligibility under the plan to an employee for purposes of §1.410(b)-3(a)(2)(i) or 1.401(k)-1(b)(1)(i).

(3) Conditions for retroactive correction--(i) In general. A retroactive amendment is not permitted under this paragraph (g) unless it satisfies each of the requirements of paragraphs (g)(3)(ii) through (v) of this section.

(ii) Allocations or accruals only increased. The retroactive amendment may not result in a reduction to an employee's benefits (including any benefit, right, or feature) determined based on the terms of the plan in effect immediately before the amendment.

(iii) Amendment effective for all purposes. For purposes of determining an employee's rights and benefits under the plan, the retroactive amendment must be effective as if the amendment had been made on the first day of the preceding plan year. Thus,

increases in an employee's allocations or accruals, along with the associated benefits, rights, and features, must be increased to the level at which they would have been had the amendment been in effect for the entire preceding plan year.

(iv) Time when amendment must be adopted and put into effect--(A) In general. Any retroactive amendment intended to apply to the preceding plan year must be adopted and implemented before the 15th day of the 10th month after the close of the plan year in order to be taken into account for the preceding plan year.

(B) Determination letter requested by employer or plan administrator. If, on or before the end of the period set forth in paragraph (g)(3)(iv)(A) of this section, the employer or plan administrator files a request pursuant to §601.201(o) of this chapter (Statement of Procedural Rules) for a determination letter on the amendment, or the initial or continuing

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qualification of the plan, or the trust that is part of the plan, the period set forth in paragraph (g)(3)(iv)(A) of this section is extended in the same manner as provided for an extension of the remedial amendment period under §1.401(b)-1(d)(3).

(v) Retroactive amendment must separately satisfy sections 401(a)(4) and 410(b)--(A) General rule. Except as provided in paragraph (g)(3)(v)(B) of this section, the additional allocations or accruals resulting from the retroactive amendment of a plan must separately satisfy section 401(a)(4) for the preceding plan year and must benefit a group of employees that separately satisfies section 410(b) for the preceding plan year. In determining whether the additional allocations or accruals resulting from the retroactive amendment benefit a group of employees that separately satisfies section 410(b), the same rules apply as in determining whether a component plan separately satisfies section 410(b) under §1.401(a)(4)-9(c)(1)(i). Thus, for example, in applying the rules of this paragraph (g)(3)(v), an employer may not aggregate the additional accruals or allocations resulting from the retroactive amendment with the other accruals or allocations already provided under the terms of the plan as in effect during the plan year without regard to the retroactive amendment.

(B) Retroactive amendment to conform to safe harbor. The requirements of paragraph (g)(3)(v)(A) of this section need not be met if the retroactive amendment is for purposes of conforming the plan to one of the safe harbors in §1.401(a)(4)-2(b) or 1.401(a)(4)-3(b) (including for purposes of applying the requirements of those safe harbors under the optional testing methods in §1.401(a)(4)-8(b)(3) or (c)(3)), or ensuring that the plan continues to meet one of those safe harbors.

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(4) Retroactive amendments affecting terminated nonvested employees. A retroactive amendment is not taken into account in determining whether a plan satisfies section 401(a)(4) or 410(b) to the extent the amendment affects nonvested employees who terminated employment with the employer as of the close of the preceding year, and therefore would not have received any economic benefit from the amendment if it had been made in the prior year.

(5) Effect under other statutory requirements. A retroactive amendment under this paragraph (g) is effective only for purposes of section 401(a). Thus, for example, the retroactive amendment is effective not only for purposes of sections 401(a)(4) and 410(b), but also for purposes of determining whether the plan satisfies the requirements of sections 401(*l*) and 401(a)(26) for the preceding plan year. By contrast, the amendment is not given retroactive effect for purposes of section 404 (deductions for contributions of an employer to an employees' trust or annuity plan) or section 412 (minimum funding standards). Thus, the otherwise applicable rules for deductions and funding are not modified by the rules in this paragraph (g).

(6) Examples. The following examples illustrate the retroactive correction rules of this paragraph (g).

Example 1. Employer A maintains a calendar year defined benefit plan that for the 1992 plan year is tested for compliance with the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) under the general test of §1.401(a)(4)-3(c). In 1993, Employer A is concerned that for the 1992 plan year the plan will fail the requirement of §1.401(a)(4)-1(b)(2). Provided that any retroactive amendment meets the requirements of paragraph (g)(2) of this section, Employer A may retroactively amend the plan to increase accruals, and those increases will be taken into account in determining whether the plan will satisfy section 401(a)(4) for the 1992 plan year as to the amount of benefits.

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Example 2. Employer B maintains a calendar year defined benefit plan that in 1992, 1993, and 1994, satisfies the requirements of the alternative safe harbor for flat benefit plans

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in §1.401(a)(4)-3(b)(4). In 1996, Employer B determines that the plan will not satisfy that safe harbor for the 1995 plan year because the average of the normal accrual rates for all nonhighly compensated employees is less than 70 percent of the average of the normal accrual rates for all highly compensated employees. Provided the retroactive amendment would otherwise satisfy the requirements of this paragraph (g), Employer B may retroactively amend the plan to increase the number of nonhighly compensated employees in the plan so that the amended plan satisfies the safe harbor for the 1995 plan year. The retroactive amendment need not meet the requirements of paragraph (g)(3)(v)(A) of this section because Employer B is retroactively amending the plan to conform to a safe harbor in §1.401(a)(4)-3(d). See paragraph (g)(3)(v)(B) of this section.

Example 3. Employer C maintains a calendar year defined contribution plan covering all the employees in Division A and Division B. Under the plan, only employees in Division A have the right to direct the investments in their account. For plan years prior to 1994, the plan met the current availability requirement of §1.401(a)(4)-4(b) because the employees in Division A were a group of employees that satisfied the nondiscriminatory classification test of §1.410(b)-4. Because of attrition in the employee population in Division A in 1994, the group of employees to whom the right to direct investments is available no longer meets the nondiscriminatory classification test of §1.410(b)-4. Thus, the right to direct investments under the plan fails the current availability requirement of §1.401(a)(4)-4(b) for 1994. In 1995, Employer C cannot retroactively amend the plan to make the right to direct investments available to a group of employees that would meet the current availability requirement of §1.401(a)(4)-4(b).

Example 4. The facts are the same as in Example 3. In 1995, Employer C may amend the plan to benefit the employees in Division C as well as Divisions A and B so that the plan will meet the minimum coverage requirements of section 410(b). In increasing plan coverage, the right to direct investments may also be made available to the employees in Division C.

Example 5. Employer D maintains a defined contribution plan that covers all employees and that offsets an employee's benefit by the employee's projected primary insurance amount. The plan is not eligible to use the safe harbors under §1.401(a)(4)-3(b) because the plan does not meet the requirements of section 401(*l*). Under the plan, the accrual rates for all highly compensated employees (determined under the general test of §1.401(a)(4)-3(c)) for 1994 are less than 1.5 percent of testing compensation, and the accrual rates for all nonhighly compensated employees (determined under the general test of §1.401(a)(4)-3(c)) for 1994 are 2 percent of testing compensation. Employer D may not retroactively increase the contributions to the highly compensated employees under the plan so that they equal that of the nonhighly compensated employees, because such a retroactive amendment would not separately satisfy sections 410(b) and 401(a)(4) if it were treated as a



separate plan. This is the case even if, after taking the amendment into account, the plan would satisfy sections 410(b) and 401(a)(4) for the 1994 plan year.

Example 6. Employer E maintains two plans--Plan M and Plan N. Plan M satisfies the ratio percentage test of §1.410(b)-2(b)(2), but Plan N does not. Thus, in order to satisfy section 410(b), Plan N must satisfy the average benefits test of §1.410(b)-2(b)(3). The average benefit percentage of plan N is 60 percent. Employer E may increase the accruals under either Plan M or Plan N so that the average benefit percentage meets the 70 percent requirement of the average benefits test.

Example 7. Employer F maintains Plan O, which does not satisfy the requirements of section 401(a)(4) in a plan year. Under the terms of paragraph (g)(2) of this section, Employer F amends Plan O to increase the benefits of certain employees retroactively. In designing the amendment, Employer F identifies those employees who have terminated without vested benefits during the period after the end of the prior plan year and before the adoption date of the amendment, and the amendment provides increases in benefits primarily to those employees. It would be inconsistent with the purpose of preventing discrimination in favor of highly compensated employees for Plan O to treat the amendment as retroactively effective under this paragraph (g)(2). See §1.401(a)(4)-1(c)(2).

Example 8. Employer G maintains both a section 401(k) plan and a section 401(m) plan that provides matching contributions at a rate of 50 percent with respect to elective contributions under the section 401(k) plan. In plan year 1995, the section 401(k) plan fails to satisfy the actual deferral percentage test of section 401(k)(3). In order to satisfy section 401(k)(3), Employer G makes corrective distributions to highly compensated employees H1 through H10 of their excess contributions as provided under §1.401(k)-1(f). The matching contributions that H1 through H10 had received on account of their excess contributions are not forfeited, however. Thus, the effective rate of matching contributions provided to H1 through H10 is increased as a result of the corrective distributions. Since no nonhighly compensated employee in the section 401(m) plan is provided with an equivalent rate of matching contributions, the rate of matching contributions provided to H1 through H10 does not satisfy the nondiscriminatory availability requirement of §1.401(a)(4)-4 in plan year 1995. This violation may not be corrected under this paragraph (g).



§1.401(a)(4)-12 Definitions.

In applying the provisions of this section and of §§1.401(a)(4)-1 through 1.401(a)(4)-13, the definitions in this section govern unless otherwise provided.

Accrual method. "Accrual method" means the method used to determine the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) of employees under a defined benefit plan as of any date.

Accumulation Plan. "Accumulation plan" means a defined benefit plan under which the benefit of every employee in the plan for each plan year is separately determined, using plan year compensation (if benefits are determined as a percentage of compensation rather than a dollar amount) separately calculated for the plan year, and each employee's total accrued benefit as of the end of a plan year is the sum of the separately determined benefits for that plan year and all prior plan years. A plan does not fail to be an accumulation plan merely because the benefits for years of service before a fresh-start date were not determined in the manner described in the preceding sentence, provided that the accrued benefit of each employee in the plan after the fresh-start date is determined in accordance with §1.401(a)(4)-13(c)(2) (formula without wear-away) without providing for compensation adjustments otherwise permitted under §1.401(a)(4)-13(c)(5)(iii).



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Actuarial equivalent. An amount or benefit is the "actuarial equivalent" of, or is "actuarially equivalent" to, another amount or benefit at a given time if the actuarial present value of the two amounts or benefits (calculated using the same actuarial assumptions) at that time is the same.

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Actuarial present value. "Actuarial present value" means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is--

(1) Multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied, and

(2) Discounted according to an assumed rate of interest to reflect the time value of money.

Ancillary benefit. "Ancillary benefit" means an ancillary benefit within the meaning of §1.401(a)(4)-4(e)(2).

Average annual compensation. "Average annual compensation" means average annual compensation within the meaning of §1.401(a)(4)-3(e)(2).

Benefit formula. "Benefit formula" means the formula a defined benefit plan applies to determine the accrued benefit (within the meaning of section 411(a)(7)(A)(i)) in the form of an annual benefit commencing at normal retirement age of an employee who continues in service until normal retirement age. Thus, for example, the benefit formula does not include the accrual method the plan applies (along with the benefit formula) to determine the accrued benefit of an employee who terminates employment before normal retirement age.

Benefits, rights, and features. "Benefits, rights, and features" means optional forms of benefit, ancillary benefits, and other rights and features within the meaning of §1.401(a)(4)-4(e). "Benefit, right, or feature" means an optional form of benefit, an ancillary benefit, or an other right or feature within the meaning of §1.401(a)(4)-4(e).

Contributory DB plan. "Contributory DB plan" means a defined benefit plan that includes employee contributions not allocated to separate accounts.

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Defined benefit excess plan. "Defined benefit excess plan" means defined benefit excess plan within the meaning of §1.401(*l*)-1(c)(16)(i).

Defined benefit plan. "Defined benefit plan" means a defined benefit plan within the meaning of §1.410(b)-9.

Defined contribution plan. "Defined contribution plan" means a defined contribution plan within the meaning of §1.410(b)-9.

Employee. With respect to a plan year, "employee" means an employee, within the meaning of §1.410(b)-9, who is benefiting under the plan within the meaning of §1.410(b)-3(a) for the plan year.

Employer. "Employer" means the employer within the meaning the of §1.410(b)-9.

ESOP. "ESOP" or "employee stock ownership plan" means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Excess benefit percentage. "Excess benefit percentage" means excess benefit percentage within the meaning of §1.401(*l*)-1(c)(14).

Former employee. "Former employee" means a former employee within the meaning of §1.410(b)-9 who is not treated as excludable under §1.410(b)-6(h).

Fresh-start date. "Fresh-start date" means a date selected by the employer that is the last day of a plan year and that is the same for all employees in the plan.

Frozen. With respect to an employee's benefits under a plan, "frozen" means determined as if the employee terminated employment with the employer as of a date, and without regard to any amendment to the plan adopted after the earlier of that date and the last

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day of the current plan year, other than amendments adopted after such earlier date but recognized as effective as of or before such earlier date under section 401(b) or §1.401(a)(4)-11(g). In the case of an employee who terminates employment before the date benefits under the plan are frozen or treated as frozen, "frozen" means determined as of the date the employee actually terminated employment, without regard to any amendment excluded from consideration under the preceding sentence.

Gross benefit percentage. "Gross benefit percentage" means gross benefit percentage within the meaning of §1.401(*l*)-1(c)(18).



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Highly compensated employee. "Highly compensated employee" means an employee who is a highly compensated employee within the meaning of section 414(q).

Highly compensated former employee. "Highly compensated former employee" means a former employee who is a highly compensated former employee within the meaning of section 414(q)(9).

Nonexcludable employee. "Nonexcludable employee" means an employee within the meaning of §1.410(b)-9, other than an excludable employee with respect to the plan as determined under §1.410(b)-6. A nonexcludable employee may be either a highly or nonhighly compensated nonexcludable employee, depending on the nonexcludable employee's status under section 414(q).

Nonhighly compensated employee. "Nonhighly compensated employee" means an employee who is not a highly compensated employee.

Nonhighly compensated former employee. "Nonhighly compensated former employee" means a former employee who is not a highly compensated former employee.

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Normalize. With respect to a benefit payable to an employee in a particular form, "normalize" means to convert the benefit to an actuarially equivalent straight life annuity commencing at the employee's testing age under the normalization procedure of §1.401(a)(4)-3(d)(5)(iv).

Offset plan. "Offset plan" means an offset plan within the meaning of §1.401(*l*)-1(c)(24).

Optional form of benefit. "Optional form of benefit" means an optional form of benefit within the meaning of §1.401(a)(4)-4(e)(1).

Plan. "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). Thus, for example, two plans (within the meaning of §1.410(b)-7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)-7(d) are treated as a single plan for purposes of section 401(a)(4).

Plan year. "Plan year" means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Plan year compensation—(1) In general. "Plan year compensation" means section 414(s) compensation for the plan year determined by measuring section 414(s) compensation during one of the periods described in paragraphs (2) through (4) of this definition. Whichever period is selected must be applied uniformly to determine the plan year compensation of every employee in the plan.

(2) Plan year. This period consists of the plan year.

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(3) Twelve-month period ending in the plan year. This period consists of a specified 12-month period ending with or within the plan year, such as the calendar year or the period for determining benefit accruals described in §1.401(a)(4)-3(f)(6).

(4) Period of plan participation during the plan year. This period consists of the portion of the plan year during which the employee is a participant in the plan. This period may be used to determine plan year compensation for the plan year in which participation begins, the plan year in which participation ends, or both. This period may be used to determine plan year compensation for purposes of §1.401(a)(4)-3(d) only if the plan year is also the period for determining benefit accruals under the plan rather than another period as permitted under §1.401(a)(4)-3(f)(6). Similarly, this period may be used to measure plan year compensation that is treated as average annual compensation under an accumulation plan, as provided in §1.401(a)(4)-3(b)(8)(x)(B), only if the plan year is also the period for determining benefit accruals under the plan rather than another period as permitted under §1.401(a)(4)-3(f)(6). Further, selection of this period must be made on a reasonably consistent basis from plan year to plan year in a manner that does not discriminate in favor of highly compensated employees. Discrimination might arise, for example, where this period is selected in all plan years except a plan year in which a highly compensated employee enters the plan at midyear.

Present value. "Present value" means the value as of a specified date of an amount or series of amounts due thereafter and discounted according to an assumed rate of interest to

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reflect the time value of money, but not adjusted to reflect the probability of payment of any amount.

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QJSA. "QJSA" or "qualified joint and survivor annuity" means a qualified joint and survivor annuity within the meaning of section 417(b).

Qualified plan. "Qualified plan" means a plan that satisfies section 401(a). For this purpose, a qualified plan includes an annuity plan described in section 403(a).

QSUPP--(1) In general. "QSUPP" or "qualified social security supplement" means a social security supplement that meets each of the requirements in paragraphs (2) through (6) of this definition.

(2) Accrual--(i) General rule. The amount of the social security supplement payable at any age for which the employee is eligible for the social security supplement is equal to the lesser of--

(A) The employee's old-age insurance benefit, unreduced on account of age, under title II of the Social Security Act, and

(B) The accrued social security supplement, determined under one of the methods in paragraphs (2)(ii) through (2)(iv) of this definition.

(ii) Section 401(*l*) plans. In the case of a section 401(*l*) plan that is a defined benefit excess plan, each employee's accrued social security supplement equals the employee's average annual compensation up to the integration level, multiplied by the disparity provided by the plan for the employee's years of service used in determining the employee's accrued benefit under the plan. In the case of a section 401(*l*) plan that is an offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan.

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(iii) PIA offset plan. In the case of a PIA offset plan, each employee's accrued social security supplement equals the dollar amount of the offset accrued for the employee under the plan. For this purpose, a PIA offset plan is a plan that reduces an employee's benefit by an offset based on a stated percentage of the employee's primary insurance amount under the Social Security Act.

(iv) Other plans. In the case of any other plan, each employee's social security supplement accrues ratably over the period beginning with the later of the employee's commencement of participation in the plan or the effective date of the social security supplement and ending with the earliest age at which the social security supplement is payable to the employee. The effective date of the social security supplement is the later of the effective date of the amendment adding the social security supplement or the effective date of the amendment modifying an existing social security supplement to comply with the requirements of this definition. In the case of an amendment made by the end of the last plan year beginning before January 1, 1993, to a social security supplement in existence on September 19, 1991 ~~[INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER]~~ the employer may treat the accrued portion of the social security supplement, as determined under the plan without regard to amendments made after September 19, 1991 ~~[INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER]~~, as included in the employee's accrued social security supplement, provided that the remainder of the social security supplement is accrued under the otherwise applicable method.

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(3) Vesting. The plan provides that an employee's right to the accrued social security supplement becomes nonforfeitable within the meaning of section 411 as if it were an early retirement benefit.

(4) Eligibility. The plan provides the same eligibility conditions on receipt of the social security supplement as on receipt of the early retirement benefit in conjunction with which the social security supplement is payable. Furthermore, if the service required for an employee to become eligible for the social security supplement exceeds 15 years, then the ratio percentage of the group of employees who actually satisfy the eligibility conditions on receipt of the QSUPP in the current plan year equals or exceeds the unsafe harbor percentage applicable to the plan under §1.410(b)-4(c)(4)(ii).

(5) QJSA. At each age, the most valuable QSUPP commencing at that age must be payable in conjunction with the QJSA commencing at that age. In addition, the plan must

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provide that, in the case of a social security supplement payable in conjunction with a QJSA, the social security supplement will be paid after the employee's death on the same terms as the QJSA, but in no event for a period longer than the period for which the social security supplement would have been paid to the employee had the employee not died. For example, if the QJSA is in the form of a joint annuity with a 50-percent survivor's benefit, the social security supplement must provide a 50-percent survivor's benefit. When section 417(c) requires the determination of a QJSA for purposes of determining a qualified pre-retirement survivor's annuity as defined in section 417(c) ("QPSA"), the social security supplement payable in conjunction with that QJSA must be paid in conjunction with the QPSA.

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(6) Protection. The plan specifically provides that the social security supplement is treated as an early retirement benefit that is protected under section 411(d)(6) (other than for purposes of sections 401(a)(11) and 417). Thus, the accrued social security supplement continues to be payable notwithstanding subsequent amendment of the plan (including the plan's termination), and an employee may meet the eligibility requirements for the social security supplement after plan termination.

Ratio percentage. "Ratio percentage" means ratio percentage within the meaning of §1.410(b)-9.

Section 401(a)(17) employee. "Section 401(a)(17) employee" means a section 401(a)(17) employee within the meaning of §1.401(a)(17)-1(e)(2)(ii).

Section 401(k) plan. "Section 401(k) plan" means a plan consisting of elective contributions described in §1.401(k)-1(g)(3) under a qualified cash or deferred arrangement described in §1.401(k)-1(a)(4)(i).

Section 401(*l*) plan. "Section 401(*l*) plan" means a plan that--

(1) Provides for a disparity in employer-provided benefits or contributions that satisfies section 401(*l*) in form, and

(2) Relies on one of the safe harbors in §1.401(a)(4)-2(b)(3), 1.401(a)(4)-3(b), 1.401(a)(4)-8(b)(3), or 1.401(a)(4)-8(c)(3)(iii)(B) to satisfy section 401(a)(4).

Section 401(m) plan. "Section 401(m) plan" means a plan consisting of employee contributions described in §1.401(m)-1(f)(6) or matching contributions described in §1.401(m)-1(f)(12), or both.

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Section 414(s) compensation--(1) In general. When used with reference to compensation for a plan year, 12-month period, or other specified period, "section 414(s) compensation" means compensation measured using an underlying definition that satisfies section 414(s). Whether an underlying definition of compensation satisfies section 414(s) is determined on a year-by-year basis, based on the provisions of section 414(s) in effect for the applicable plan year, and if relevant, the employer's highly and nonhighly compensated employees for that plan year. Notwithstanding the foregoing, see paragraph (3) of this definition for rules for determining section 414(s) compensation for plan years or 12-month periods beginning before January 1, 1988.

(2) Determination period for section 414(s) nondiscrimination requirement--(i) General rule. If a definition of underlying compensation must satisfy the nondiscrimination requirement in §1.414(s)-1(d) in order to satisfy section 414(s) for a plan year, any one of the following determination periods may be used--

(A) The plan year,

(B) The calendar year ending in the plan year, or

(C) The 12-month period ending in the plan year that is used to determine the underlying definition of compensation.

(ii) Exception for partial plan year compensation. Notwithstanding the general rule in paragraph (2)(i) of this definition, if the period for measuring underlying compensation is the portion of the plan year during which each employee is a participant in the plan (as provided in paragraph (4) of the definition of plan year compensation in this section) that period must be used as the determination period.

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(3) Years before 1988. Any underlying definition of compensation used to measure the amount of employees' compensation for a plan year or a 12-month period beginning



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before January 1, 1988, for purposes of this definition is not required to satisfy section 414(s), provided that the definition was nondiscriminatory based on the facts and circumstances in effect for that plan year or for the plan year in which that 12-month period ends and the definition is used consistently to determine the compensation for the plan year or the 12-month period for all employees in the plan.

(4) Plans using permitted disparity. In the case of a section 401(*l*) plan or a plan that imputes permitted disparity in accordance with §1.401(a)(4)-7, an underlying definition of compensation is not section 414(s) compensation, if the definition results in significant under-inclusion of compensation for employees.

Social security supplement. "Social security supplement" means a social security supplement within the meaning of §1.411(a)-7(c)(4)(ii).

Standard interest rate. "Standard interest rate" means an interest rate that is neither less than 7.5 percent nor greater than 8.5 percent, compounded annually. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard interest rate.

Standard mortality table. "Standard mortality table" means one of the following tables: the UP-1984 Mortality Table (Unisex); the 1983 Group Annuity Mortality Table (1983 GAM) (Female); the 1983 Group Annuity Mortality Table (1983 GAM) (Male); the 1983 Individual Annuity Mortality Table (1983 IAM) (Female); the 1983 Individual Annuity Mortality Table (1983 IAM) (Male); the 1971 Group Annuity Mortality Table (1971 GAM)



(Female); the 1971 Group Annuity Mortality Table (1971 GAM) (Male); the 1971 Individual Annuity Mortality Table (1971 IAM) (Female); or the 1971 Individual Annuity Mortality Table (1971 IAM) (Male). These standard mortality tables are available from the Society of Actuaries, 475 N. Martingale Road, Suite 800, Schaumberg, Illinois 60173. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, change the definition of standard mortality table.

Straight life annuity. "Straight life annuity" means an annuity payable in equal installments for the life of the employee that terminates upon the employee's death.

Straight life annuity factor. "Straight life annuity factor" means the actuarial present value of an immediate straight life annuity equal to $1 per year. The straight life annuity factor may reflect equal periodic payments made more frequently than annually, provided that they total $1 per year.

Testing age. With respect to an employee, "testing age" means the age determined for the employee under the following rules--

(1) If the plan provides the same uniform normal retirement age for all employees in the plan, the employee's testing age is the employee's normal retirement age under the plan.

(2) If a plan provides different uniform normal retirement ages for different employees or different groups of employees in the plan, the employee's testing age is the employee's latest normal retirement age under any uniform normal retirement age under the plan, regardless of whether that particular uniform normal retirement age actually applies to the employee under the plan.



(3) If the plan does not provide a uniform normal retirement age, the employee's testing age is 65.

(4) If an employee is beyond the testing age otherwise determined for the employee under paragraphs (1) through (3) of this definition, the employee's testing age is the employee's current age. The rule in the preceding sentence does not apply in the case of a defined benefit plan that does not satisfy the requirements of §1.401(a)(4)-3(f)(3)(i)(A) through (C) (permitting certain increases to be disregarded in an employee's benefits due to delayed commencement of benefits after normal retirement age).

Testing compensation. "Testing compensation" means testing compensation within the meaning of §1.401(a)(4)-3(e)(2).

Testing service--(1) Defined contribution plans. In the case of a defined contribution plan, "testing service" means the number of plan years for which an amount taken into account under §1.401(a)(4)-2(c)(2)(ii) has been allocated or treated as allocated to the account of the employee under the plan.

(2) Defined benefit plans--(i) General rule. In the case of a defined benefit plan,

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"testing service" means an employee's years of service as defined in the plan for purposes of applying the benefit formula under the plan, provided that the plan uses the same definition of years of service for this purpose for all employees in the plan. Alternatively, testing service may be determined for all employees in the plan under the rules of paragraph (2)(ii) of this definition, even though the plan uses the same definition of years of service for all employees in the plan.

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(ii) Plans with nonuniform service definition. In the case of a defined benefit plan that does not use the same definition of years of service for purposes of applying the benefit formula under the plan to all employees in the plan, "testing service" means the number of plan years the employee has benefited under the plan within the meaning of section 410(b), plus an employee's years of service as defined in the plan for purposes of applying the benefit formula under the plan with respect to years of service (if any) before the employee first benefited under the plan. For plan years beginning before the first day of the first plan year for which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 apply to the plan, an employee is treated as benefiting under the plan for a plan year if the employee was covered under the plan for the plan year for purposes of section 410(b) as in effect at that time.

(iii) Service caps ignored. In determining an employee's testing service, any limitation on the number of years of service taken into account for purposes of applying the benefit formula under the plan is disregarded.

(3) Limitations on testing service. For purposes of determining testing service, only service with the employer (or a predecessor employer within the meaning of section 414(a)) may be taken into account, plus any period of imputed service permitted under §1.401(a)(4)-11(d)(2). An employee may be credited with no more than 1 year of testing service with respect to any plan year. In the case of a short plan year, an employee may be credited with no more than a fraction of a year of testing service, determined by dividing the number of months in the plan year by 12.

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(4) Time of determination. An employee's testing service generally is determined as of the close of the current plan year. However, in applying the projected method in §1.401(a)(4)-3(d)(4) or the fresh-start alternative to the project method in §1.401(a)(4)-3(d)(6)(viii), testing service is determined as of the date (other than a fresh-start date, if applicable) that the employee's benefits under the plan are treated as frozen. Thus, for example, in determining an employee's normal accrual rate under §1.401(a)(4)-3(d)(4)(i), the employee's testing service is determined as of the employee's testing age. Similarly, in determining an employee's most valuable accrual rate under §1.401(a)(4)-3(d)(4)(ii), the employee's testing service is determined as of the date payment of the underlying QJSA and QSUPP (if any) would commence to the employee under the plan. If, as a result, an employee's testing service is determined as of a date after the current plan year, the employee's testing service is determined by assuming that the amount of testing service credited to the employee for the current plan year continues to be credited to the employee in each future plan year through the date on which the employee's benefits under the plan are treated as frozen.

Uniform normal retirement age. "Uniform normal retirement age" means a single normal retirement age that does not exceed age 65 and that is the same for all of the employees in a given group. A group of employees do not fail to have a uniform normal retirement age merely because the plan provides that the normal retirement age of all employees in the group is the later of a stated age (not exceeding age 65) or a stated anniversary no later than the 5th anniversary of the time the employee commenced participation in the plan.

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Year of service. "Year of service" means a year of service as defined in the plan for a specific purpose, including the method of crediting service for that purpose under the plan. In the absence of a specific indication to the contrary, the term "year of service" generally refers to a year of service as defined in the plan for purposes of applying the benefit formula or accrual method under the plan. An employee may be credited with no more than 1 year

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of service with respect to any 12-consecutive-month period, except for those cases in which additional service is required to be credited under section 410 or 411, whichever is applicable.

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§1.401(a)(4)-13 Effective dates and fresh-start rules.

(a) In general. Sections 1.401(a)(4)-1 through 1.401(a)(4)-13 apply to plan years beginning on or after January 1, 1992. For plan years beginning before that date and on or after the first day of the first plan year to which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 ("TRA '86") apply, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4), taking into account pre-existing guidance and the amendments made by TRA '86 to related provisions of the Code (including, for example, sections 401(*l*), 401(a)(17), and 410(b)). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) will generally be determined on the basis of all relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(4) if it is operated in accordance with the terms of §§1.401(a)(4)-1 through 1.401(a)(4)-13.

(b) Effective date for governmental plans. In the case of governmental plans described in section 414(d), including section 401(a) plans and nonelective plans subject to section 403(b)(12)(A)(i), section 401(a)(4) is considered satisfied for plan years beginning before the later of January 1, 1993, or 90 days after the opening of the first legislative session beginning on or after January 1, 1993, of the governing body with authority to amend the plan, if that body does not meet continuously. For purposes of this paragraph (b), the term "governing body with authority to amend the plan" means the legislature, board, commission, council, or other governing body with authority to amend the plan.

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(c) Fresh-start rules for defined benefit plans--(1) Introduction--(i) In general. In order to use the fresh-start rules under §1.401(a)(4)-3(b)(8)(viii), 1.401(a)(4)-3(d)(6)(vii) or (viii), 1.401(a)(4)-8(b)(3)(ii)(A), or 1.401(a)(4)-8(c)(3)(xi), a defined benefit plan (or the stated benefit formula under a target benefit plan) must, for plan years after the fresh-start date, determine each employee's accrued benefit under the plan under one of the formulas provided in paragraph (c)(2) through (c)(4) of this section. Paragraphs (c)(5) and (c)(6) of this section allow certain changes in an employee's accrued benefit frozen as of the fresh-start date (the employee's "frozen accrued benefit") for purposes of applying the formulas after the fresh-start date. See §1.401(a)(4)-12 for the definitions of "fresh-start date" and "frozen."

(ii) Consistency. Unless otherwise provided, the same fresh-start formula must be applied to all employees who have accrued benefits as of the fresh-start date and who have at least one hour of service with the employer in a plan year beginning after that date. Thus, for example, if two or more plans are aggregated and treated as a single plan for purposes of sections 401(a)(4) and 410(b) in the plan year ending on the fresh-start date or any later year, those plans are also treated as a single plan for purposes of this paragraph (c). Thus, if a plan makes a fresh start and for a later plan year is aggregated for purposes of section 401(a)(4) with another plan that did not make the same fresh start, the aggregated plan must make a new fresh start in order to use any of the fresh-start rules referenced in paragraph (c)(1)(i) of this section for that later plan year or any subsequent plan year.

(iii) Multiple fresh starts. If a plan makes a new fresh start after having made an earlier fresh start, each employee's accrued benefit, as determined under the original fresh-

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start formula as of the new fresh-start date, must be frozen as of the new fresh-start date for purposes of applying the new fresh-start formula.

(2) Formula without wear-away. An employee's accrued benefit under the plan is equal to the sum of--

(i) The employee's frozen accrued benefit, and

(ii) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to years of service after the fresh-start date.



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(3) Formula with wear-away. An employee's accrued benefit under the plan is equal to the greater of--

(i) The employee's frozen accrued benefit, or

(ii) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to the employee's total years of service for the employer before and after the fresh-start date.

(4) Formula with extended wear-away. An employee's accrued benefit under the plan is equal to the greater of--

(i) The sum determined under paragraph (c)(2) of this section, or

(ii) The employee's accrued benefit determined under the formula applicable to benefit accruals in the current plan year as applied to the employee's total years of service for the employer before and after the fresh-start date.

(5) Permitted adjustments. An employee's accrued benefit will not fail to be frozen as of the fresh-start date merely because the plan increases the employee's frozen accrued

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benefit in one or more of the ways described in paragraphs (c)(5)(i) through (iv) of this section. Any adjustment must be made uniformly for all employees with frozen accrued benefits under the plan.

(i) Increases in section 415 limits. A plan may provide for increases in the frozen accrued benefit of every employee in the plan whose benefit would be greater, but for the application of section 415, to the extent permitted under section 415(d)(1).

(ii) Former employees. A plan may increase the benefits of former employees who were employees on the fresh-start date, if the increase satisfies the requirements of §1.401(a)(4)-10 and applies consistently to all former employees with frozen accrued benefits under the plan.

(iii) Adjusted accrued benefit. A plan that satisfies the requirements of paragraph (d) of this section may make the adjustments described in paragraphs (d)(5) and (d)(6) of this section. However, if the plan makes a new fresh start after the effective date applicable to the plan under paragraph (a) or (b) of this section, in accordance with paragraph (c)(1)(iii) of this section the adjustments otherwise permitted under paragraph (d)(6) of this section must cease as of the new fresh-start date.

(iv) Compensation adjustments to top-heavy minimum benefits. If the frozen accrued benefit of an employee under the plan includes top-heavy minimum benefits, the plan may increase the employee's frozen accrued benefit solely to the extent necessary to comply with the average compensation requirement of section 416(c)(1)(D)(i).

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(6) Benefits, rights, and features--(i) Eligibility and vesting. Service for the employer after the fresh-start date continues to be taken into account for purposes of determining eligibility and vesting for benefits, rights, and features under the plan.

(ii) Changes in optional forms. A plan may provide a new optional form of benefit with respect to the frozen accrued benefit, provided the following requirements are met--

(A) The optional form is provided with respect to each employee's entire accrued benefit (i.e, accrued both before and after the fresh-start date).

(B) The plan provided meaningful coverage as of the fresh-start date, as described in paragraph (d)(3) of this section.

(C) The plan provides meaningful current benefit accruals, as described in paragraph (d)(4) of this section.

(7) Examples. The following examples illustrate the provisions of this paragraph (c).

Example 1. (a) Employer M maintains a defined benefit plan with a calendar plan year. The plan contains several formulas covering different groups of employees, and, for plan years before 1996, the plan satisfies section 401(a)(4) by passing the general test of §1.401(a)(4)-3(c). Effective for the 1996 plan year, the employer amends the plan to satisfy the unit credit safe harbor under §1.401(a)(4)-3(b)(3). The amended plan formula provides a normal retirement benefit for all employees of 1.25 percent of average annual compensation for each year of service up to 30. The plan otherwise satisfies the requirements of §1.401(a)(4)-2(b)(2) and (b)(3). For plan years after 1995, each employee's accrued benefit is determined under the fresh-start formula in paragraph (c)(3) of this section (formula with wear-away), using December 31, 1995, as the fresh-start date.

(b) As of December 31, 1995, Employee A has 20 years of service with Employer M, average annual compensation of $40,000, and an accrued benefit of $14,000. As of December 31, 1996, Employee A has 21 years of service with Employer M and average annual compensation of $43,000. Employee A's accrued benefit as of December 31, 1996, is $14,000, the greater of $14,000 (Employee A's accrued benefit frozen as of December 31, 1995) and $11,288 (1.25 percent x $43,000 x 21 years).

(c) As of December 31, 2000, Employee A has 25 years of service with Employer M and average annual compensation of $52,000. Employee A's accrued benefit as of December

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31, 2000, is $16,250, the greater of $14,000 (Employee A's accrued benefit frozen as of December 31, 1995) and $16,250 (1.25 percent x $52,000 x 25 years).

Example 2. (a) Employer Y maintains a defined benefit plan with a calendar plan year. The plan formula provides an employee with a normal retirement benefit at age 65 of 1 percent of average annual compensation up to covered compensation multiplied by the employee's years of service for Employer Y, plus 1.5 percent of average annual compensation in excess of the covered compensation, multiplied by the employee's years of service for Employer Y up to 40.

(b) For plan years beginning after 1992, Employer Y amends the plan formula to provide a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation multiplied by the employee's total years of service for Employer Y up to 35, plus 1.4 percent of average annual compensation in excess of covered compensation multiplied by the employee's years of service for Employer Y up to 35. For plan years after 1992, each employee's accrued benefit is determined under the fresh-start formula in paragraph (c)(4) of this section (formula with extended wear-away), using December 31, 1992, as the fresh-start date.

(c) As of December 31, 1992, Employee C has 10 years of service for Employer Y, has average annual compensation of $38,000, and has covered compensation of $30,000. Employee C's accrued benefit as of December 31, 1992, is therefore $4,200 ((1 percent x $30,000 x 10 years) + (1.5 percent x $8,000 x 10 years)). As of December 31, 1993, Employee C has 11 years of service for Employer Y, has average annual compensation of $40,000, and has covered compensation of $32,000. Employee C's accrued benefit as of December 31, 1993, is $4,762, the greater of--

(1) $4,762, the sum of Employee C's accrued benefit frozen as of December 31, 1992, ($4,200) and the amended formula applied to Employee C's years of service after 1992 ((0.75 percent x $32,000 x 1 year) + (1.4 percent x $8,000 x 1 year), or $562), or

(2) $3,872, the amended formula applied to Employee C's total years of service ((0.75 percent x $32,000 x 11 years) + (1.4 percent x $8,000 x 11 years)).

(d) Plans using pre-effective-date fresh-start dates--(1) In general. A defined benefit plan that uses a fresh-start date before the effective date applicable to the plan under paragraph (a) or (b) of this section, and that satisfies the requirements of paragraphs (d)(2) through (d)(5) of this section, may substitute an employee's adjusted accrued benefit for the



employee's frozen accrued benefit in applying the formulas in paragraphs (c)(2) through (c)(4) of this section (or paragraph (f)(2) of this section, if applicable).

(2) Average pay requirement. As of the fresh-start date, the plan contained a benefit formula under which increases in an employee's benefits accrued as of the fresh-start date would have been determined by reference to the employee's compensation in plan years beginning after the fresh-start date. A plan would satisfy this requirement, for example, if it based benefits on an employee's highest average pay over a fixed period of years or on an employee's average pay over the employee's entire career with the employer.

(3) Meaningful coverage as of fresh-start date. The plan provided meaningful coverage as of the fresh-start date. A plan provided meaningful coverage as of the fresh-start date if the group of employees with accrued benefits under the plan as of the fresh-start date satisfied the minimum coverage requirements of section 410(b) as in effect on that date (including the average benefit percentage test, if applicable). In order to satisfy the requirement in the preceding sentence, an employer may amend the plan to grant past service credit under the formula in effect as of the fresh-start date to nonhighly compensated employees, provided that the amount of past service granted them is reasonably comparable, on average, to the amount of past service highly compensated employees have under the plan. The portion of an amendment that grants past service credit to nonhighly compensated employees as described in the preceding sentence is not considered adopted after the fresh-start date for purposes of paragraph (d)(2) of this section or for purposes of the definition of "frozen" in §1.401(a)(4)-12. Thus, any benefit increase that results from the grant of past



service credit to a nonhighly compensated employee under this paragraph (d)(3) is included in the employee's frozen accrued benefit.

(4) Meaningful current benefit accruals. The benefit formula and accrual method under the plan provides benefit accruals in the current plan year (other than increases in benefits accrued as of the fresh-start date) that are meaningful in comparison to the rate at which benefits accrued in plan years beginning before the fresh-start date.

(5) Minimum benefit adjustment--(i) In general. In the case of a section 401(*l*) plan or a plan that imputes disparity under §1.401(a)(4)-7, the plan makes the minimum benefit adjustment described in paragraph (d)(5)(ii) or (iii) of this section.

(ii) Excess or offset plans. In the case of a plan that is a defined benefit excess plan as of the fresh-start date, each employee's frozen accrued benefit is adjusted so that the base benefit percentage is not less than 50 percent of the excess benefit percentage. In the case of

a plan that is a PIA offset plan as of the fresh-start date, each employee's offset as applied to determine the frozen accrued benefit is adjusted so that it does not exceed 50 percent of the benefit determined without applying the offset. For purposes of this paragraph (d)(5)(ii), a PIA offset plan is a plan that applies the plan's benefit rates uniformly regardless of an employee's compensation, but that reduces an employee's benefit by a stated percentage of the employee's primary insurance amount under the Social Security Act.

(iii) Other plans. In the case of a plan that is not described in paragraph (d)(5)(ii) of this section, each employee's frozen accrued benefit is adjusted in a manner that is economically equivalent to the adjustment required under that paragraph, taking into account

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the plan's benefit formula, accrual rate, and relevant employee factors, such as period of service.

(6) Adjusted accrued benefit--(i) General rule. The term "adjusted accrued benefit" means an employee's frozen accrued benefit that is adjusted as provided in paragraph (d)(5) of this section, and then multiplied by a fraction (not less than 1) determined under one of the following methods that is the same for every employee in the plan--

(A) Old compensation fraction. The numerator is the employee's compensation for the current plan year determined under the compensation definition and formula used to determine the frozen accrued benefit, and the denominator is the employee's compensation for the plan year ending on the fresh-start date determined under the same compensation definition and formula used in the numerator.

(B) New compensation fraction. The numerator is the employee's average annual compensation for the current plan year, and the denominator is the employee's average annual compensation for the plan year ending on the fresh-start date, determined in the same manner as the numerator.

(C) Reconstructed compensation fraction. The numerator is the employee's average annual compensation for the current plan year, and the denominator is the employee's reconstructed average annual compensation, as defined in paragraph (d)(6)(ii) of this section. In determining the numerators and the denominators of the fractions described in this paragraph (d)(6), the annual compensation limit under section 401(a)(17) generally applies.

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See, however, §1.401(a)(17)-1(e)(4) for special rules applicable to section 401(a)(17) employees.

(ii) Reconstructed average annual compensation. The term "reconstructed average annual compensation" means an employee's average annual compensation for the plan year ending on the fresh-start date determined under the following method for every employee in the plan--

(A) Select a single plan year beginning after the fresh-start date but beginning not later than December 31, 1992.

(B) Determine the employee's average annual compensation for the selected plan year under the same method used to determine the employee's average annual compensation for the current plan year under paragraph (d)(6)(i)(C) of this section.

(C) Multiply the employee's average annual compensation for the selected plan year by a fraction, the numerator of which is the employee's compensation for the plan year ending on the fresh-start date determined under the same compensation definition and formula used to determine the employee's frozen accrued benefit, and the denominator of which is the employee's compensation for the selected plan year determined under the compensation definition and formula used to determine the employee's frozen accrued benefit. The product is the employee's reconstructed average annual compensation.

(iii) Permissible compensation definitions. Any compensation or average annual compensation definition used for purposes of this paragraph (d)(6) must be the same for every employee with benefits accrued under the plan as of the fresh-start date. The definition may, but need not, be the same as the compensation or average annual

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compensation definition used in the current plan year for other purposes under section 401(a)(4).

(iv) Option to make less than the full permitted adjustment. A plan may make less



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than the full increase in each employee's frozen accrued benefit ("FAB") as permitted under paragraph (d)(6)(i) of this section by determining each employee's adjusted accrued benefit ("AAB") under the following formula, where P is a single percentage (not to exceed 100 percent) designated in the plan for this purpose, and where F is one of the fractions described in paragraph (d)(6)(ii) of this section that is the same for all employees in the plan:

$$AAB = FAB + [P \times FAB \times (F - 1)]$$

In addition, a plan may impose a uniform maximum dollar amount on the adjusted accrued benefit of every employee in the plan or, in the alternative, of every highly compensated employee in the plan, provided the maximum dollar amount does not reduce any employee's accrued benefit. Furthermore, the plan may, at any time, terminate all future adjustments permitted under this paragraph (d).

(7) Examples. The following examples illustrate this paragraph (d).

Example 1. (a) Employer X maintains a defined benefit plan with a calendar plan year. Effective for the 1991 plan year, the plan is amended to provide a new formula. The amended plan also provides that, for plan years after 1990, each employee's accrued benefit is determined under the formula in paragraph (c)(3) of this section (formula with wear-away) and, in applying the fresh-start formula, each employee's frozen accrued benefit under paragraph (c)(3)(i) of this section will be adjusted under this paragraph (d), using the new compensation fraction under paragraph (d)(6)(i)(B) of this section. The plan is not a section 401(*l*) plan and does not impute permitted disparity under §1.401(a)(4)-7 for years after 1990; thus, the minimum benefit adjustment under paragraph (d)(5) of this section does not apply.

(b) As of December 31, 1990, Employee A has average annual compensation of $24,000 and an accrued benefit of $3,000. As of December 31, 1994, Employee A has average annual compensation (determined in the same manner as average annual



compensation as of December 31, 1990) of $30,000. As of December 31, 1994, Employee A's adjusted accrued benefit is $3,750 ($3,000 x $30,000/$24,000). Thus, Employee A's accrued benefit is the greater of $3,750 and the employee's accrued benefit determined under the new formula as applied to the employee's total years of service.

Example 2. (a) Employer Y maintains a defined benefit excess plan with a calendar plan year. For plan years before 1989, the plan is integrated with benefits provided under the Social Security Act, providing each employee with a normal retirement benefit equal to 1 percent of the employee's average annual compensation in excess of the employee's covered compensation, multiplied by the employee's years of service for Y. The benefit formula thus provides no benefit with respect to average annual compensation up to covered compensation.

(b) As of December 31, 1988, Employee A has 10 years of service for Y and has covered compensation of $25,000 and average annual compensation of $20,000. Employee A's average annual compensation has never exceeded $20,000. Therefore, as of December 31, 1988, Employee A's accrued benefit under the plan is zero.

(c) Effective with the 1989 plan year, the plan is amended to provide each employee with a normal retirement benefit of 0.6 percent of average annual compensation up to covered compensation plus 1.2 percent of average annual compensation in excess of covered compensation, multiplied by the employee's years of service up to 35. The plan also provides that, for plan years after 1988, each employee's accrued benefit is determined under the formula in paragraph (c)(2) of this section (formula without wear-away) and, in applying the fresh-start formula, each employee's frozen accrued benefit under paragraph (c)(3)(i) of this section will be adjusted under this paragraph (d), using the old compensation fraction under paragraph (d)(6)(i)(A) of this section.

(d) The plan is a section 401(*l*) plan and thus must also make the minimum benefit adjustment under paragraph (d)(5) of this section. Because the excess benefit percentage under the plan for years before 1989 was 1 percent, the plan must provide a base benefit percentage for those years of at least 0.5 percent. After the minimum benefit adjustment, Employee A's accrued benefit as of December 31, 1988, is $1,000 (0.5 percent x $20,000 x 10 years).

(e) As of December 31, 1992, Employee A has 14 years of service and has covered compensation of $30,000 and average annual compensation of $35,000. Employee A's adjusted accrued benefit as of December 31, 1992, is $1,750 ($1,000 x $35,000/$20,000), and Employee A's accrued benefit as of December 31, 1992, is $2,710 (the sum of $1,750 plus $960 ((0.6 percent x $30,000 x 4 years) plus (1.2 percent x $5,000 x 4 years))).

Example 3. (a) Employer Z maintains an offset plan with a calendar plan year. For plan years before 1989, the plan is integrated with benefits provided under the Social Security Act, providing each employee with a normal retirement benefit of 50 percent of average annual compensation, offset by 83 1/3 percent of the employee's projected primary



insurance amount under the Social Security Act. The plan determines each employee's accrued benefit under the fractional accrual rule of section 411(b)(1)(C).

(b) As of December 31, 1988, Employee A, who was hired at age 40, has 10 years of service for Z and has projected service at normal retirement age of 25. Employee A also has a projected annual primary insurance amount of $10,000, covered compensation of $25,000, and average annual compensation of $30,000. Therefore, as of December 31, 1988, Employee A's accrued benefit under the plan is $2,667 (((50 percent x $30,000) minus (83 1/3 percent x $10,000)) x 10/25)).

(c) Effective with the 1989 plan year, the plan is amended to provide each employee with a normal retirement benefit of 2 percent of average annual compensation reduced by 0.65 percent of final average compensation up to covered compensation per year of service. The plan also provides that, for plan years after 1988, each employee's accrued benefit is determined under the formula in paragraph (c)(2) of this section (formula without wear-away) and, in applying the fresh-start formula, each employee's frozen accrued benefit under paragraph (c)(3)(i) of this section will be adjusted under this paragraph (d), using the old compensation fraction under paragraph (d)(6)(i)(A) of this section.

(d) The plan is a section 401(*l*) plan and thus must also make the minimum benefit adjustment under paragraph (d)(5) of this section. Because the offset applied to determine Employee A's frozen accrued benefit as of December 31, 1988 ($3,333), exceeded 50 percent of the benefit determined without regard to the offset ($6,000), the offset must be reduced to no more than 50 percent. After the minimum benefit adjustment, Employee A's accrued benefit as of December 31, 1988, is $3,000 ($6,000 minus the reduced offset of $3,000).

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(e) As of December 31, 1992, Employee A has 14 years of service and has covered compensation of $30,000 and average annual compensation and final average compensation of $40,000. Employee A's adjusted accrued benefit as of December 31, 1992, is $4,000 ($3,000 x $40,000/$30,000), and Employee A's accrued benefit as of December 31, 1992, is $6,420 (the sum of $4,000 plus $2,420 ((2 percent x $40,000 x 4 years) minus (0.65 percent x $30,000 x 4 years))).

(e) Special fresh-start rules for target benefit plans--(1) Plans qualified under prior law. A target benefit plan that was adopted and in effect on [~~INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER~~] September 19, 1991, and that satisfied the applicable nondiscrimination requirements for target benefit plans on that date and in all prior periods, may be treated as satisfying the requirements of §1.401(a)(4)-

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8(b)(3) in plan years beginning before the effective date applicable to the plan under paragraph (a) or (b) of this section that were taken into account in determining employees' stated benefits. In determining whether a plan satisfied the applicable nondiscrimination requirements for target benefit plans for any period prior to the applicable effective date, no amendments after [~~INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER~~] September 19, 1991, other than amendments necessary to satisfy section 401(*l*), are taken into account.

(2) Determination of initial theoretical reserve. In the case of a target benefit plan described in paragraph (e)(1) of this section, the theoretical reserve, as of the determination date (within the meaning of §1.401(a)(4)-8(b)(3)(iv)(A)) for the last plan year beginning before the earlier of the first day of the first plan year in which the plan actually satisfied §1.401(a)(4)-8(b)(3) (i.e., without regard to paragraph (e)(1) of this section) or the effective date applicable to the plan under paragraph (a) or (b) of this section, of an employee who was a participant in the plan on such earlier date is determined as follows--

(i) Determine the actuarial present value, as of the determination date, of the stated benefit that the employee is projected to have at the employee's normal retirement age, using the actuarial assumptions, the provisions of the plan, and the employee's compensation as of the determination date. For an employee beyond normal retirement, determine the actuarial present value of the employee's stated benefit at current age, but using a straight life annuity factor as of normal retirement age.

(ii) Calculate the present value of future required employer contributions as of the determination date (i.e., the present value of the level contributions due for each plan year

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through the end of the plan year in which the employee attains normal retirement age). This calculation is made using the actuarial assumptions as of the determination date and the required contribution for the plan year including the determination date.

(iii) Determine the excess, if any, of the amount determined in paragraph (e)(2)(i) of this section over the amount determined in paragraph (e)(2)(ii) of this section. This is the employee's theoretical reserve on the determination date.

(3) Example. The following example illustrates the determination of an employee's theoretical reserve.

Example. (a) A target benefit plan that in 1991 satisfies the requirements of Rev. Rul. 76-464, 1976-2 C.B. 115, provides a stated benefit equal to 40 percent of compensation, payable annually as a straight life annuity beginning at normal retirement age. Normal retirement age under the plan is 65. The stated interest rate under the plan is 6 percent. The determination date for required contributions under the plan is the last day of the plan year. Employee A is 38 years old on the determination date for the 1991 plan year, has participated in the plan for 5 years, and has compensation equal to $60,000 in 1991. The amount of employer contribution to Employee A's account for 1991 was $2,468.

(b) Under these facts, Employee A's theoretical reserve is equal to $13,909, calculated as follows--

(1) The actuarial present value of Employee A's stated benefit is calculated using the actuarial assumptions, provisions of the plan and Employee A's compensation as of the determination date for the 1991 plan year. This amount is equal to $46,512, Employee A's stated benefit of $24,000 ($60,000 multiplied by 40 percent), multiplied by 1.938, the actuarial present value factor applicable to a participant who is 38 years old using a stated interest rate of 6 percent.

(2) The actuarial present value of future employer contributions is calculated using the actuarial assumptions, provisions of the plan and Employee A's compensation as of the determination date for the 1991 plan year. This amount is equal to $32,603, which is equal to the amount of level employer contribution ($2,468) multiplied by a factor of 13.2105, the temporary annuity factor for a period of 27 years, assuming a stated interest rate of 6 percent.

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(3) Employee A's theoretical reserve is $13,909, the excess of the amount determined in paragraph (b)(2) of this Example over the amount determined in paragraph (b)(3) of this Example.

(f) Special fresh-start rules for cash balance plans--(1) In general. In order to satisfy the optional testing method of §1.401(a)(4)-8(c)(3) after a fresh-start date, a cash balance



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plan must apply the rules of paragraph (c) of this section as modified under this paragraph (f). Paragraph (f)(2) of this section provides an alternative formula that may be used in addition to the formulas in paragraphs (c)(2) through (c)(4) of this section. Paragraph (f)(3) of this section sets forth certain limitations on use of the formulas in paragraph (c) or (f)(2) of this section.

(2) Alternative formula--(i) In general. An employee's accrued benefit under the plan is equal to the greater of--

(A) The employee's frozen accrued benefit, or

(B) The employee's accrued benefit determined under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to years of service after the fresh-start date, modified in accordance with paragraph (f)(2)(ii) of this section.

(ii) Addition of opening hypothetical account. As of the first day after the fresh-start date, the plan must credit each employee's hypothetical account with an amount equal to the employee's opening hypothetical account (determined under paragraph (f)(2)(iii) of this section), adjusted for interest for the period that begins on the first day after the fresh-start date and that ends at normal retirement age. The interest adjustment in the preceding sentence must be made using the same interest rate applied to the hypothetical allocation for the first plan year beginning after the fresh-start date.

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(iii) Determination of opening hypothetical account--(A) General rule. An employee's opening hypothetical account equals the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date. For this purpose, if the plan provides for a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date equals the amount of a single sum distribution payable under the plan on that date, assuming that the employee terminated employment on the fresh-start date, the employee's accrued benefit was 100-percent vested, and the employee satisfied all eligibility requirements under the plan for the single sum distribution. If the plan does not offer a single sum distribution as of the fresh-start date, the actuarial present value of the employee's frozen accrued benefit as of the fresh-start date must be determined using a standard mortality table and the applicable section 417(e) rates, as defined in §1.417(e)-1(d).

(B) Alternative opening hypothetical account. Alternatively, the employee's opening hypothetical account is the greater of the opening hypothetical account determined under paragraph (f)(2)(ii)(A) of this section and the employee's hypothetical account as of the fresh-start date determined in accordance with §1.401(a)(4)-8(c)(3)(v)(A) calculated under the plan's benefit formula applicable to benefit accruals in the current plan year as applied to the employee's total years of service through the fresh-start date in a manner that satisfies the past service credit rules of §1.401(a)(4)-8(c)(3)(viii).

(3) Limitations on formulas--(i) Past service restriction. If the plan does not satisfy the uniform hypothetical allocation formula requirement of §1.401(a)(4)-8(c)(3)(iii)(B) as of the fresh-start date, under §1.410(a)(4)-8(c)(3)(viii) the plan may not provide for past service

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credits, and thus may not use the formula in paragraph (c)(3) of this section (formula with wear-away), the formula in paragraph (c)(4) of this section (formula with extended wear-away), or the alternative determination of the opening hypothetical account in paragraph (f)(2)(iii)(B) of this section.

(ii) Change in interest rate. If the interest rate used to adjust employees' hypothetical allocations under §1.401(a)(4)-8(c)(3)(iv) for the plan year is different from the interest rate used for this purpose in the immediately preceding plan year, the plan must use the formula in paragraph (c)(2) of this section (formula without wear-away).

(iii) Meaningful benefit requirement. A plan is permitted to use the formula provided in paragraph (f)(2) of this section only if the plan satisfies paragraphs (d)(3) through (d)(5) of this section (regarding coverage as of fresh-start date, current benefit accruals, and minimum benefit adjustment, respectively).

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Par. 4. Section 1.411(d)-4 is amended by revising A-1(a), by adding a sentence at the end of paragraph A-1(b)(1), and by revising A-1(d) to read as follows--

§1.411(d)-4 Section 411(d)(6) protected benefits.

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* * * * *

~~Q-1: What are "section 411(d)(6) protected benefits"?~~

A-1: (a) In general. The term "section 411(d)(6) protected benefit" includes any benefit that is described in one or more of the following categories--

(1) benefits described in section 411(d)(6)(A),

(2) early retirement benefits and retirement-type subsidies described in section 411(d)(6)(B)(i), including qualified social security supplements as defined in §1.401(a)(4)-12(q), and

(3) optional forms of benefit described in section 411(d)(6)(B)(ii).

Such benefits, to the extent they have accrued, are subject to the protection of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a) (including section 401(a)(25)) and cannot, therefore, be reduced, eliminated, or made subject to employer discretion except to the extent permitted by regulations.

(b) Optional forms of benefit--(1) In general. * * * See §1.401(a)(4)-4(d) for the definition of an optional form of benefit for plan years beginning on or after January 1, 1992. * * * * *

(d) Benefits that are not section 411(d)(6) protected benefits. The following benefits are examples of items that are not section 411(d)(6) protected benefits: (1) ancillary life insurance protection; (2) accident or health insurance benefits; (3) social security supplements



described in section 411(a)(9), except qualified social security supplements as defined in §1.401(a)(4)-12; (4) the availability of loans (other than the distribution of an employee's accrued benefit upon default under a loan); (5) the right to make after-tax employee contributions or elective deferrals described in section 402(g)(3); (6) the right to direct investments; (7) the right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities, commercial paper, or other investment media); (8) the allocation dates for contributions, forfeitures, and earnings, the time for making contributions (but not the conditions for receiving an allocation of contributions or forfeitures for a plan year after such conditions have been satisfied), and the valuation dates for account balances; (9) administrative procedures for distributing benefits, such as provisions relating to the particular dates on which notices are given and by which elections must be made; and (10) rights that derive from administrative and operational provisions, such as mechanical procedures for allocating investment experience among accounts in defined contribution plans.

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Commissioner of Internal Revenue

Approved:

Assistant Secretary of the Treasury

August 30, 1991



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[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

T.D. 8359

RIN 1545-AI86

Permitted disparity with respect to benefits and contributions

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the permitted disparity in employer contributions to, and employer-derived benefits under, qualified plans. They reflect changes to the applicable tax law made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance needed to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning after December 31, 1988, and applied to those plan years except as set forth in §1.401(*l*)-6.

FOR FURTHER INFORMATION CONTACT: Patricia McDermott at 202-377-9372 (not a toll-free number).



SUPPLEMENTARY INFORMATION:

Background

Proposed regulations under section 401(*l*) were published in the **Federal Register** on November 15, 1988 (53 FR 45917). The November 1988 proposed regulations were supplemented and modified by proposed regulations published in the **Federal Register** on May 14, 1990 (55 FR 19947), and September 14, 1990 (55 FR 37888).

Written comments were received from the public on the proposed regulations. In addition, public hearings on the proposed regulations were held June 29, 1989, and September 26, 27, and 28, 1990. After consideration of all the written comments received and the statements made at the hearings, the proposed regulations under section 401(*l*) are adopted as modified by this Treasury Decision.

Explanation of Provisions:

Organization of Regulation

These final regulations have been generally modified to reflect final regulations under section 401(a)(4). They have also been reorganized in certain respects to improve their readability. Other changes in style and organization have been made in order to improve, clarify and resolve areas that commentators noted as ambiguous.

1. Coordination with final section 401(a)(4) regulations

Regulations under section 401(*l*) were proposed prior to the issuance of proposed regulations under section 401(a)(4). Because these final regulations have been developed in conjunction with the final section 401(a)(4) regulations that are being issued simultaneously, it has been possible to eliminate unnecessary duplication and provide for better coordination



of the rules under the two sections. For example, some provisions contained in proposed regulations under section 401(*l*) apply to plans generally under section 401(a)(4). To the extent possible, these provisions have been moved to the regulations under section 401(a)(4), while retaining a reference in the section 401(*l*) regulations.

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Certain definitions in the permitted disparity regulations now cross-refer to the definitions in the final regulations under sections 401(a)(4) and section 410(b). For example, terms such as "average annual compensation," "employee," "plan year compensation," and "plan" are defined in §1.401(a)(4)-12. In response to comments, the concept of "plan" under section 401(a)(4), including aggregated plans and component plans, has been extended for purposes of section 401(*l*). Thus, although a plan as a whole might not satisfy section 401(*l*), the plan may be restructured into component plans under §1.401(a)(4)-9(c), some or all of which satisfy section 401(*l*) and qualify for safe harbor treatment under section 401(a)(4).

Some of the deemed uniformity rules originally contained in the proposed regulations under section 401(*l*), such as the multiple formula rule, have been consolidated with the safe harbor uniformity rules in §§1.401(a)(4)-2(b) and 1.401(a)(4)-3(b). In addition, the final regulations under section 401(*l*) now provide that the special rules under the final section 401(a)(4) regulations enumerating those plan provisions that will not cause a plan to be nonuniform under the safe harbors apply also for purposes of section 401(*l*), thus allowing the same flexibility in designing safe harbor plans under section 401(*l*) as under section 401(a)(4). For example, a plan may limit each employee's benefit to a specified dollar amount without violating the uniformity rule.



Special rules for target benefit plans and certain insurance contract plans (section 412(i) plans) that use the permitted disparity rules, originally contained in the proposed regulations under section 401(*l*), are now contained in §§1.401(a)(4)-8(b)(3) and 1.401(a)(4)-3(b)(7), respectively.

Safe harbor rules for cash balance plans have also been added to the final section 401(a)(4) regulations. Many comments on the section 401(*l*) proposed regulations requested that cash balance plans, which are a hybrid type of defined benefit plan, be allowed to use the permitted disparity rules for defined contribution plans. They stated that the permitted disparity rules for defined benefit plans were incompatible with the basic design of a cash balance plan. In response to those comments, the cash balance plan safe harbor adopted in the final section 401(a)(4) regulations allows a plan to satisfy section 401(*l*) on the basis of the defined contribution plan rules.

The rules in the proposed regulations under section 401(*l*) relating to employee contributions under a defined benefit plan have been consolidated with the regulations under section 401(a)(4) to provide a single set of rules under §1.401(a)(4)-6. The preamble to the final section 401(a)(4) regulations discusses changes in the employee contribution rules under the final regulations.

Finally, the transition rules in the proposed regulations under both section 401(*l*) and section 401(a)(4) provided rules for determining employees' accrued benefits after amendment of a defined benefit plan to comply with the Tax Reform Act of 1986 ("TRA '86") and rules relating to increases in an employee's benefit accrued before the effective date of the new rules under section 401(*l*) and section 401(a)(4) to reflect pay increases after



the effective date. These rules have been combined into a single set of "fresh start" rules under §1.401(a)(4)-13(c), with a single set of examples, that apply to plan amendments made to comply with TRA '86. In addition, under the final regulations, the fresh-start rules will also apply to later plan amendments, including an amendment to bring the plan within one of the design-based safe harbors under the final section 401(a)(4) regulations. Thus, an employer that chooses not comply to with section 401(*l*) as of the original effective date, now has the option of amending the plan to comply with section 401(*l*) at a later date. Since complying with section 401(*l*) in form is a prerequisite to satisfying the nondiscriminatory amounts test under the final section 401(a)(4) regulations on a safe harbor basis, this will permit use of the safe harbors by additional plans.

The rules for increasing a pre-effective date accrued benefit to reflect pay increases after the effective date have been consolidated in §1.401(a)(4)-13(d). The proposed regulations allowed increases in pre-effective date accrued benefits under a plan using section 401(*l*) only if the plan satisfied section 401(*l*) as of the 1989 plan year. The final regulations remove that restriction, allowing the increases for any plan that satisfies section 401(*l*) as of the 1992 plan year, the effective date of the final regulations under section 401(a)(4).



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2. Reorganization of the final section 401(*l*) regulations

The final regulations under section 401(*l*) have also been reorganized to eliminate unnecessary internal duplication in order to improve their readability. For example, the proposed regulations contained separate rules for defined benefit excess plans and for defined benefit offset plans. The two sets of rules have been combined in the final regulations into a single set of rules that apply to both types of plans. Only in those cases where in different



rule applies to each type of plan has a separate rule been set forth. The defined contribution plan rules have also been reorganized in a parallel manner.

New terms have been added to the definitions in §1.401(*l*)-1(c) to make a single set of rules possible. For offset plans, the new terms "gross benefit percentage," "offset percentage," and "offset level" serve functions similar to the defined benefit excess plan terms "excess benefit percentage," "base benefit percentage," and "integration level." Another new term, "disparity," means, in the case of an excess plan, the amount by which the excess percentage exceeds the base percentage and means, in the case of an offset plan, the offset percentage. Except as discussed below, use of those new terms has not generally modified the substance of the rules.

The final regulations have also been revised to add the amendments made by Notice 89-70, 1989-1 C.B. 730. Those amendments generally expanded the proposed regulations in response to comments by providing more flexibility in determining integration (or offset) levels, covered compensation, average annual compensation, and early retirement reductions. Notice 89-70 also required that, in the case of early retirement under an offset plan, the rate of the gross benefit be reduced as well as the rate of the offset.

Finally, comments on the proposed regulations under section 401(*l*) requested clarification of the permitted disparity rules, particularly in the form of examples. Thus, a number of examples have been added to the regulations at various points to illustrate their application.



Section 401(*l*) Permitted Disparity

1. Plans not eligible to use section 401(*l*).

The proposed regulations under section 401(*l*) provided that section 401(*l*) does not apply to a plan maintained by an employer not subject to the tax under section 3111(a) (the Federal Insurance Contributions Act or "FICA") or section 3221 (the Railroad Retirement Tax Act or "RRTA"). Similarly, the proposed regulations provided that section 401(*l*) does not apply to an employee stock ownership plan. In addition, the proposed regulations under section 401(a)(4) indicated that section 401(*l*) does not apply to contributions subject to section 401(k) or (m). The final regulations under section 401(*l*) make it clear that disparity is not permitted with respect to elective contributions under a qualified cash or deferred arrangement, or with respect to employee or matching contributions, as those terms are defined under the final section 401(k) and (m) regulations. Nor is disparity permitted with respect to contributions to a simplified employee pension made under a salary reduction arrangement described in section 408(k)(6).

Under section 3121(b)(7), the FICA (and the tax under section 3111(a)) generally does not apply to service performed in the employ of a state, a political subdivision of a state, or an instrumentality of a state or political subdivision. Section 401(*l*) therefore does not apply to a plan maintained by a state or local government employer not subject to the tax under section 3111(a). Comments indicated that there was some confusion on this provision and requested that the final regulations extend section 401(*l*) to a state or local government employer that makes social security contributions under an agreement with the Social Security Administration under section 218 of the Social Security Act (a "218 agreement").



This was not necessary because section 3121(b)(7)(E) provides that employment for FICA purposes includes service performed for an employer covered by a 218 agreement. Thus, that employer is subject to the tax under section 3111(a) and is eligible to use the permitted disparity rules under section 401(*l*).

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The final regulations clarify that, for purposes of section 401(*l*), an individual subject to the tax on self-employment income under section 1401 ("SECA") is deemed to be subject to the tax under section 3111(a). The final regulations also allow an employer not to provide disparity in contributions or benefits for an employee not covered by FICA, RRTA, or SECA by deeming disparity for that employee to be uniform.

2. Permitted disparity under defined contribution plans

Few changes to the disparity rules for defined contribution plans have been made in the final regulations under section 401(*l*). As permitted under Notice 89-70, a defined contribution plan may use an integration level below the taxable wage base and make specified adjustments in the disparity provided under the plan. Final regulations also allow a plan that has a short plan year and bases allocations on employees' compensation for that short plan year to pro-rate the integration level for the year.

The proposed regulations under section 401(*l*) required a defined contribution plan to provide uniform disparity for all employees. In contrast, the safe harbor rules under §1.401(a)(4)-2(b) of the proposed section 401(a)(4) regulations specifically required a plan relying on section 401(*l*) to use the same base and excess contribution percentages for all employees. Because that requirement directly relates to section 401(*l*), the uniformity requirement under section 401(*l*) has been revised to require the plan to use same base and



excess contribution percentages for all employees. The final regulations also allow disparity to be adjusted for an employee who has reached the cumulative disparity limit without violating the uniformity requirement.

The maximum excess allowance for a defined contribution plan is the lesser of (1) the base contribution percentage or (2) the greater of (a) 5.7 percent or (b) the portion of the tax under section 3111(a) that is attributable to "old-age" or retirement benefits. A number of practitioners have contacted the Service to ask for the current rate of the retirement portion of the tax under section 3111(a). At this point the retirement portion of the tax is well below 5.7 percent and is not expected to exceed 5.7 percent for many years. When it does exceed 5.7 percent, thus increasing the maximum excess allowance, the Commissioner will publish the new rate.

3. Permitted disparity for defined benefit plans

a. Uniform and maximum disparity

The proposed regulations under section 401(*l*) required that the disparity provided under a defined benefit plan be uniform for all employees and that it not exceed the maximum permitted disparity. In response to comments, final regulations clarify those requirements and revise them to provide greater flexibility to accommodate existing plan designs.

The final regulations make it clear that the permitted disparity limits and uniformity apply not just to the disparity provided in the plan formula, but also to the rate of disparity provided in the benefit that accrues. After publication of the supplemental proposed regulations under section 401(a)(4) in September 1990, it became apparent that some



practitioners had not recognized that the permitted disparity limits and uniformity were affected by the accrual method used under the plan. Accordingly, the final regulations clarify this point.

The proposed regulations defined the maximum excess allowance and maximum offset allowance to include an annual disparity limit and a cumulative limit on the disparity provided for an employee's total years of service. The final regulations define maximum excess and offset allowance only as an annual limit. The cumulative limit has been added to the overall permitted disparity rules discussed below.

The proposed regulations also defined the maximum offset allowance as a dollar amount. New terminology for offset plans, as discussed above, has made it possible to define the maximum offset allowance, like the maximum excess allowance, as a percentage.

The proposed regulations limited the offset to the lesser of (1) 0.75 percent of an employee's final average compensation up to covered compensation or (2) one-half of the benefit provided the employee with respect to average annual compensation up to covered

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compensation or, if lower, final average compensation up to covered compensation. Many commentators criticized the offset limit as inconsistent with the statutory limit of one-half the total benefit provided the employee. After consideration of those comments, the offset limit from the proposed regulations has been retained. One purpose of the legislative changes to the integration rules was to achieve parity between defined benefit excess plans and offset plans. To do this, it is necessary to define the maximum excess allowance in terms of the benefit provided with respect to the lesser of average annual compensation or final average compensation up to covered compensation.



Many commentators asked for clarification of the uniformity rules and expansion of the deemed uniformity rules. In response to those comments, a number of modifications have been made to the final regulations. Thus, the final regulations clarify that uniformity applies on the basis of employees with the same number of years of service, permitting a plan formula to vary the rate of disparity for employees with different years of service without violating uniformity. The proposed regulations also provided that a plan could adjust the rate of disparity for employees with different social security retirement ages without violating uniformity. The final regulations clarify that those adjustments must be made by increasing the base benefit percentage or reducing the offset percentage.

Commentators asked that the uniformity rules be revised to allow an offset plan to provide the same gross benefit for an employee's years of service up to 35, but to stop applying an offset after 25 years of service. Such a benefit design violates the 133 1/3% accrual rule under section 411(b)(1)(B) and thus must be accrued fractionally. However, under the proposed regulations, fractional accrual of such a benefit would violate uniformity because the rate of disparity varies for employees with the same service. Thus, the final regulations deem such a plan design to be uniform. In order to provide parity, the deemed uniformity rule allows a similar plan design in a defined benefit excess plan. The deemed uniformity rules also allow a defined benefit plan, like a defined contribution plan, to adjust the disparity provided for an employee who has reached the cumulative disparity limit.

b. Reductions in the permitted disparity

Commentators suggested changes to the adjustments required in the rate of disparity if a plan uses an integration or offset level other than covered compensation or if benefits



commence at an age other than social security retirement age or in a form other than a straight life annuity. A number of those suggestions are reflected in final regulations.

Commentators asked that final regulations under section 401(a)(4) provide a safe harbor for "PIA offset plans." Under a PIA offset plan, benefits are offset by a portion of the employee's primary insurance amount ("PIA") under the Social Security Act. While the final section 401(a)(4) regulations do not include an explicit safe harbor for PIA offset plans, the final regulations under section 401(*l*) have been modified to allow certain reductions in the maximum permitted disparity to be determined on an individual basis, as described in more detail below. This change will enable plans to meet section 401(*l*), while providing benefit levels generally comparable to those under a PIA offset formula. This, in turn, will allow the plans access to the safe harbors provided under the final section 401(a)(4) regulations.

Under the proposed section 401(*l*) regulations, the 0.75 percent maximum offset allowance prescribed in section 401(*l*)(4)(B) was required to be reduced equally for all employees if any employee's offset was based on final average compensation including amounts above covered compensation. The amount of the reduction was determined by comparing the highest amount of final average compensation that could be used in the calculation of the permitted disparity to the covered compensation of an employee currently at the social security retirement age, using a table in the regulations.

The reduction in the maximum offset allowance implemented section 401(*l*)(4)(C)(i)(II), which requires reductions in the maximum permitted disparity for any participant in an offset plan with final average compensation in excess of covered



compensation. Commentators noted, however, that the approach taken in the proposed regulations reduced the permitted disparity factors for all employees, including those with





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final average compensation that did not exceed covered compensation. They suggested that the reduction was therefore inconsistent with section 401(*l*)(4)(C)(ii), which provides that the reduction for participants whose compensation exceeds covered compensation is to be based on the replacement ratio, or percentage of compensation replaced by the employer-derived portion of primary insurance amounts under the Social Security Act.

Two changes were suggested in the method for determining the reduced maximum offset allowance, which have been adopted in the final regulations. First, the reduction may be determined on an individual-by-individual basis by comparing each employee's final average compensation to the employee's covered compensation. Thus, the reduction will be made only with respect to employees with final average compensation in excess of covered compensation. Second, the reduction may be made by interpolating the adjustments in the table in the regulations. To retain parity, these changes also apply to defined benefit excess plans.

The use of individual disparity reductions under the final regulations will allow plans to define an offset that generally parallels replacement ratios for employer-provided social security benefits for each employee whose final average compensation exceeds covered compensation. At the same time, there will be no reduction in the permitted disparity for employees whose final average compensation does not exceed covered compensation. Plans designed in this manner should be able to approximate the replacement ratios for a PIA offset



plan within the structure of section 401(*l*) and should therefore be able to use the existing safe harbors under the final section 401(a)(4) regulations.

Section 401(*l*) also requires the rate of permitted disparity to be reduced if benefits commence before an employee's social security retirement age. This is because social security benefits before social security retirement age are paid at a reduced rate. Under the regulations, the disparity reduction is based on the age at which benefits commence, using tables under §1.401(*l*)-3(e). Many commentators requested that the regulations be revised to take into account social security supplements. They noted a common distribution option that (1) provides an employee with a temporary supplement at early retirement, thus "filling in" the disparity in an employee's benefit until the employee begins collecting social security benefits, and (2) applies the permitted disparity rate applicable at the age the supplement ends, rather than the lower rate applicable at the age benefits originally commenced. That plan design allows an employee to delay commencement of social security benefits until social security retirement age (thus avoiding a reduction in social security benefits) and, in combination with social security benefits, provides an employee with a level stream of retirement income. The final section 401(*l*) regulations have been modified to allow such a plan design, provided the supplement is a "qualified social security supplement" as defined in §1.401(a)(4)-12, by treating benefits as commencing at the age the supplement ends.

Because the maximum permitted disparity of 0.75 percent applies at social security retirement age, the disparity provided at normal retirement age of 65 must be reduced to 0.70 percent or 0.65 percent for employees with social security retirement ages of 66 or 67 respectively. For simplicity, some plans use a disparity rate of 0.65 percent for all



employees at age 65, thus providing less than the maximum disparity for some employees. Commentators asked that such a plan be permitted to apply the early retirement reduction factors under section 401(*l*) on the basis of 0.65 percent without regard to the employees' different social security retirement ages. Accordingly, the final regulations provide a simplified table of early retirement factors for those plans.

Commentators also requested that a plan be permitted to provide an increased rate of disparity for an employee who continues working beyond social security retirement age to parallel increases under the Social Security Act if benefit commencement is delayed beyond social security retirement age. Final regulations allow a plan to increase the rate of disparity to reflect benefit commencement after social security retirement age. Increased disparity rates are included in the tables under §1.401(*l*)-3(e) and are based on the increases under the Social Security Act.

Generally, section 401(*l*) requires the rate of disparity to be reduced if benefits are paid in a form more valuable than a straight life annuity. Commentators asked that a plan be permitted to provide cost-of-living increases after retirement without having to reduce the



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disparity provided in the benefit commencing at retirement. In response to these comments, the final regulations allow the permitted disparity limit to be applied at retirement without regard to automatic post-retirement cost-of-living increases that do not exceed the rate of increase in social security benefits for the period since retirement. Similarly, the final section 401(a)(4) regulations also contain a special safe harbor for ad hoc post-retirement cost-of-living increases under §1.401(a)(4)-10.



4. Railroad plans

Section 401(*l*) authorizes special permitted disparity rules for plans maintained by railroad employers to reflect differences between the social security and railroad retirement systems. The proposed regulations therefore provided special rules for railroad plans. Commentators asked that the final regulations provide (1) a special definition of "covered compensation" for railroad plans and (2) special rules for disparity reductions if a plan uses an integration level other than covered compensation or if benefits commence at an age other than social security retirement age.

Consistent with those requests, the final regulations in §1.401(*l*)-4 define "railroad covered compensation" based on the compensation taken into account to determine benefits under the RRTA and allow disparity reductions based on a comparison of the integration level to railroad covered compensation. In addition, the final regulations provide special tables of reduced disparity factors applicable to early retirement benefits under a railroad plan.

5. Overall permitted disparity

Because social security benefits are based on an employee's earnings for 35 years, section 401(*l*) limits the disparity that may be provided for an employee's total years of service to 35 times the annual permitted disparity. Section 401(*l*) also requires the publication of regulations preventing the multiple use of permitted disparity if an employee participates in more than one plan maintained by the employer. The proposed section 401(*l*) regulations therefore contained a cumulative limit on the disparity provided for an



employee's total years of service and contained bas: overall permitted disparity rules for an employee in more than one plan.

Since publication of the proposed regulations, questions from practitioners indicated that further guidance was needed. Accordingly, section 1.401(*l*)-5 of the final regulations provides greater detail concerning the overall permitted disparity limits. Those rules deal with the disparity that may be provided if an employee benefits under more than one plan for the plan year (the "annual overall permitted disparity limit") and the disparity that may be provided for an employee's total years of service under all plans (the "cumulative overall permitted disparity limit"). The overall permitted disparity rules take into account plans that satisfy section 401(*l*) and plans that impute permitted disparity under §1.401(a)(4)-7.

The annual overall permitted disparity limit requires the determination of a fraction based on the disparity provided an employee for the plan year under each plan. The annual overall permitted disparity limit is met if the sum of those fractions does not exceed one. The cumulative overall permitted disparity limit provides generally that the total of an employee's annual disparity fractions for all years cannot exceed 35. A special rule deems the cumulative overall permitted disparity limit to be met if an employee has not benefited under a defined benefit plan for any plan year beginning after December 31, 1991. Special rules are also provided for plans that contain multiple formulas and plans under which benefits or allocations are offset by benefits or allocations under another plan.

6. Final pay plans under section 401(a)(5)(D)

Section 401(a)(5)(D) provides special rules for plans that limit an employee's benefit to the total of the employee's final pay and the employee's employer-provided primary



insurance amount ("PIA"). The proposed section 401(a)(5)(D) regulations required that the employee's employer-provided PIA be reduced in accordance with §1.401(*l*)-3(e) if benefits commence before an employee's social security retirement age. Commentators requested guidance on how the reductions in §1.401(*l*)-3(e) are applied. Thus, the final regulations



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under §1.401(a)(5)-1(e) provide that the reduction is made by multiplying the employee's employer-provided PIA by the ratio of the factor under §1.401(*l*)-3(e) to 0.75.

7. Plans maintained by more than one employer

Multiple employer plans must satisfy section 401(*l*) on an employer-by-employer basis rather than on the basis of participating employers in the aggregate. Any non-collectively bargained portion of a multiemployer plan is tested as a multiple employer plan. The consequences of failure to satisfy section 401(*l*) with respect to any component of this testing process may affect the plan for all participating employers. The final regulations, like the proposed regulations, do not provide an exception to this rule. However, where a multiemployer plan or a multiple employer plan fails to satisfy section 401(*l*), in a proper case, the Commissioner could treat the plan as satisfying section 401(*l*) for innocent employers by requiring corrective and remedial action with respect to the plan, such as allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have knowledge of the disqualifying event or was otherwise notified by the Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive



Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations published after November 20, 1988, were submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Patricia McDermott of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Treasury and the Service participated in their development.

List of Subjects in 26 CFR 1.401-0 through 1.419A-2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and Trustees.



Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by adding the following citations:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * §1.401(a)(5)-1 also issued under 26 U.S.C. 401(a)(5); §§1.401(*l*)-0 through 1.401(*l*)-6 also issued under 26 U.S.C. 401(*l*). * * *

Par. 2. Section 1.401-3 is amended by adding a new paragraph (e)(6) to read as follows:

§1.401-3. Requirements as to coverage.

* * * * *

(e) * * *

(6) This paragraph (e) does not apply to plan years beginning on or after January 1, 1989.

* * * * *

Par. 3. A new §1.401(a)(5)-1 is added to read as follows:

§1.401(a)(5)-1. Special rules relating to nondiscrimination requirements.

(a) In general. Section 401(a)(5) sets out certain provisions that will not of themselves be discriminatory within the meaning of section 410(b)(2)(A)(i) or section 401(a)(4). The exceptions specified in section 401(a)(5) are not an exclusive enumeration,

but are merely a recital of provisions frequently encountered that will not of themselves constitute prohibited discrimination in contributions or benefits. See section 401(a)(4) and the regulations thereunder for the basic nondiscrimination rules. See §1.410(b)-4 for the rule of section 410(b)(2)(A)(i) (relating to the nondiscriminatory classification test that is part of the minimum coverage requirements) referred to in section 401(a)(5)(A). See paragraphs (b) through (f) of this section for special rules used in applying the section 401(a)(4) nondiscrimination requirements under the remaining provisions of section 401(a)(5).

(b) Salaried or clerical employees. A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because contributions or benefits provided under the plan are limited to salaried or clerical employees.

(c) Uniform relationship to compensation. A plan does not fail to satisfy the nondiscrimination requirements of section 401(a)(4) merely because the contributions or benefits of, or on behalf of, the employees under the plan bear a uniform relationship to the compensation (within the meaning of section 414(s)) of those employees.

(d) Certain disparity permitted. (1) Under section 401(a)(5)(C), a plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)), within the meaning of section 401(a)(4), in the amount of employer-provided contributions or benefits solely because--

(i) In the case of a defined contribution plan, employer contributions allocated to the accounts of employees favor highly compensated employees in a manner permitted by section 401(*l*) (relating to permitted disparity in plan contributions and benefits), and



(ii) In the case of a defined benefit plan, employer-provided benefits favor highly compensated employees in a manner permitted by section 401(*l*) (relating to permitted disparity in plan contributions and benefits).

See §§1.401(*l*)-1 through 1.401(*l*)-6 for rules under which a plan may satisfy section 401(*l*) for purposes of the safe harbors of §§1.401(a)(4)-2(b)(3) and 1.401(a)(4)-3(b).

(e) Defined benefit plans integrated with social security--(1) In general. Under section 401(a)(5)(D), a defined benefit plan does not discriminate in favor of highly compensated employees (as defined in section 414(q)) with respect to the amount of employer-provided contributions or benefits solely because the plan provides that, with respect to each employee, the employer-provided accrued retirement benefit under the plan is limited to the excess (if any) of--

(i) The employee's final pay from the employer, over

(ii) The employer-provided retirement benefit created under the Social Security Act and attributable to service by the employee for the employer.

(2) Final pay. For purposes of paragraph (e)(1)(i) of this section, an employee's final pay from the employer as of a plan year is the employee's compensation (as defined in section 414(q)(7)) for the year (ending with or within the 5-plan-year period ending with the plan year in which the employee terminates from employment with the employer) in which the employee receives the highest compensation from the employer. Notwithstanding the preceding sentence, final pay for each employee under the plan may be determined with reference to the 5-plan-year period ending with the plan year before the plan year in which



the employee terminates from employment with the employer. In determining an employee's final pay, the plan may specify any 12-month period (ending with or within the applicable 5-plan-year period) as a year provided the specified 12-month period is uniformly and consistently applied with respect to all employees. In determining an employee's final pay, compensation for any year in excess of the applicable limit under section 401(a)(17) for the year may not be taken into account.

(3) Rules for determining amount of employer-provided social security retirement benefit. For purposes of paragraph (e)(1)(ii) of this section, the following rules apply.

(i) The employer-provided retirement benefit on which any reduction or offset in the employee's accrued retirement benefit is based is limited solely to the employer-provided primary insurance amount payable under section 215 of the Social Security Act attributable to service by the employee for the employer.

(ii) The employer-provided primary insurance amount attributable to service by the employee for the employer is determined by multiplying the employer-provided portion of the employee's projected primary insurance amount by a fraction (not exceeding 1), the numerator of which is the employee's number of complete years of covered service for the employer under the Social Security Act, and the denominator of which is 35.

(4) Projected primary insurance amount. (i) As of a plan year, an employee's projected primary insurance amount is the primary insurance amount, determined as of the close of the plan year (the "determination date"), payable to the employee upon attainment of the employee's social security retirement age (as determined under section 415(b)(8)), assuming the employee's annual compensation from the employer that is treated as wages for

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purposes of the Social Security Act remains the same from the plan year until the employee's attainment of social security retirement age. With respect to service by the employee for the employer before the determination date, the actual compensation paid to the employee by the employer during all periods of service of the employee for the employer covered by the Social Security Act must be used in determining an employee's projected primary insurance amount. With respect to years before the employee's commencement of service for the employer, in determining the employee's projected primary insurance amount, it may be assumed that the employee received compensation in an amount computed by using a six-percent salary scale projected backwards from the determination date to the employee's 21st birthday. However, if the employee provides the employer with satisfactory evidence of the employee's actual past compensation for the prior years treated as wages under the Social Security Act at the time the compensation was earned and the actual past compensation results in a smaller projected primary insurance amount, the plan must use the actual past compensation. The plan administrator must give clear written notice to each employee of the employee's right to supply actual compensation history and of the financial consequences of failing to supply the history. The notice must be given each time the summary plan description is provided to the employee and must also be given upon the employee's separation from service. The notice must also state that the employee can obtain the actual compensation history from the Social Security Administration. In determining the employee's projected primary insurance amount, the employer may not take into account any compensation from any other employer while the employee is employed by the employer.

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(ii) As of a plan year, the employer-provided portion of the employee's projected primary insurance amount under the Social Security Act is 50 percent of the employee's projected primary insurance amount (as determined under paragraph (e)(4)(i) of this section).

(5) Employer-provided accrued retirement benefit. For purposes of this section, the employee's employer-provided accrued retirement benefit as of a plan year is the employee's accrued retirement benefit under the plan (determined on an actual basis and not on a projected basis) attributable to employer contributions under the plan. With respect to plans that provide for employee contributions, see section 411(c) for rules relating to the allocation of accrued benefits between employer contributions and employee contributions.

(6) Additional rules. (i) As of a plan year, paragraph (e)(1) of this section does not apply to the extent that its application would result in a decrease in an employee's accrued benefit. See sections 411(b)(1)(G) and 411(d)(6).

(ii) Section 401(a)(5)(D) and this paragraph (e) do not apply to a plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(iii) If a plan provides for the payment of an employee's accrued retirement benefit (whether or not subsidized) commencing before an employee's social security retirement age, the projected employer-provided primary insurance amount attributable to service by the

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employee for the employer (as determined under paragraphs (e)(3) and (e)(4) of this section) that may be applied as an offset to limit the employee's accrued retirement benefit must be



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reduced in accordance with §1.401(*l*)-3(e)(1). The reduction is made by multiplying the employee's projected employer-provided primary insurance amount by a fraction, the numerator of which is the appropriate factor under §1.401(*l*)-3(e)(1), and the denominator of which is 0.75 percent.

(iv) The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of this section, including rules relating to the determination of an employee's projected primary insurance amount attributable to the employee's service for former employers and rules applying section 401(a)(5)(D) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not for other years.

(7) Effective date. This paragraph (e) is effective for plan years beginning after December 31, 1988.

(8) Examples. The following examples illustrate this paragraph (e).

Example 1. Employer Z maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The plan provides a normal retirement benefit, commencing at age 65, equal to $500 a year, multiplied by the employee's years of service for Z, limited to the excess of the amount of the employee's final pay from Z (as determined in accordance with paragraph (e)(2) of this section) over the employee's employer-provided primary insurance amount attributable to the employee's service for Z. If an employee's social security retirement age is greater than 65, the plan provides for reduction of the employee's employer-provided primary insurance amount in accordance with paragraph (e)(6)(iii) of this section. The plan provides no limitation on the number of years of service taken into account in determining benefits under the plan. Employee A retires on July 6, 1995, at A's social security retirement age of 65 with 35 years of service for Z. The plan



uses the plan year as the 12 month period for determining an employee's year of final highest pay from the employer. A's compensation for A's final 5 plan years is as follows:

1995 plan year - $10,500
1994 plan year - $20,000
1993 plan year - $18,000
1992 plan year - $17,000
1991 plan year - $16,500

A's annual primary insurance amount under social security, determined as of A's social security retirement age, is $9,000, of which $4,500 is the employer-provided portion attributable to A's service for Z ($9,000 x 50 percent x 35/35). Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive a normal retirement benefit of $17,500 ($500 x 35 years). However, under the plan, A's otherwise determined normal retirement benefit of $17,500 is limited to the excess of the amount of A's final pay from Z over A's employer-provided primary insurance amount under social security attributable to A's service for Z. Accordingly, A's normal retirement benefit is determined to be $15,500 ($20,000 (A's final pay from Z) less $4,500 (A's employer-provided primary insurance amount attributable to A's service for Z)) rather than $17,500. The final pay limitation in Z's plan satisfies section 401(a)(5)(D) and this paragraph (e). Accordingly, the plan maintained by Z does not discriminate in favor of highly compensated employees within the meaning of section 401(a)(4) merely because of the final pay limitation contained in the plan.

Example 2. Assume the same facts as in Example 1, except that A has 32 years of service and service for Z when A retires at A's social security retirement age. Under the plan's benefit formula (disregarding the final pay limitation), A would be entitled to receive an annual normal retirement benefit of $16,000 ($500 x 32 years). However, the plan provides that A's normal retirement benefit of $16,000 will be limited to $15,500 ($20,000 (the amount of A's final pay from Z) less $4,500 (1/2 of A's primary insurance amount under the Social Security Act)). The final pay limitation does not satisfy this paragraph (e). The portion of A's employer-provided primary insurance amount under the Social Security Act attributable to A's service for Z is 32/35 x $4,500, or $4,114. Therefore, to satisfy this paragraph (e), the final pay provision in Z's plan may not limit A's otherwise determined normal retirement benefit of $16,000 to less than $15,886 ($20,000 (the amount of X's final pay) - $4,114 (the portion of A's employer-provided primary insurance amount attributable to A's service for Z)).

Example (3). (a) Employer X maintains a noncontributory defined benefit plan that uses the calendar year as its plan year. The formula for determining benefits under the plan provides a normal retirement benefit at age 65 equal to 90 percent of an employee's final average compensation, with the benefit reduced by 1/30th for each year of the employee's service less than 30 and limited to the employee's final pay (as determined in accordance with paragraph (e)(2) of this section) less the employee's employer-provided primary



insurance amount under social security attributable to the employee's service for X. The plan determines an employee's employer-provided projected primary insurance amount under social security attributable to the employee's service for X in accordance with paragraph (e)(3) of this section and applies the reductions applicable under paragraph (e)(6)(iii) of this section if benefits commence before social security retirement age. The plan determines an employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C).

(b) Employee A commences participation in the plan on January 1, 1990, when A is 35 years of age. A's social security retirement age is age 67. As of the close of the 2014 plan year, A's final average compensation from X is $15,000; A's final pay from X is $15,400, and A's projected employer-provided annual primary insurance amount under social security attributable to A's service for X is $4,000 (after the reduction applicable under paragraph (e)(6)(iii) of this section). Under the plan formula, A's accrued benefit as of the close of the 2014 plan year is $11,250 (90 percent x $15,000 x 25/30). As of the close of the 2014 plan year, the plan's final pay limitation does not affect A's benefit because A's accrued benefit under the plan as of the close of the plan year ($11,250) does not exceed A's final pay of $15,400 from X, determined as of the close of the plan year, less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,000).

(c) Assume that, as of the close of the 2015 plan year, A's final average compensation from X is $14,500 and A's final pay from X is $15,400. Assume also that as of the close of the 2015 plan year, A's employer-provided primary insurance amount attributable to A's service for X is $4,200 (after the reduction applicable under paragraph



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(e)(6)(iii) of this section). Accordingly, A's accrued benefit as of the close of the 2015 plan year is $11,310 (90 percent x $14,500 x 26/30). Under the plan's final pay limitation, A's accrued benefit of $11,310 would be limited to $11,200, the amount of A's final pay from X ($15,400), less A's employer-provided projected primary insurance amount under social security attributable to A's service for X ($4,200). However, the plan's final pay limitation may not be applied to limit A's accrued benefit for the 2015 plan year to an amount below $11,250, which was A's accrued benefit under the plan at the close of the prior plan year. The foregoing is further illustrated in the following table for the plan years presented above and for additional years of service performed by A for X.

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TABLE

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|
| Years of service | Final average compensation | Benefit under plan formula (Column 2 x 0.9 x years of service/30) | Final pay | Employer-provided projected primary insurance amount under social security attributable to service for employer | Benefit if final pay reduction is applied in full (Column 4 - Column 5) | Benefit to which A is entitled (smaller of Column 6 or Column 3, but not less than Column 7 for prior year) |
| 25 | $15,000 | $11,250 | $15,400 | $4,000 | $11,400 | $11,250 |
| 26 | $14,500 | $11,310 | $15,400 | $4,200 | $11,200 | $11,250 |
| 27 | $15,500 | $12,555 | $15,800 | $4,400 | $11,400 | $11,400 |
| 28 | $15,500 | $13,020 | $16,000 | $4,500 | $11,500 | $11,500 |
| 29 | $15,000 | $13,050 | $16,000 | $4,800 | $11,200 | $11,500 |
| 30 | $14,500 | $13,050 | $16,000 | $5,000 | $11,000 | $11,500 |

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(f) Certain benefits not taken into account. In determining whether a plan satisfies section 401(a)(4) and this section, other benefits created under state or federal law (e.g., worker's compensation benefits or black lung benefits) may not be taken into account.

(g) More than one plan treated as single plan. [Reserved]

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Par. 4. There is added the following new §§1.401(*l*)-0 through 1.401(*l*)-6 after §1.401(k)-1 to read as follows:

§1.401(*l*)-0 Table of contents.

This section contains a listing of the headings of §§1.401(*l*)-1 through 1.401(*l*)-6.

§1.401(*l*)-1 Permitted disparity with respect to employer-provided contributions or benefits.

(a) Permitted disparity.
- (1) In general.
- (2) Overview.
- (3) Exclusive rules.
- (4) Exceptions.
- (5) Additional rules.

(b) Relationship to other requirements.
- (1) In general.
- (2) Determination of accrued benefit to avoid reduction.

(c) Definitions.
- (1) Accumulation plan.
- (2) Average annual compensation.
- (3) Base benefit percentage.
- (4) Base contribution percentage.
- (5) Benefit formula.
- (6) Benefits, rights, and features.
- (7) Covered compensation.

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§1.401(*l*)-4 Special rules for railroad plans.



§1.401(*l*)-5 Overall permitted disparity limits.









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§1.401(*l*)-1 Permitted disparity in employer-provided contributions or benefits.

(a) Permitted disparity--(1) In general. Section 401(a)(4) provides that a plan is a qualified plan only if the amount of contributions or benefits provided under the plan does



not discriminate in favor of highly compensated employees. See §1.401(a)(4)-1(b)(2). Section 401(a)(5)(C) provides that a plan does not discriminate in favor of highly compensated employees merely because of disparities in employer-provided contributions or benefits provided to, or on behalf of, employees under the plan that are permitted under section 401(*l*). Thus, if a plan satisfies section 401(*l*), permitted disparities in employer-provided contributions or benefits under a plan are disregarded, by reason of section 401(a)(5)(C), in determining whether the plan satisfies any of the safe harbors under §§1.401(a)(4)-2(b)(3) and 1.401(a)(4)-3(b). However, even if disparities in employer-provided contributions or benefits under a plan are permitted under section 401(*l*) and thus do not cause the plan to fail to satisfy §1.401(a)(4)-1(b)(2), the plan may still fail to satisfy section 401(a)(4) for other reasons. Similarly, even if disparities in employer-provided contributions or benefits under a plan are not permitted under section 401(*l*) and thus may not be disregarded under section 401(a)(4) by reason of section 401(*l*), the plan may still be found to be nondiscriminatory under the tests of section 401(a)(4), including the rules for imputing permitted disparity under §1.401(a)(4)-7.

(2) Overview. Rules relating to disparities in employer-provided contributions under a defined contribution plan are provided in §1.401(*l*)-2. For rules relating to disparities in employer-provided benefits under a defined benefit plan, see §1.401(*l*)-3. For rules relating to the application of section 401(*l*) to a plan maintained by a railroad employer, see §1.401(*l*)-4. For rules relating to the overall permitted disparity limits, see §1.401(*l*)-5. For rules relating to the effective date of section 401(*l*), see §1.401(*l*)-6.



(3) Exclusive rules.. The rules provided in §§1.401(*l*)-1 through 1.401(*l*)-6 are the exclusive means for a plan to satisfy sections 401(*l*) and 401(a)(5)(C). Accordingly, a plan that provides disparities in employer-provided contributions or benefits that are not permitted under §§1.401(*l*)-1 through 1.401(*l*)-6 does not satisfy section 401(*l*) or 401(a)(5)(C). For example, a defined benefit plan that reduces an employee's employer-provided benefit by an offset based on the employee's benefits under the Social Security Act does not satisfy section 401(*l*) and may not rely on section 401(*l*) to satisfy section 401(a)(4).

(4) Exceptions. Sections 401(a)(5)(C) and 401(*l*) are not available in the following arrangements--

(i) A plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(ii) A plan, or the portion of a plan, that is an employee stock ownership plan described in section 4975(e)(7) (an ESOP) or a tax credit employee stock ownership plan described in section 409(a) (a TRASOP), except as provided in §54.4975-11(a)(7)(ii) of this chapter, which contains a limited exception to this rule for certain ESOPs in existence on November 1, 1977.

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(iii) With respect to elective contributions as defined in §1.401(k)-1(g)(3) under a qualified cash or deferred arrangement as defined in §1.401(k)-1(a)(4)(i) or with respect to employee or matching contributions defined in §1.401(m)-1(f)(6) or (f)(12), respectively.

(iv) With respect to contributions to a simplified employee pension made under a salary reduction arrangement described in section 408(k)(6) (a SARSEP).

(5) Additional rules. The Commissioner may, in revenue rulings, notices, or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of section 401(*l*), including rules applying section 401(l) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not other years.

(b) Relationship to other requirements--(1) In general. Unless explicitly provided otherwise, section 401(*l*) does not provide an exception to any other requirement under section 401(a). Thus, for example, even if the plan complies with section 401(*l*), the plan may not adjust benefits in any manner that results either in a decrease in any employee's accrued benefit in violation of section 411(d)(6) and section 411(b)(1)(G) or in a benefit lower than the minimum benefit required under section 416. Similarly, see section 401(a)(15) for additional rules relating to circumstances under which plan benefits may not be decreased because of increases in social security benefits. A plan does not fail to satisfy section 401(*l*) merely because, in order to comply with section 411, an employee's accrued benefit under the plan is not reduced, even though a strict application of the plan's benefit formula and accrual method would otherwise result in a reduced benefit.



(2) Determination of accrued benefit to avoid reduction. If a strict application of the plan's benefit formula and accrual method would otherwise result in a benefit lower than the employee's accrued benefit (for example, as a result of an increase in covered compensation), the employee's accrued benefit for later years must be determined under the formula contained in §1.401(a)(4)-13(c)(3) (formula with wear-away). In applying that formula, the plan must use the last day of the plan year immediately before the potential reduction in accrued benefit as the fresh-start date and the plan's benefit formula as the formula applicable to benefit accruals in the current plan year.

(c) Definitions. In applying §§1.401(*l*)-1 through 1.401(*l*)-6, the definitions in this paragraph (c) govern unless otherwise provided.

(1) Accumulation plan. "Accumulation plan" means an accumulation plan within the meaning of §1.401(a)(4)-12.

(2) Average annual compensation. "Average annual compensation" means average annual compensation within the meaning of §1.401(a)(4)-3(e)(2), taking into account the special optional rules under §1.401(a)(4)-3(b)(8)(x).

(3) Base benefit percentage. "Base benefit percentage" means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(4) Base contribution percentage. "Base contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under a defined



contribution excess plan with respect to the employee's plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(5) Benefit formula. "Benefit formula" means benefit formula within the meaning of §1.401(a)(4)-12.

(6) Benefits, rights, and features. "Benefits, rights, and features" means benefits, rights, and features within the meaning of §1.401(a)(4)-12.

(7) Covered compensation--(i) In general. "Covered compensation" for an employee means the average (without indexing) of the taxable wage bases 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. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in

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effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under this paragraph (c)(7)(i) is the employee's covered compensation for the plan year during which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under this paragraph (c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

(ii) Special rules--(A) Rounded table. For purposes of determining the amount of an employee's covered compensation under paragraph (c)(7)(i) of this section, a plan may use



tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

(B) Proposed regulation definition. For plan years beginning before January 1, 1995, in lieu of the definition of covered compensation contained in paragraph (c)(7)(i) of this section, a plan may define covered compensation as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year preceding the calendar year in which the employee attains (or will attain) social security retirement age.

(iii) Period for using covered compensation amount. A plan must generally provide that an employee's covered compensation is automatically adjusted for each plan year. However, a plan may use an amount of covered compensation for employees equal to each employee's covered compensation (as defined in paragraph (c)(7)(i) or (c)(7)(ii) of this section) for a plan year earlier than the current plan year, provided the earlier plan year is the same for all employees and is not earlier than the later of--

(A) the plan year that begins 5 years before the current plan year, and

(B) the plan year beginning in 1989.

In the case of an accumulation plan, the benefit accrued for an employee in prior years is not affected by changes in the employee's covered compensation that occur in later years.

(8) Defined benefit plan. "Defined benefit plan" means a defined benefit plan within the meaning of §1.410(b)-9.



(9) Defined contribution plan. "Defined contribution plan" means a defined contribution plan within the meaning of §1.410(b)-9.

(10) Disparity. "Disparity" means--

(i) In the case of a defined contribution excess plan, the amount by which the excess contribution percentage exceeds the base contribution percentage,

(ii) In the case of a defined benefit excess plan, the amount by which the excess benefit percentage exceeds the base benefit percentage, and

(iii) In the case of an offset plan, the offset percentage.

(11) Employee. "Employee" means employee within the meaning of §1.401(a)(4)-12.

(12) Employer. "Employer" means the employer within the meaning of §1.410(b)-9.

(13) Employer contributions. "Employer contributions" means all amounts taken into account with respect to an employee under a plan under §1.401(a)(4)-2(c)(2)(ii).

(14) Excess benefit percentage. "Excess benefit percentage" means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation above the integration level (expressed as a percentage of such average annual compensation).

(15) Excess contribution percentage. "Excess contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation above the integration level (expressed as a percentage of such plan year compensation).

(16) Excess plan--(i) Defined benefit excess plan. "Defined benefit excess plan" means a defined benefit plan under which the rate at which employer-provided benefits are



determined with respect to average annual compensation above the integration level under the plan (expressed as a percentage of such average annual compensation) is greater than the rate

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at which employer-provided benefits are determined with respect to average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(ii) Defined contribution excess plan. "Defined contribution excess plan" means a defined contribution plan under which the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation above the integration level (expressed as a percentage of such plan year compensation) is greater than the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(17) Final average compensation--(i) In general. "Final average compensation" for an employee means the average of the employee's annual section 414(s) compensation from the employer for the 3-consecutive-year period ending with or within the plan year. The year in which an employee terminates employment may be disregarded in determining final average compensation. If, as of a plan year, an employee's entire period of employment with the employer is less than 3 consecutive years, the employee's final average compensation must be determined by averaging the annual section 414(s) compensation received by the employee from the employer during the employee's entire period of employment with the employer. The definition of final average compensation used in the plan must be applied consistently with respect to all employees. For example, if the plan provides that the year in which the



employee terminates employment is disregarded in determining final average compensation, the year must be disregarded for all employees who terminate employment in that year. The plan may specify any 3-consecutive-year period ending in the plan year, provided the period is determined consistently for all employees.

(ii) Limitations. In determining an employee's final average compensation under this paragraph (c)(16), annual section 414(s) compensation for any year in excess of the taxable wage base in effect at the beginning of that year must not be taken into account. A plan may provide that each employee's final average compensation for a plan year is limited to the employee's average annual compensation for the plan year.

(iii) Determination of section 414(s) compensation. A plan must use the same definition of section 414(s) compensation to determine final average compensation as the plan uses to determine average annual compensation (or plan year compensation in the case of an accumulation plan).

(18) Gross benefit percentage. "Gross benefit percentage" means the rate at which employer-provided benefits are determined under an offset plan (before application of the offset) with respect to an employee's average annual compensation (expressed as a percentage of average annual compensation).

(19) Highly compensated employee. "Highly compensated employee" means a highly compensated employee within the meaning of §1.401(a)(4)-12.

(20) Integration level. "Integration level" means the dollar amount specified in an excess plan at or below which the rate of employer-provided contributions or benefits (expressed in each case as a percentage of an employee's plan year compensation or average



annual compensation up to the specified dollar amount) under the plan is less than the rate of employer-provided contributions or benefits (expressed in each case as a percentage of the employee's plan year compensation or average annual compensation above the specified dollar amount) under the plan above such dollar amount.

(21) Nonexcludable employee. "Nonexcludable employee" means an employee within the meaning of §1.410(b)-9, other than an excludable employee with respect to the plan as determined under §1.410(b)-6. A nonexcludable employee may be either a highly or nonhighly compensated nonexcludable employee, depending on the nonexcludable employee's status under section 414(q).

(22) Offset level. "Offset level" means the dollar limit specified in the plan on the amount of each employee's final average compensation taken into account in determining the offset under an offset plan.



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(23) Offset percentage. "Offset percentage" means the rate at which an employee's employer-provided benefit is reduced or offset under an offset plan (expressed as a percentage of the employee's final average compensation up to the offset level).

(24) Offset plan. "Offset plan" means a defined benefit plan that is not a defined benefit excess plan and that provides that each employee's employer-provided benefit is reduced or offset by a specified percentage of the employee's final average compensation up to the offset level under the plan.

(25) Plan. "Plan" means a plan within the meaning of §1.401(a)(4)-12 or a component plan treated as a plan under §1.401(a)(4)-9(c).

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(26) Plan year compensation. "Plan year compensation" means plan year compensation within the meaning of §1.401(a)(4)-12.

(27) Qualified plan. "Qualified plan" means a qualified plan within the meaning of §1.401(a)(4)-12.

(28) Section 401(*l*) plan. "Section 401(*l*) plan" means a section 401(*l*) plan within the meaning of §1.401(a)(4)-12.

(29) Section 414(s) compensation. "Section 414(s) compensation means section 414(s) compensation within the meaning of §1.401(a)(4)-12.

(30) Social security retirement age. "Social security retirement age" for an employee means the social security retirement age of the employee as determined under section 415(b)(8).

(31) Straight life annuity. "Straight life annuity" means a straight life annuity within the meaning of §1.401(a)(4)-12.

(32) Taxable wage base. "Taxable wage base" means the contribution and benefit base under section 230 of the Social Security Act (42 U.S.C. §430).

(33) Year of service. "Year of service" means a year of service as defined in the plan for purposes of the benefit formula and the accrual method under the plan, unless the context clearly indicates otherwise. An employee may be credited with no more than 1 year of service with respect to any 12-consecutive-month period, except for those cases in which additional service is required to be credited under section 410 or 411, whichever is applicable.

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§1.401(*l*)-2 Permitted disparity for defined contribution plans.

(a) Requirements--(1) In general. Disparity in the rates of employer contributions allocated to employees' accounts under a defined contribution plan is permitted under section 401(*l*) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(5) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(*l*) merely because it contains one or more provisions described in §1.401(a)(4)-2(b)(5). See §1.401(a)(4)-8(b)(3)(i)(E) for special rules applicable to target benefit plans.

(2) Excess plan requirement. The plan must be a defined contribution excess plan.

(3) Maximum disparity. The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) Uniform disparity. The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) Integration level. The integration level specified in the plan must satisfy paragraph (d) of this section.

(b) Maximum permitted disparity--(1) In general. The disparity provided for the plan year must not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In addition, the plan must satisfy the overall permitted disparity limits of §1,401(*l*)-5.

(2) Maximum excess allowance. The maximum excess allowance for a plan year is the lesser of--

(i) The base contribution percentage, or

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(ii) The greater of--

(A) 5.7 percent, reduced as required under paragraph (d) of this section, or



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(B) The percentage rate of tax under section 3111(a), in effect as of the beginning of the plan year, that is attributable to the old age insurance portion of the Old Age, Survivors and Disability Insurance provisions of the Social Security Act, reduced as required under paragraph (d) of this section. For a year in which the percentage rate of tax described in this paragraph (b)(2)(ii)(B) exceeds 5.7 percent, the Commissioner will publish the rate of such tax and a revised table under paragraph (d)(4) of this section.

(c) Uniform disparity--(1) In general. The disparity provided under a plan is uniform only if the plan uses the same base contribution percentage and the same excess contribution percentage for all employees in the plan.

(2) Deemed uniformity--(i) In general. The disparity under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2)(ii) and (iii) of this section.

(ii) Overall permitted disparity. The plan provides that, in the case of each employee who has reached the cumulative permitted disparity limit applicable to the employee under §1.401(*l*)-5(c), employer contributions are allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(iii) Non-FICA employees. The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer contributions are allocated to the account of



the employee with respect to the employee's total plan year compensation at the excess contribution percentage.

(d) Integration level--(1) In general. The integration level under the plan must satisfy paragraph (d)(2), (d)(3), or (d)(4) of this section, as modified by paragraph (d)(5) of this section in the case of a short plan year. If a reduction applies to the disparity factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined contribution plans are satisfied.

(2) Taxable wage base. The requirement of this paragraph (d)(2) is satisfied only if the integration level under the plan for each employee is the taxable wage base in effect as of the beginning of the plan year.

(3) Single dollar amount. The requirement of this paragraph (d)(3) is satisfied only if the integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or 20 percent of the taxable wage base in effect as of the beginning of the plan year.

(4) Intermediate amount. The requirement of this paragraph (d)(4) is satisfied only if--

(i) the integration level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(3) of this section and less than the taxable wage base, and



(ii) the plan adjusts the factor determined under paragraph (b)(2)(ii) of this section in accordance with the table below.

TABLE

| If the integration level | | The 5.7 percent factor in the maximum excess allowance is reduced to-- |
|---|---|---|
| Is more than | But not more than | |
| Greater of $10,000 or 20% of taxable wage base. | 80% of taxable wage base. | 4.3% |
| 80% of taxable wage base. | Amount less than taxable wage base. | 5.4% |

(5) Prorated integration level for short plan year. If a plan uses paragraph (4) of the definition of plan year compensation under §1.401(a)(4)-12 (i.e., section 414(s) compensation for the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration level under the plan for each employee must be an amount equal to the otherwise applicable integration level described in paragraph (d)(2), (d)(3), or (d)(4) of this section, multiplied by a fraction, the numerator of which is the number of months in the



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plan year, and the denominator of which is 12. No adjustment to the maximum excess allowance is required as a result of the application of this paragraph (d)(5), other than any adjustment already required under paragraph (d)(4) of this section.

(e) Examples. The following examples illustrate this section. In each example, 5.7 percent exceeds the percentage rate of tax described in paragraph (b)(2)(ii) of this section.

Example 1. Employer X maintains a profit-sharing plan with the calendar year as its plan year. For the 1989 plan year, the plan provides that the account of each employee who has plan year compensation in excess of the taxable wage base in effect at the beginning of the plan year will receive an allocation for the plan year of 5.7 percent of plan year compensation in excess of the taxable wage base. The plan provides that no allocation will be made to the account of any employee for the plan year with respect to plan year

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compensation not in excess of the taxable wage base. The maximum excess allowance is exceeded for the 1989 plan year because the excess contribution percentage (5.7 percent) for the plan year exceeds the base contribution percentage (0 percent) for the plan year by more than the lesser of the base contribution percentage (0 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 2. Employer Y maintains a money purchase pension plan with the calendar year as its plan year. For the 1990 plan year, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to the taxable wage base in effect at the beginning of the plan year plus an allocation of 10 percent of the employee's plan year compensation in excess of the taxable wage base. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (10 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 3. Assume the same facts as in Example 2, except that the plan provides that, with respect to plan year compensation in excess of the taxable wage base, the account of each employee will receive an allocation for the plan year of 12 percent of such compensation. The maximum excess allowance is exceeded for the plan year because the excess contribution percentage (12 percent) for the plan year exceeds the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent) for the plan year.

Example 4. Employer Z maintains a money purchase pension plan with a plan year beginning July 1 and ending June 30. The taxable wage base for the 1990 calendar year is $51,300 and the taxable wage base for the 1991 calendar year is $53,400. For the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 4 percent of the employee's plan year compensation up to $53,400 plus an allocation of 6 percent of the employee's plan year compensation in excess of $53,400. Although the excess contribution percentage (6 percent) for the plan year does not exceed the base contribution percentage (4 percent) for the plan year by more than the lesser of the base contribution percentage (4 percent) or the percentage determined under paragraph (b)(2)(ii) of this section (5.7 percent), the plan does not satisfy paragraph (a)(5) of this section because the integration level of $53,400 exceeds the maximum permitted integration level of $51,300 (the taxable wage base in effect as of the beginning of the plan year).

Example 5. Assume the same facts as in Example 4, except that for the plan year beginning July 1, 1990, and ending June 30, 1991, the plan provides that the account of each employee will receive an allocation of 5 percent of the employee's plan year compensation up to $30,000 plus an allocation of 9 percent of the employee's plan year compensation in

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excess of $30,000. The integration level of $30,000 is 58 percent of the taxable wage base of $51,300 for the 1990 calendar year. The maximum excess allowance is not exceeded for the plan year because the excess contribution percentage (9 percent) for the plan year does not exceed the base contribution percentage (5 percent) for the plan year by more than the lesser of the base contribution percentage (5 percent) or the percentage determined under paragraphs (b)(2)(ii) and (d) of this section (4.3 percent) for the plan year.

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§1.401(*l*)-3 Permitted disparity for defined benefit plans.

(a) Requirements--(1) In general. Disparity in the rates of employer-provided benefits under a defined benefit plan is permitted under section 401(*l*) and this section for a plan year only if the plan satisfies paragraphs (a)(2) through (a)(6) of this section. A plan that otherwise satisfies this paragraph (a) will not be considered to fail section 401(*l*) merely because it contains one or more provisions described in §1.401(a)(4)-3(b)(8) (such as multiple formulas). Section 401(a)(5)(D) and §1.401(a)(5)-1(d) provide other rules under which benefits provided under a defined benefit plan (including defined benefit excess and offset plans) may be limited. See §1.401(a)(4)-3(b)(7)(viii) for special rules under which an insurance contract plan may satisfy §1.401(a)(4)-1(b)(2) and section 401(*l*). See §1.401(a)(4)-8(c)(3)(iii)(B) for special rules applicable to cash balance plans.

(2) Excess or offset plan requirement. The plan must be a defined benefit excess plan or an offset plan.

(3) Maximum disparity. The disparity for all employees under the plan must not exceed the maximum permitted disparity prescribed in paragraph (b) of this section.

(4) Uniform disparity. The disparity for all employees under the plan must be uniform within the meaning of paragraph (c) of this section.

(5) Integration or offset level. The integration or offset level specified in the plan must satisfy paragraph (d) of this section.

(6) Benefits, rights, and features. The benefits, rights, and features provided under the plan must satisfy paragraph (f) of this section.

(b) Maximum permitted disparity--(1) In general. In the case of a defined benefit excess plan, the disparity provided for the plan year may not exceed the maximum excess allowance as defined in paragraph (b)(2) of this section. In the case of an offset plan, the disparity provided for the plan year may not exceed the maximum offset allowance as defined in paragraph (b)(3) of this section. In addition, either type of plan must satisfy the overall permitted disparity limits of §1.401(*l*)-5.

(2) Maximum excess allowance. The maximum excess allowance for a plan year is the lesser of--

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) The base benefit percentage for the plan year.

(3) Maximum offset allowance. The maximum offset allowance for a plan year is the lesser of--

(i) 0.75 percent, reduced as required under paragraphs (d) and (e) of this section, or

(ii) One-half of the gross benefit percentage, multiplied by a fraction (not to exceed one), the numerator of which is the employee's average annual compensation, and the denominator of which is the employee's final average compensation up to the offset level.

(4) Rules of application--(i) Disparity provided for the plan year. Disparity provided for the plan year generally means the disparity provided under the plan's benefit formula for the employee's year of service with respect to the plan year. However, if a plan determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C), disparity provided under the plan also means the disparity in the benefit accrued for the employee for the plan year. Thus, a plan using the fractional accrual method must satisfy



this paragraph (b) with respect to the plan's benefit formula and with respect to the benefits accrued for the plan year.

(ii) Reductions in disparity rate. Any reductions in the 0.75-percent factor required under paragraphs (d) and (e) of this section are cumulative.

(iii) Normal and optional forms of benefit--(A) In general. A plan satisfies the maximum permitted disparity requirement of this paragraph (b) only if the plan satisfies this paragraph (b) with respect to each optional form of benefit (including the normal form of benefit) provided under the plan.

(B) Level annuity forms. In the case of an optional form of benefit payable as a level annuity over a period of not less than the life of the employee, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b). Thus, for example, if the form of a defined benefit plan's normal retirement benefit is an annuity for life with a 10-year certain feature and the plan permits employees to elect an optional form of benefit in the form of a straight life annuity, the plan must satisfy the maximum disparity requirement of this paragraph (b) with respect to each of the optional forms of benefit. An annuity that decreases only after the death of the employee, or that decreases only after the death of either the employee or the joint annuitant, is considered a level annuity for purposes of this paragraph (b).

(C) Other forms. In the case of an optional form of benefit that is not described in paragraph (b)(4)(iii)(B) of this section, the optional form must satisfy the maximum permitted disparity requirement of this paragraph (b), when the respective portions of the optional form are normalized under the rules of §1.401(a)(4)-3(d)(5)(iv) to a straight life annuity



commencing at the same time as the optional form of benefit, regardless of whether the straight life annuity form is actually provided under the plan. In the case of a defined benefit excess plan, the respective portions are the portion of the optional form attributable to average annual compensation up to the integration level (the "base portion") and the portion of the optional form attributable to average annual compensation in excess of the integration level (the "excess portion"). In the case of an offset plan, the respective portions are the optional form determined without regard to the offset (the "gross amount") and the offset applied to the gross amount to determine the optional form (the "offset amount").

(D) Post-retirement cost-of-living adjustments--(1) In general. A benefit does not fail to be a level annuity described in paragraph (b)(4)(iii)(B) of this section merely because it

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provides an automatic post-retirement cost-of-living adjustment that satisfies paragraph (b)(4)(iii)(D)(2) of this section. Thus, increases in the employee's annuity pursuant to such a cost-of-living adjustment do not cause the disparity provided under the optional form of benefit to exceed the maximum disparity permitted under this paragraph (b). For rules on ad hoc post-retirement cost-of-living adjustments, see §1.401(a)(4)-10(b).

(2) Requirements. A cost-of-living adjustment satisfies this paragraph (b)(4)(iii)(D)(2) if--

(i) It is included in the accrued benefit of all employees, and

(ii) It increases, on a uniform and consistent basis, the benefits of all former employees who are no younger than age 62, at a rate no greater than adjustments to social security benefits under section 215(i)(2)(A) of the Social Security Act that have occurred since the later of the employee's attainment of age 62 or commencement of benefits.



(E) Section 417(e) exception. A plan will not fail to satisfy this paragraph (b) merely because the disparity in a benefit that is subject to the interest rate restrictions of sections 401(a)(11) and 417(e) exceeds the maximum disparity that would otherwise be allowed under this paragraph (b) to the extent the increase in disparity is required to satisfy §1.417(e)-1(d).

(5) Examples. The following examples illustrate this paragraph (b). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan N is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation in excess of the integration level, for each year of service. The plan provides no benefits with respect to average annual compensation up to the integration level. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (0.5 percent) exceeds the base benefit percentage (0 percent) by more than the base benefit percentage (0 percent).

Example 2. Plan O is an offset plan that provides a normal retirement benefit equal to 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity provided under the plan satisfies this paragraph (b) because the offset percentage (0.75 percent) does not exceed the maximum offset allowance equal to the lesser of 0.75 percent or one-half of the gross benefit percentage (1 percent).

Example 3. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.5 percent of average annual compensation up to the integration level, plus 1.25



percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.25 percent) exceeds the base benefit percentage (0.5 percent) by more than the base benefit percentage (0.5 percent).

Example 4. Plan Q is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. The disparity under the plan exceeds the maximum offset allowance because the offset percentage exceeds one-half of the gross benefit percentage (0.5 percent).

Example 5. (a) Plan R is an offset plan that provides a normal retirement benefit of 1 percent of average annual compensation, minus 0.5 percent of final average compensation up to the offset level, for each year of service up to 35. The plan determines an employee's average annual compensation using an averaging period comprising five consecutive 12-month periods and taking into account the employee's compensation for the ten consecutive 12-month periods ending with the plan year. The plan does not provide that an employee's final average compensation is limited to the employee's average annual compensation.

(b) Employee A has average annual compensation of $20,000, final average compensation of $25,000, and covered compensation of $32,000. The maximum offset allowance applicable to Employee A for the plan year under paragraph (b)(3) of this section is one-half of the gross benefit percentage multiplied by the ratio, not to exceed one, of Employee A's average annual compensation to Employee A's final average compensation up to the offset level. Thus, the maximum offset allowance is 0.4 percent (1/2 x 1 percent x $20,000/$25,000). With respect to Employee A, the benefit formula provides an offset that exceeds the maximum offset allowance. The plan must therefore reduce Employee A's offset percentage to 0.4 percent. (Under paragraph (c)(2)(viii) of this section, Employee A's adjusted disparity rate is deemed uniform.)

(c) Alternatively, under §1.401(*l*)-1(c)(17)(ii) (the definition of final average compensation), the plan could specify that an employee's final average compensation is limited to the amount of the employee's average annual compensation. Thus, the ratio of average annual compensation to final average compensation would always be equal to at least one, and the maximum offset allowance under the plan would be one-half of the gross benefit percentage.

Example 6. Plan S is a defined benefit excess plan that provides a base benefit percentage of 1 percent of average annual compensation up to the integration level for each year of service. The plan also provides, for each of the first 10 years of service, an excess benefit percentage of 1.85 percent of average annual compensation in excess of the



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integration level. For each year of service after 10, the plan provides an excess benefit percentage of 1.65 percent of the employee's average annual compensation in excess of the integration level. The disparity provided under the plan exceeds the maximum excess

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allowance because the excess benefit percentage for each of the first ten years of service (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 7. The facts are the same as in Example 6, except that the plan provides an excess benefit percentage of 1.65 percent of average annual compensation in excess of the integration level for each of the first 10 years of service and an excess benefit percentage of 1.85 percent of average annual compensation in excess of the integration level for each year of service after 10. The disparity provided under the plan exceeds the maximum excess allowance because the excess benefit percentage for each year of service after 10 (1.85 percent) exceeds the base benefit percentage (1 percent) by more than 0.75 percent.

Example 8. Plan T is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a joint and survivor annuity. The plan also allows an employee to receive the retirement benefit in the form of an actuarially equivalent straight life annuity. The actuarially equivalent straight life annuity equals 1.09 percent of average annual compensation up to the integration level, plus 1.85 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The disparity provided under the plan with respect to the straight life annuity form of benefit (0.76 percent) exceeds the maximum excess allowance because the excess benefit percentage (1.85 percent) exceeds the base benefit percentage (1.09 percent) by more than 0.75 percent.

Example 9. Plan U is a defined benefit excess plan that provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.7 percent of average annual compensation in excess of the integration level, for each year of service up to 35, payable in the form of a straight life annuity. Plan U provides a single sum optional form of benefit at normal retirement age equal to 100 times the monthly annuity payable at that age. Thus, if an employee elects the single sum optional form of benefit, the base portion of the single sum benefit is 100 percent (100 times 1.0 percent) of average annual compensation up to the integration level per year of service, and the excess portion of the single sum benefit is 170 percent (100 times 1.7 percent) of average annual compensation in excess of the integration level per year of service. Each respective portion of the single sum option is normalized to a straight life annuity commencing at normal retirement age, using 8-percent interest and the UP-84 mortality table. After normalization, the base portion of the benefit is 1.02 percent of average annual compensation up to the integration level, and the excess portion of the benefit is 1.73 percent of average annual compensation in excess of the integration level. The single sum optional form of benefit satisfies this paragraph (b) because the disparity provided in the optional form of benefit does not exceed the maximum excess allowance.

(c) Uniform disparity--(1) In general. The disparity provided under a defined benefit excess plan is uniform only if the plan uses the same base benefit percentage and the same

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excess benefit percentage for all employees with the same number of years of service. The disparity provided under an offset plan is uniform if and only if the plan uses the same gross benefit percentage and the same offset percentage for all employees with the same number of years of service. The disparity provided under a plan that determines each employee's accrued benefit under the fractional accrual method of section 411(b)(1)(C) is uniform only if the plan satisfies one of the deemed uniformity rules of paragraph (c)(2)(ii) or (iii) of this section.

(2) Deemed uniformity--(i) In general. The disparity provided under a plan does not fail to be uniform for purposes of this paragraph (c) merely because the plan contains one or more of the provisions described in paragraphs (c)(2)(ii) through (viii) of this section.

(ii) Use of fractional accrual and disparity for 35 years. The plan formula provides a benefit as described in paragraphs (c)(2)(ii)(A) and (B) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)-3(b)(4)(i)(B) or 1.401(a)(4)-3(b)(5)(i)(B), i.e., by multiplying the employee's fractional rule benefit (within the meaning of §1.411(b)-1(b)(3)(ii)(A)) by a fraction, the numerator of which is the employee's years of service determined as of the plan year, and the denominator of which is the employee's projected years of service as of normal retirement age.

(A) For each year of service at least up to 35, the plan formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

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(B) For each additional year of service, the plan provides a benefit at a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(ii)(A) of this section, whichever is applicable.

(iii) Use of fractional accrual and disparity for fewer than 35 years. The plan formula provides a benefit as described in paragraphs (c)(2)(iii)(A) through (C) of this section, and the plan determines each employee's accrued benefit under the method described in §1.401(a)(4)-3(b)(4)(i)(B) or 1.401(a)(4)-3(b)(5)(i)(B).



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(A) For each year in the employee's initial period of service comprising fewer than 35 years, the plan formula provides the same base benefit percentage and the same excess benefit percentage for all employees in the case of a defined benefit excess plan or the same gross benefit percentage and the same offset percentage for all employees in the case of an offset plan.

(B) For each year of service after the initial period and at least up to 35, the plan formula provides a benefit at a uniform percentage of all average annual compensation, that is equal to the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

(C) For each year of service after the period described in paragraph (c)(2)(iii)(B) of this section, the plan provides a benefit at a uniform percentage of all average annual compensation that is no greater than the excess benefit percentage or the gross benefit percentage under paragraph (c)(2)(iii)(A) of this section.

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(iv) Different social security retirement ages. The benefit formula uses the same excess benefit percentage or the same gross benefit percentage for all employees with the same number of years of service and, for employees with social security retirement ages later than age 65, adjusts the 0.75-percent factor in the maximum excess or offset allowance as required under paragraph (e)(1) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan, or reducing the offset percentage in the case of an offset plan.

(v) Reduction for integration level. The plan uses an integration level or offset level greater than each employee's covered compensation and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by increasing the base benefit percentage in the case of a defined benefit excess plan or reducing the offset percentage in the case of an offset plan.

(vi) Overall permitted disparity. The benefit formula provides that, with respect to each employee's years of service after reaching the cumulative permitted disparity limit applicable to the employee under §1.401(*l*)-5(c), employer-provided benefits are determined with respect to the employee's total average annual compensation at a rate equal to the lesser of--

(A) The excess benefit percentage or gross benefit percentage applicable to an employee with the same number of years of service, or

(B) The highest percentage permitted under the 133 1/3 percent accrual rule of section 411(b)(1)(B).

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(vii) Non-FICA employees. The plan provides that, in the case of each employee under the plan with respect to whom none of the taxes under section 3111(a), section 3221, or section 1401 is required to be paid, employer-provided benefits are determined with respect to the employee's total average annual compensation at the excess benefit percentage or gross benefit percentage applicable to an employee with the same number of years of service.

(viii) Average annual compensation adjustment for offset plan. In the case of each employee whose final average compensation exceeds the employee's average annual compensation, the plan adjusts the offset percentage as required under paragraph (b)(3)(ii) of this section in order to satisfy the maximum offset allowance.

(3) Examples. The following examples illustrate this paragraph (c). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that satisfies the 133 1/3 percent accrual rule of section 411(b)(1)(B). The plan provides a normal retirement benefit of 1.0 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation in excess of the integration level, for each year of service up to

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25. The plan also provides a benefit of 1.0 percent of all average annual compensation for each year of service in excess of 25. The disparity provided under the plan is uniform because the plan uses the same base and excess benefit percentages for all employees with the same number of years of service. If the plan formula were the same except that it used a different excess benefit percentage for some of the years of service between one and 25, the disparity under the plan would continue to be uniform.

Example 2. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 50 percent of average annual compensation up to the integration level and 68.75 percent of average annual compensation in excess of the integration level, multiplied by a fraction, the numerator of which is the employee's service, up to 25 years, and the denominator of which is 25. The plan determines an employee's accrued benefit as described in §1.401(a)(4)-3(b)(5)(i)(B). Under the plan an employee accrues 1/25th of the normal retirement benefit for each of the employee's first 25 years of service. The plan thus provides a base benefit percentage of 2 percent (50 percent x 1/25) and an excess benefit percentage of 2.75 percent (68.75 percent x 1/25) for each of an employee's first 25 years of service and no benefit for years of service after 25. The disparity provided under the plan is not uniform within the meaning of this paragraph (c) because the plan does not satisfy either of the uniform disparity rules for fractional accrual plans under paragraphs (c)(2)(ii) and (iii) of this section.

Example 3. Plan P is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation for each year of service up to 35, minus 0.75 percent of final average compensation up to the offset level for each year of service up to 25. The plan determines an employee's accrued benefit under the method described in §1.401(a)(4)-3(b)(4)(i)(B). Because the formula under the plan provides the same gross benefit percentage and offset percentage for 25 years of service (fewer than 35) and, for years of service after 25 and up to 35, provides a benefit at a uniform rate (equal to the gross benefit percentage) of all average annual compensation, and the plan accrues the benefit ratably, the disparity under the plan is deemed to be uniform under paragraph (c)(2)(iii) of this section.

Example 4. Plan Q is an offset plan that benefits employees with social security retirement ages of 65, 66, and 67. For each year of service up to 35, the plan provides a normal retirement benefit equal to 2 percent of average annual compensation, minus an offset based on the employee's final average compensation up to the offset level. For employees with a social security retirement age of 65, the offset percentage is 0.75 percent; for employees with a social security retirement age of 66, the offset percentage is 0.70 percent; and for employees with a social security retirement age of 67, the offset percentage is 0.65 percent. The disparity under the plan is deemed to be uniform under paragraph (c)(2)(iv) of this section because the plan uses the same gross benefit percentage for all employees and reduces the offset percentage for employees with social security retirement ages of 66 and 67 to comply with the adjustments in the 0.75-percent factor in the maximum excess or offset allowance required under paragraph (e)(1) of this section. (Because Plan Q effectively



provides unreduced benefits prior to the social security retirement age for employees with social security retirement ages of 66 and 67, the 0.75-percent factor in the maximum offset allowance must be reduced to 0.70 percent and 0.65 percent, respectively.) Alternatively, Plan Q could satisfy this paragraph (c) if it provided a uniform offset percentage of 0.65 percent for all employees because 0.65 percent is the maximum offset allowance under the plan for an employee with a social security retirement age of 67.

Example 5. Plan R is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus an offset determined as a percentage of total final average compensation, for each year of service up to 35. For an employee whose final average compensation does not exceed the employee's covered compensation, the offset percentage is 0.75 percent. For an employee whose final average compensation exceeds the employee's covered compensation, the plan reduces the offset percentage, as required by paragraph (d) of this section. The reduced offset percentage is determined by comparing the employee's final average compensation to the employee's covered compensation as permitted under paragraph (d)(9)(iii)(B) of this section. The disparity provided under the plan is deemed uniform under paragraph (c)(2)(v) of this section because the plan uses the same gross benefit percentage for all employees and makes individual reductions in the 0.75-percent factor, as permitted under paragraph (d)(9)(iii)(B) of this section, by reducing the offset percentage in the case of an employee whose final average compensation exceeds covered compensation.

(d) Requirements for integration or offset level--(1) In general. The integration level under a defined benefit excess plan or the offset level under an offset plan must satisfy paragraphs (d)(2), (d)(3), (d)(4), (d)(5) or (d)(6) of this section, as modified by paragraph (d)(7) of this section in the case of a short plan year. Paragraph (d)(8) of this section contains demographic tests that apply to certain defined benefit plans. Paragraph (d)(9) of this section explains certain reductions required in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. Paragraph (d)(10) of this section contains examples. If a reduction applies to the 0.75-percent factor under this paragraph (d), the reduced factor is used for all purposes in determining whether the permitted disparity rules for defined benefit plans are satisfied.



(2) Covered compensation. The requirement of this paragraph (d)(2) is satisfied only if the integration or offset level under the plan for each employee is the employee's covered compensation.

(3) Uniform percentage of covered compensation. The requirement of this paragraph (d)(3) is satisfied only if--

(i) The integration or offset level under the plan for each employee is a uniform percentage (greater than 100 percent) of each employee's covered compensation,

(ii) In the case of a defined benefit excess plan, the integration level does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the offset level does not exceed the employee's final average compensation, and

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(iii) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

(4) Single dollar amount. The requirement of this paragraph (d)(4) is satisfied only if the integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that does not exceed the greater of $10,000 or one-half of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(5) Intermediate amount. The requirement of this paragraph (d)(5) is satisfied only if-



(i) The integration or offset level under the plan for all employees is a single dollar amount (either specified in the plan or determined under a formula specified in the plan) that is greater than the highest amount determined under paragraph (d)(4) of this section,

(ii) In the case of a defined benefit excess plan, the single dollar amount does not exceed the taxable wage base in effect for the plan year, and, in the case of an offset plan, the single dollar amount does not exceed the employee's final average compensation,

(iii) The plan satisfies the demographic requirements of paragraph (d)(8) of this section, and

(iv) The plan adjusts the 0.75-percent factor in the maximum excess or offset allowance in accordance with paragraph (d)(9) of this section.

For purposes of this paragraph (d)(5), an offset level of each employee's final average compensation is considered a single dollar amount determined under a formula specified in the plan.

(6) Intermediate amount safe harbor. The requirement of this paragraph (d)(6) is satisfied only if--

(i) The integration or offset level under the plan for all employees is a single dollar amount described in paragraph (d)(5) of this section, and

(ii) The 0.75-percent factor in the maximum excess or offset allowance under paragraph (b)(2) or (b)(3) of this section is reduced to the lesser of the adjusted factor determined under paragraph (d)(9) of this section or 80 percent of the otherwise applicable



factor under paragraph (b)(2) or (b)(3) of this section, determined without regard to paragraph (d)(9) of this section.

(7) Prorated integration level for short plan year. If an accumulation plan uses paragraph (4) of the definition of plan year compensation under §1.401(a)(4)-12 (i.e., section 414(s) compensation for the period of plan participation) and has a plan year that comprises fewer than 12 months, the integration or offset level under the plan for each employee must be an amount equal to the otherwise applicable integration or offset level described in paragraph (d)(2), (d)(3), (d)(4), (d)(5), or (d)(6) of this section, multiplied by a fraction, the numerator of which is the number of months in the plan year and the denominator of which is 12. No adjustment to the maximum excess or offset allowance is required as a result of the application of this paragraph (d)(7), other than any adjustment already required under paragraph (d)(6) or (d)(9) of this section.

(8) Demographic requirements--(i) In general. A plan that satisfies the demographic requirements of paragraphs (d)(8)(ii) and (iii) of this section may use an integration level described in paragraph (d)(5) of this section.

(ii) Attained age requirement. The requirement of this paragraph (d)(8)(ii) is satisfied only if the average attained age of the nonhighly compensated employees in the plan is not greater than the greater of--

(A) Age 50, or

(B) 5 plus the average attained age of the highly compensated employees in the plan.



For purposes of this paragraph (d)(8)(ii), attained ages are determined as of the beginning of the plan year.



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(iii) Nondiscrimination requirement. The requirement of this paragraph (d)(8)(iii) is satisfied only if at least one of the following three tests is satisfied.

(A) Minimum percentage test. This test is satisfied only if more than 50 percent of the nonhighly compensated employees in the plan have average annual compensation at least equal to 120 percent of the integration or offset level.

(B) Ratio test. This test is satisfied only if the percentage of nonhighly compensated nonexcludable employees, who are in the plan and who have average annual compensation at least equal to 120 percent of the integration or offset level, is at least 70 percent of the percentage of highly compensated nonexcludable employees who are employees in the plan.

(C) High dollar amount test. This test is satisfied only if the integration or offset level exceeds 150 percent of the covered compensation of an individual who attains social security retirement age in the calendar year in which the plan year begins. In the case of a calendar year in which no individual could attain social security retirement age, for example, the year 2003, this rule is applied using covered compensation of an individual attaining social security retirement age in the preceding calendar year.

(9) Reduction in the 0.75-percent factor if integration or offset level exceeds covered compensation—(i) In general. If the integration or offset level specified under the plan is each employee's covered compensation as of the plan year, no reduction in the 0.75-percent factor in the maximum excess or offset allowance is required for the plan year under this paragraph (d)(9). If a plan specifies an integration or offset level that exceeds an employee's



covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced as required in paragraph (d)(9)(ii) or (iii) of this section. Paragraph (d)(9)(iv) of this section contains a table of the applicable reductions.

(ii) Uniform percentage of covered compensation. If a plan specifies an integration or offset level that is a uniform percentage (in excess of 100 percent) of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced in accordance with the table in paragraph (d)(9)(iv) of this section. Thus, for example, if a plan specifies an integration or offset level of 120 percent of each employee's covered compensation, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.69 percent in accordance with the table because the specified integration or offset level is more than covered compensation but not more than 125 percent of covered compensation.

(iii) Single dollar amount. If a plan specifies an integration or offset level of a single dollar amount as permitted under paragraph (d)(5) of this section (for example, $30,000), the applicable reduction in the maximum excess or offset allowance must be determined under paragraph (d)(9)(iii)(A) or (B) of this section, as specified under the plan.

(A) Plan-wide reduction. The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by comparing the single dollar amount specified in the plan to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees for a plan year and the covered compensation of



an individual attaining social security retirement age in the calendar year in which the plan year begins is $20,000, the 0.75-percent factor in the maximum excess allowance must be reduced to 0.60 percent for all employees in accordance with the table in paragraph (d)(9)(iv) of this section because the specified integration or offset level of $30,000 is more than 125 percent of $20,000 but not more than 150 percent of $20,000. In the case of a calendar year in which no individual could attain social security retirement age (for example, 2003), the comparison is made with covered compensation of an individual who attained social security retirement age in the preceding calendar year. If an offset plan uses an offset level of each employee's final average compensation, the reduction under this paragraph (d)(9)(iii)(A) is determined by comparing the highest possible amount of final average compensation to the covered compensation of an individual attaining social security retirement age in the calendar year in which the plan year begins.

(B) Individual reductions. The applicable reduction in the maximum excess or offset allowance under the table in paragraph (d)(9)(iv) of this section may be determined by



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comparing the single dollar amount specified in the plan to the covered compensation of each employee under the plan. Thus, for example, if a plan specifies a single integration or offset level of $30,000 that is uniformly applicable to all employees for a plan year, the 0.75-percent factor in the maximum excess or offset allowance must be reduced to 0.60 percent for an employee with covered compensation of $20,000, but need not be reduced for an employee whose covered compensation is $30,000 or greater.



(iv) Reductions—(A) Table.

TABLE

| If the integration or offset level is | the permitted disparity factor is |
|---|---|
| 100 percent of covered compensation | 0.75 percent |
| 125 percent of covered compensation | 0.69 percent |
| 150 percent of covered compensation | 0.60 percent |
| 175 percent of covered compensation | 0.53 percent |
| 200 percent of covered compensation | 0.47 percent |
| the taxable wage base or final average compensation | 0.42 percent |

(B) Interpolation. If the integration or offset level used under a plan is between the percentages of covered compensation in the table, the permitted disparity factor applicable to the plan can be determined either by straight-line interpolation between the permitted disparity factors in the table or by rounding the integration or offset level up to the next highest percentage of covered compensation in the table.

(10) Examples. The following examples illustrate this paragraph (d). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of an offset plan, the plan provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. (a) Plan M is a defined benefit excess plan that uses the calendar year as its plan year. For the 1989 plan year, the plan uses an integration level of $20,000, which is



118 percent of the 1989 covered compensation of $16,968 for an individual reaching social security retirement age in 1989. The plan may use that integration level without satisfying paragraph (d)(8) of this section, provided the adjustment to the 0.75-percent factor required under paragraph (d)(6) of this section is made. That adjustment is the lesser of the factor determined under paragraph (d)(9) of this section or 80 percent of the factor otherwise applicable under paragraph (b)(2) or (b)(3) of this section.

(b) The plan determines the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of an individual attaining social security retirement age in calendar year in which the plan year begins and by rounding the integration level up to 125 percent of that covered compensation amount. The 0.75-percent factor is therefore replaced by 0.69 percent pursuant to the table in paragraph (d)(9) of this section. The 0.69 percent factor is 92 percent of the 0.75-percent factor. Because the lesser of 80 percent and 92 percent is 80 percent, the 0.75-percent factor is reduced to 0.6 percent (80 percent of 0.75 percent) under paragraph (d)(6) of this section. The 0.6 percent factor applies to benefits commencing at age 65 for an employee with a social security retirement age of 65. In determining normal retirement benefits for employees with social security retirement ages of 66 or 67, the applicable factors for benefits commencing at age 65 are, respectively, 0.56 percent (80 percent of 0.7 percent) and 0.52 percent (80 percent of 0.65 percent).

(c) The plan could also determine the factor under paragraph (d)(9) of this section by comparing the integration level to the covered compensation of each employee under the plan, or by straight line interpolation between the disparity factors contained in the table in paragraph (d)(9) of this section, or both. (Of course, if the plan satisfied paragraph (d)(8) of this section, the plan could use the factor determined under paragraph (d)(9) of this section.)

Example 2. (a) Plan N, an accumulation plan, is a defined benefit excess plan that, for each year of service up to 35, accrues a normal retirement benefit of 1 percent of plan year compensation up to the taxable wage base, plus 1.75 percent of plan year compensation above the taxable wage base, for each year of service up to 35. An employee's total retirement benefit is the sum of the accruals for all years. The plan satisfies paragraph (d)(8) of this section.

(b) Because the plan uses the taxable wage base (an amount above covered compensation) as the integration level, it must reduce the 0.75-percent factor in the maximum excess allowance as required under paragraphs (d)(5) and (d)(9) of this section. The reduced factor, if determined on a plan-wide bases under paragraph (d)(9)(iii)(A) of this section, is 0.42 percent. The plan must therefore reduce the disparity in the plan so that it does not exceed 0.42 percent.

Example 3. (a) For the 1990 plan year, Plan O provides a normal retirement benefit of 2 percent of average annual compensation, minus a percentage of final average compensation up to $48,000, for each year of service up to 35. The plan satisfies paragraph



(d)(8) of this section. As permitted under paragraph (d)(9) of this section, the plan provides that each employee's offset percentage is determined by comparing $48,000 to the employee's covered compensation and by rounding the result up to the next highest percentage of covered compensation.

(b) Employee A has a social security retirement age of 66 and covered compensation of $40,000. Because the plan provides for commencement of Employee A's benefit at age 65, the 0.75-percent factor in the maximum offset allowance is reduced to 0.7 percent under



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paragraph (e)(1) of this section (the "paragraph (e) factor"). In addition, because $48,000 is rounded up to 125 percent of Employee A's covered compensation, the 0.75-percent factor in the maximum offset allowance is reduced to 0.69 percent under paragraph (d)(9) of this section (the "paragraph (d) factor"). The reductions are cumulative under paragraph (b)(3)(ii) of this section.

(c) The cumulative reductions can be made by multiplying the paragraph (e) factor by the ratio of the paragraph (d) factor to 0.75 percent or by multiplying the paragraph (d) factor by the ratio of the paragraph (e) factor to 0.75 percent. The disparity factor for Employee A is therefore 0.64 percent ((0.7 percent x 0.69 percent/0.75 percent) or (0.69 percent x 0.7 percent/0.75 percent)).

Example (4). Plan P is an offset plan that uses the calendar year as the plan year and uses an offset level of each employee's final average compensation. Assume that the taxable wage bases for 1990-1992 are the following:

1990 - $51,300
1991 - $53,400
1992 - $58,000

Employee B's final average compensation, determined as of the close of the 1992 plan year, is the average of Employee B's annual compensation for the period 1990-1992. Employee B's annual compensation for each year is the following:

1990 - $47,000
1991 - $59,000
1992 - $65,000

For purposes of determining the offset applied to Employee B's employer-provided benefit under the plan, Employee's final average compensation as of the close of the 1992 plan year is $52,800 ($47,000 + $53,400 + $58,000)/3. This is because annual compensation in excess of the taxable wage base in effect at the beginning of the year may not be taken into account in determining an employee's final average compensation or in determining the employee's offset. If the plan determines the offset applied to Employee A's benefit by reference to compensation in excess of $52,800, the plan fails to satisfy this paragraph (d).



(e) Adjustments to the 0.75-percent factor for benefits commencing at ages other than social security retirement age--(1) In general. The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applies to a benefit commencing at an employee's social security retirement age. Except as provided in paragraph (e)(4) of this section, if a benefit payable to an employee under a defined benefit excess plan or a defined benefit offset plan commences at an age before the employee's social security retirement age (including a benefit payable at the normal retirement age under the plan), the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance, respectively, is reduced in accordance with paragraph (e)(2)(i) of this section. If a benefit payable to an employee under a defined benefit excess plan or a defined benefit offset plan commences at an age after the employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance, respectively, may be increased in accordance with paragraph (e)(2)(ii) of this section. Paragraph (e)(5) of this section provides rules on the age at which a benefit commences. See paragraph (f) of this section for the requirements applicable to optional forms of benefit.

(2) Adjustments--(i) Benefits commencing on or after age 55 and before social security retirement age. If benefits commence before an employee's social security retirement age, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance must be reduced for such early commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(ii) Benefits commencing after social security retirement age and on or before age 70. If benefits commence after an employee's social security retirement age, the 0.75-percent



factor in the maximum excess allowance and in the maximum offset allowance may be increased for such delayed commencement of benefits in accordance with the tables set forth in paragraph (e)(3) of this section.

(iii) Benefits commencing before age 55. If benefits commence before the employee attains age 55, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is further reduced (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor, as adjusted under the tables in paragraph (e)(3) of this section, applicable to a benefit commencing in the month in which the employee attains age 55. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality table must be used to determine the actuarial present value, as defined in §1.401(a)(4)-12, of the benefits commencing at age 55 and at the earlier commencement age, and a reasonable mortality table may be used to determine the actuarial present value at the earlier commencement age of the benefits commencing at age 55. A standard interest rate and a standard mortality table, as defined in §1.401(a)(4)-12, are considered reasonable.



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(iv) Benefits commencing after age 70. If benefits commence after the employee attains age 70, the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance may be further increased (on a monthly basis to reflect the month in which benefits commence) to a factor that is the actuarial equivalent of the 0.75-percent factor (as adjusted in accordance with this paragraph (e)) applicable to a benefit commencing in the month in which the employee attains age 70. In determining actuarial equivalence for this purpose, a reasonable interest rate must be used. In addition, a reasonable mortality



table must be used to determine the actuarial present value, as defined in §1.401(a)(4)-12, of the benefits commencing at age 70 and at the later commencement age, and a reasonable mortality table may be used to determine the value at the later commencement age of the benefits commencing at age 70. A standard interest rate and a standard mortality table, as defined in §1.401(a)(4)-12, are considered reasonable.

(3) Tables. Tables I, II, and III provide the adjustments in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance applicable to benefits commencing on or after age 55 and on or before age 70 to an employee who has a social security retirement age of 65, 66 or 67. Table IV is a simplified table for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. The factors in the following tables are applicable to benefits that commence in the month the employee attains the specified age. Accordingly, if benefits commence in a month other than the month in which the employee attains the specified age, appropriate adjustments in the 0.75-percent factor in the maximum excess allowance and the maximum offset allowance must be made. For this purpose, adjustments may be based on straight-line interpolation from the factors in the tables or in accordance with the methods of adjustment specified in paragraphs (e)(2)(iii) and (iv) of this section.



TABLE I

Social security retirement age 67

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 70 | 1.002 |
| 69 | 0.908 |
| 68 | 0.825 |
| 67 | 0.750 |
| 66 | 0.700 |
| 65 | 0.650 |
| 64 | 0.600 |
| 63 | 0.550 |
| 62 | 0.500 |
| 61 | 0.475 |
| 60 | 0.450 |
| 59 | 0.425 |
| 58 | 0.400 |
| 57 | 0.375 |
| 56 | 0.344 |
| 55 | 0.316 |



TABLE II

Social security retirement age 66

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 70 | 1.101 |
| 69 | 0.998 |
| 68 | 0.907 |
| 67 | 0.824 |
| 66 | 0.750 |
| 65 | 0.700 |
| 64 | 0.650 |
| 63 | 0.600 |
| 62 | 0.550 |
| 61 | 0.500 |
| 60 | 0.475 |
| 59 | 0.450 |
| 58 | 0.425 |
| 57 | 0.400 |
| 56 | 0.375 |
| 55 | 0.344 |

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TABLE III

Social security retirement age 65

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 70 | 1.209 |
| 69 | 1.096 |
| 68 | 0.996 |
| 67 | 0.905 |
| 66 | 0.824 |
| 65 | 0.750 |
| 64 | 0.700 |
| 63 | 0.650 |
| 62 | 0.600 |
| 61 | 0.550 |
| 60 | 0.500 |
| 59 | 0.475 |
| 58 | 0.450 |
| 57 | 0.425 |
| 56 | 0.400 |
| 55 | 0.375 |

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TABLE IV

Simplified table

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 70 | 1.048 |
| 69 | 0.950 |
| 68 | 0.863 |
| 67 | 0.784 |
| 66 | 0.714 |
| 65 | 0.650 |
| 64 | 0.607 |
| 63 | 0.563 |
| 62 | 0.520 |
| 61 | 0.477 |
| 60 | 0.433 |
| 59 | 0.412 |
| 58 | 0.390 |
| 57 | 0.368 |
| 56 | 0.347 |
| 55 | 0.325 |

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(4) Exception for certain disability benefits. The maximum excess allowance and the maximum offset allowance are not subject to the reductions set forth in paragraphs (e)(2)(i) and (iii) of this section solely because the plan provides a temporary disability benefit described in this paragraph (e)(4) commencing before an employee's social security retirement age. However, if a disability benefit commencing before an employee's social security retirement age is payable under the plan and the disability benefit does not meet the definition of a temporary disability benefit in this paragraph (e)(4), the disability benefit will be treated as a benefit described in paragraphs (e)(2)(i) and (iii) of this section and the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance applicable to the benefit must be reduced in accordance with paragraphs (e)(2)(i) and (iii) of this section. For purposes of this paragraph (e)(4), a disability benefit is a temporary disability benefit only if--

(i) The benefit is payable under the plan solely on account of an employee's disability, as determined by the Social Security Administration,

(ii) The benefit terminates no later than at the employee's normal retirement age,

(iii) The benefit is not in excess of the amount of the benefit that would be payable to the employee under the plan if the employee had separated from service at the employee's normal retirement age, and

(iv) Upon attainment of early or normal retirement age, an employee receives a benefit that satisfies the accrual and vesting rules of section 411 without taking into account the disability benefit payments made up to that age.

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(5) Benefit commencement date--(i) In general. Except as provided in paragraph (e)(5)(ii) of this section, a benefit commences for purposes of this paragraph (e) on the first day of the period for which the benefit is paid under the plan.

(ii) Qualified social security supplement. If a plan uses a qualified social security supplement, as defined in §1.401(a)(4)-12, to provide an aggregate benefit at retirement before social security retirement age that is a uniform percentage of average annual

compensation, benefits will be considered to commence on the first day of the period for which the qualified social security supplement is no longer payable. In order for this paragraph (e)(5)(ii) to apply, the uniform percentage must be equal to the excess benefit percentage in the case of an excess plan or the gross benefit percentage in the case of an offset plan.

(6) Examples. The following examples illustrate this paragraph (e). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of



average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. For an employee with at least 20 years of service for X, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent (2 percent - 1.25 percent). Because this disparity exceeds the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 2. Assume the same facts as in Example 1, except that the base benefit percentage under the plan is 1.75 percent. Thus, the disparity provided under the plan at age 55 is 0.25 percent (2 percent - 1.75 percent). Because the disparity does not exceed the 0.375 percent factor provided in the table for a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit.

Example 3. Plan N is an offset plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.75 percent of average annual compensation, minus 0.75 percent of final average compensation up to the offset level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is 0.75 percent. Because this disparity exceeds the 0.375 percent factor provided in the table for an offset applied to a benefit payable at age 55 to an employee with a social security retirement age of 65, the plan fails to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit. The plan would not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefit if the applicable factor for determining the offset applied to the benefit were reduced to 0.375 percent.

Example 4. Plan O is a defined benefit excess plan that, for an employee with a social security retirement age of 65, provides a normal retirement benefit of 1.25 percent of average annual compensation up to the integration level, plus 2.0 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides benefits commencing before normal retirement age with the following reductions:

| Age | Percentage of normal retirement benefit |
|---|---|
| 64 | 90% |
| 63 | 85% |
| 62 | 80% |

Under the plan, a benefit payable at age 64 is equal to 90 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.8 percent,



the base benefit percentage under the plan is 1.125 percent, and the disparity provided under the plan at age 64 is 0.675 percent. Similarly, a benefit payable at age 63 is equal to 85 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.7 percent, the base benefit percentage under the plan is 1.0625 percent, and the disparity provided under the plan at age 63 is 0.6375 percent. Finally, a benefit payable at age 62 is equal to 80 percent of the normal retirement benefit payable at age 65. Thus, the excess benefit percentage under the plan is 1.6 percent, the base benefit percentage under the plan is 1.0 percent, and the disparity provided under the plan at age 62 is 0.6 percent. Because the disparities provided under the plan at each early commencement age do not exceed the factors provided in the applicable table in paragraph (e)(3) of this section, the plan does not fail to satisfy paragraphs (b) and (e) of this section with respect to the early retirement benefits.

Example 5. Plan P is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to the integration level, plus 1.5 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan does not provide any benefits, other than normal retirement benefits, commencing before an employee's social security retirement age. Employee A, born in 1947, has a social security retirement age of 66. Because the plan provides for the distribution of normal retirement benefits before Employee A's social security retirement age, the 0.75-percent factor in the maximum excess allowance applicable to Employee A must be reduced to 0.70 percent in accordance with this paragraph (e). Accordingly, the disparity provided to A under the plan exceeds the maximum excess allowance because the excess benefit percentage (1.5 percent) exceeds the base benefit percentage (0.75 percent) by more than the maximum excess allowance of 0.70 percent, as reduced in accordance with this paragraph (e).

Example 6. Assume the same facts as in Example 5, except that the plan also provides an early retirement benefit, commencing at age 62, to an employee who satisfies the conditions for early retirement specified in the plan. The early retirement benefit is based upon the employee's accrued benefit at early retirement age and equals the amount that would have been paid commencing at the employee's normal retirement age based upon the



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employee's average annual compensation, covered compensation and years of service at the date of the employee's early retirement. Employee B, who has a social security retirement age of 65, meets the conditions for early retirement under the plan and retires at age 62 with 30 years of service. At the time of early retirement, Employee B has average annual compensation of $20,000 and covered compensation of $16,000. Under the plan's benefit formula, Employee B has accrued a normal retirement benefit, commencing at age 65, of $5,400 ((22.5 percent x $16,000) + (45 percent x $4,000)) based on Employee B's average annual compensation, covered compensation and years of service at early retirement. Accordingly, under the plan's early retirement provisions, Employee B is entitled to receive, commencing at early retirement, a benefit of $5,400. Because the early retirement benefit is a benefit (other than a qualified disability benefit) commencing at age 62 (before Employee B's social security retirement age), the 0.75-percent factor in the maximum excess allowance



must be reduced to 0.60 percent in accordance with this paragraph (e). Accordingly, the disparity provided to Employee B under the plan at early retirement exceeds the maximum excess allowance.

Example 7. (a) Plan Q is a defined benefit excess plan that provides a normal retirement benefit of 1.35 percent of average annual compensation up to the integration level, plus 2 percent of average annual compensation in excess of the integration level, for each year of service up to 35. The plan provides that an employee with 10 years of service at age 55 may receive an unreduced retirement benefit. The plan also provides that employee with a supplemental benefit of 0.65 percent of average annual compensation up to the integration level for each year of service up to 35, payable from early retirement until age 65. The supplemental benefit is a qualified social security supplement under §1.401(a)(4)-12. The effect of the supplement is to provide an employee with a uniform benefit of 2 percent of average annual compensation from early retirement until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(b) Assume that Plan Q is instead an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan provides the same early retirement benefit on the same conditions, except that the supplement is 0.65 percent of an employee's final average compensation up to the offset level. An employee at age 55 thus receives a uniform benefit of 2 percent of average annual compensation until age 65, when the supplement is no longer payable. Therefore, for purposes of this paragraph (e), the employee's benefit will be considered to commence at age 65.

(f) Benefits, rights, and features--(1) Defined benefit excess plan. In the case of a defined benefit excess plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits attributable to average annual compensation above the integration level (an "excess benefit, right, or feature") must also be provided on the same terms with respect to employer-provided benefits attributable to average annual compensation up to the integration level (a "base benefit, right, or feature"). Alternatively, an excess benefit, right, or feature may be provided on different terms than the base benefit, right, or feature, if the terms used to determine the base benefit, right, or feature produce a benefit,



right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the excess benefit, right, or feature.

(2) Offset plan. In the case of an offset plan, each benefit, right, or feature provided under the plan with respect to employer-provided benefits before application of the offset (a "gross benefit, right, or feature") must be provided on the same terms as those used to determine the offset applied to the gross benefit, right, or feature. Alternatively, a gross benefit, right, or feature may be provided on different terms from those used to determine the offset applied to the gross benefit, right, or feature, if the terms used to determine the gross benefit, right, or feature produce a benefit, right, or feature of inherently equal or greater value than the benefit, right, or feature that would be produced under the terms used to determine the offset applied to the gross benefit, right, or feature. In addition, if benefits commence before an employee's normal retirement age, the gross benefit percentage under the plan must be reduced by a number of percentage points that is not less than the number of percentage points by which the offset percentage must be reduced, from normal retirement age to the age at which benefits commence, under the rules of paragraph (e) of this section.

(3) Examples. The following examples illustrate this paragraph (f). Unless otherwise provided, the following facts apply. The plan is noncontributory and is the only plan ever maintained by the employer. The plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. In the case of a defined benefit excess plan, the plan uses each employee's covered compensation as the integration level; in the case of an offset plan, the plan uses each employee's covered compensation as the offset level and provides that an



employee's final average compensation is limited to the employee's average annual compensation. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65. All optional forms of benefit under each plan are provided on the same terms.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65



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percent of average annual compensation above the integration level, for each year of service up to 35. The plan provides an early retirement benefit for any employee who terminates employment at or after age 55 with 10 or more years of service. In determining an employee's early retirement, the 1.65 percent excess benefit percentage is reduced in accordance with the table in paragraph (e)(3) of this section for a plan that uses a single disparity factor of 0.65 percent for all employees at age 65. However, a larger reduction factor is applied to determine the base benefit percentage at early retirement. The plan violates this paragraph (f) because the excess early retirement benefit is not provided on the same terms as the base early retirement benefit, nor do the terms used to determine the base early retirement benefit produce an early retirement benefit of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 2. The fact are the same as in Example 1 except that the plan determines the early retirement benefit by applying the same reduction factors under paragraph (e)(3) of this section to the base and excess benefit percentages. Furthermore, if an employee terminates employment at or after age 55 with 30 or more years of service, the plan provides that the base benefit percentage of 1 percent is not reduced. Although the excess early retirement benefit is provided on different terms than the base early retirement benefit, the plan satisfies this paragraph (f) because the terms used to determine the base early retirement benefit produce an early retirement of inherently equal or greater value than the early retirement benefit that would be produced under the terms used to determine the excess benefit, right, or feature.

Example 3. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In determining the qualified joint and survivor ("QJSA") form of the normal retirement benefit, the plan applies a factor of 80 percent to the gross benefit percentage and a factor of 100 percent to the offset percentage. Thus, the QJSA form is 1.6 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. The plan violates this paragraph (f) because the gross QJSA form is not provided on the same terms as the terms used to determine the offset applied to the QJSA, nor does it produce a



QJSA benefit that is of inherently equal or greater value than the QJSA benefit that would be produced under the terms used to determine the offset under the plan.

Example 4. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. The plan also provides a single sum optional form of benefit determined by applying a single interest rate and mortality assumption to the entire normal retirement benefit. The plan satisfies this paragraph (f) because the excess optional form is provided on the same terms as the base optional form. The plan would also satisfy this paragraph (f) if it used a lower interest rate to determine the base optional form than used to determine the excess optional form because the lower interest rate would produce an optional form of inherently equal or greater value than the optional form produced by using the same interest rate.

Example 5. Plan R is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to the integration level, plus 1.65 percent of average annual compensation above the integration level, for each year of service up to 35. If an employee continues to work after normal retirement age, the plan provides that the employee receives credit for additional years of service up to the service limit of 35. The plan also provides that the disparity provided under the plan will increase as permitted under paragraph (e) of this section for benefits commencing after social security retirement age. However, the plan does not provide an increase in the base benefit percentage to reflect the fact that the employee has delayed commencement of benefits past normal retirement age. Thus, for example, for an employee at age 68, the plan provides a benefit of 1 percent of average annual compensation up to the integration level, plus 1.86 percent of average annual compensation above the integration level, for each year of service up to 35. The plan violates this paragraph (f) because the excess benefit provided for an employee after normal retirement age is not provided on the same terms as the base benefit, nor do the terms used to determine the base benefit produce a benefit of inherently equal or greater value than the benefit that would be produced under the terms used to determine the excess benefit.

Example 6. Plan Q is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.65 percent of final average compensation up to the offset level, for each year of service up to 35. In accordance with paragraph (e) of this section, the plan reduces the offset percentage under the plan for early retirement and provides a benefit at age 55 of 2 percent of average annual compensation, minus 0.325 percent of final average compensation up to the offset level, for each year of service up to 35. However, the early retirement benefit does not meet this paragraph (f) because an employee's gross benefit percentage is not reduced for early retirement.

Example 7. The facts are the same as in Example 6 except that the plan reduces the gross benefit percentage for early retirement at age 55 to 1.675 percent. Because the gross benefit percentage is reduced by 0.325 percent (from 2.0 percent to 1.675 percent), the same



percentage point reduction made in the offset percentage (from 0.65 percent to 0.325 percent), the early retirement benefit meets this paragraph (f).

(g) No reductions in 0.75-percent factor for death benefits. For purposes of applying the maximum excess allowance described in paragraph (b)(2) of this section and the maximum offset allowance described in paragraph (b)(3) of this section, no reduction is made to the 0.75-percent factor in the maximum excess allowance or in the maximum offset allowance solely because the plan provides disparity in death benefits that are unrelated to retirement benefits and are payable before an employee's social security retirement age.

(h) Benefits attributable to employee contributions not taken into account. Benefits attributable to employee contributions to a defined benefit excess plan or to an offset plan are not taken into account in determining whether the disparity provided under a defined benefit excess plan or an offset plan exceeds the maximum permitted disparity described in paragraph (b) of this section. Therefore, the base benefit percentage and the excess benefit percentage under a defined benefit excess plan for the plan year are reduced to the extent that benefits are attributable to employee contributions. Similarly, the gross benefit percentage under a defined benefit offset plan for the plan year is reduced to the extent the benefit is



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attributable to employee contributions. See §1.401(a)(4)-6(b) for methods of determining the employer-provided benefit under a plan that includes employee contributions not allocated to separate accounts (i.e., a contributory DB plan).

(i) Multiple integration levels-- [Reserved].

(j) Additional rules. The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe additional rules as may be necessary or appropriate to carry out the purposes of this section, including updated tables under

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paragraphs (d) and (e) of this section providing for reductions in the 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance and rules in paragraph (h) of this section for determining the portion of an employee's benefit attributable to employee contributions.

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§1.401(*l*)-4 Special rules for railroad plans.

(a) In general. Section 401(*l*)(6) provides that, in the case of a plan maintained by a railroad employer that covers employees who are entitled to benefits under the Railroad Retirement Act of 1974, in determining whether such a plan satisfies section 401(*l*), rules similar to the rules under section 401(*l*) apply and such rules take into account the employer-derived portion of tier 2 and supplemental annuity benefits provided under the railroad retirement system. In general, for purposes of determining whether a defined contribution plan or a defined benefit plan maintained by a railroad employer and covering employees described in the preceding sentence, satisfies section 401(*l*), the employer-derived portion of an employee's tier 2 benefits and supplementary annuity benefits under the Railroad Retirement Act of 1974 are treated as though such benefits were provided by the railroad employer under a qualified plan. Paragraph (b) of this section contains rules for defined contribution plans. Paragraph (c) of this section contains rules for defined benefit excess plans. Paragraph (d) of this section contains rules for offset plans. Paragraph (e) of this section contains definitions and additional rules of application.

(b) Defined contribution plans--(1) In general. A defined contribution plan maintained by a railroad employer satisfies section 401(*l*) and §1.401(*l*)-2 for a plan year only if the plan satisfies paragraph (b)(2) or (b)(3) of this section for the plan year.

(2) Single integration level method--(i) In general. A plan satisfies this paragraph (b)(2) if--

(A) The plan specifies a single integration level for all employees that does not exceed the railroad retirement taxable wage base in effect as of the beginning of the plan year,

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(B) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(C) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(ii) Definitions. The following definitions govern for purposes of this paragraph (b)(2).

(A) "Base contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) "Excess contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation above the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(3) Two integration level method--(i) In general. A plan satisfies this paragraph (b)(3) if--

(A) The plan specifies two integration levels for all employees, equal to the railroad retirement taxable wage base in effect as of the beginning of the plan year and the taxable wage base in effect as of the beginning of the plan year, and

(B) The plan satisfies paragraphs (b)(3)(ii) and (iii) of this section.

(ii) Total disparity requirement. A plan satisfies this paragraph (b)(3)(ii) if--

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(A) The plan uses the same base contribution percentage and the same excess contribution percentage for all employees, and

(B) The excess contribution percentage does not exceed the sum of 11.4 percentage points and the base contribution percentage.

(iii) Intermediate disparity requirement. A plan satisfies this paragraph (b)(3)(iii) if--

(A) The plan uses the same base contribution percentage and the same intermediate contribution percentage for all employees, and

(B) The intermediate contribution percentage does not exceed the sum of 5.7 percentage points and the base contribution percentage.

(iv) Definitions. The following definitions govern for purposes of this paragraph (b)(3).

(A) "Base contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's plan year compensation at or below the railroad retirement taxable wage base (expressed as a percentage of such plan year compensation).

(B) "Intermediate contribution percentage means the rate at which employer contributions are allocated to account of an employee under the plan with respect to the employee's plan year compensation between the railroad retirement taxable wage base and the taxable wage base (expressed as a percentage of such plan year compensation).

(C) "Excess contribution percentage" means the rate at which employer contributions are allocated to the account of an employee under the plan with respect to the employee's



plan year compensation above the taxable wage base (expressed as a percentage of such plan year compensation).

(c) Defined benefit excess plans--(1) In general. A defined benefit excess plan maintained by a railroad employer satisfies section 401(*l*) and §1.401(*l*)-3 for a plan year only if the plan satisfies paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) Single integration level method--(i) In general. A plan satisfies this paragraph (c)(2) if--

(A) The plan specifies a single integration level for all employees that does not exceed railroad retirement covered compensation,

(B) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees, and

(C) The excess benefit percentage does not exceed the lesser of--

(1) Two times the sum of 0.56 percent and the base benefit percentage, or

(2) 0.56 percent plus the base benefit percentage plus 0.75 percent.

(ii) Definitions. The following definitions govern for purposes of this paragraph (c)(2).

(A) "Base benefit percentage" means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(B) "Excess benefit percentage" means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation



above the employee's railroad retirement covered compensation (expressed as a percentage of such average annual compensation).

(3) Two integration level method--(i) In general. A plan satisfies this paragraph (c)(3) for a plan year if--

(A) The plan specifies two integration levels for all employees, equal to each employee's railroad retirement covered compensation and each employee's covered compensation, and

(B) The plan satisfies paragraphs (c)(3)(ii) and (iii) of this section.

(ii) Employee with lower covered compensation. A plan satisfies this paragraph (c)(3)(ii) if, with respect to each employee whose lower integration level is the employee's covered compensation--

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(A) The plan uses the same base benefit percentage and the same intermediate benefit percentage for all employees,

(B) The intermediate benefit percentage does not exceed the base benefit percentage by more than the lesser of 0.75 percent or the base benefit percentage,

(C) The plan uses the same intermediate benefit percentage and the same excess benefit percentage by an amount for all employees, and

(D) The excess benefit percentage does not exceed the intermediate benefit percentage by more than 0.56 percent.

(iii) Employee with lower railroad retirement covered compensation. A plan satisfies this paragraph (c)(3)(iii) if, with respect to each employee whose lower integration level is the employee's railroad retirement covered compensation--

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(A) The plan uses the same base benefit percentage and the same excess benefit percentage for all employees,

(B) The excess benefit percentage does not exceed the lesser of--

(1) Two times the sum of 0.56 percent and the base benefit percentage, or

(2) The sum of 0.56 percent plus the base benefit percentage plus 0.75 percent,

(C) The plan uses the same the base benefit percentage and the same intermediate benefit percentage for all employees, and

(D) The intermediate benefit percentage does not exceed the sum of 0.56 percent plus the base benefit percentage.

(iv) Definitions. The following definitions govern for purposes of this paragraph (c)(3).

(A) "Base benefit percentage" means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation at or below the lower integration level specified in the plan (expressed as a percentage of such average annual compensation).

(B) "Intermediate benefit percentage" means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation between the lower and higher integration levels specified in the plan (expressed as a percentage of such average annual compensation).

(C) "Excess benefit percentage" means the rate at which employer-provided benefits are determined under the plan with respect to an employee's average annual compensation

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above the higher integration level specified in the plan (expressed as a percentage of such average annual compensation).

(d) Offset plans--(1) In general. An offset plan maintained by a railroad employer satisfies section 401(*l*) and §1.401(*l*)-3 for a plan year only if--

(i) The plan satisfies §1.401(*l*)-3 for the plan year without regard to the offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system, and

(ii) The offset for the employer-derived portion of tier 2 and supplementary annuity benefits provided under the railroad retirement system does not exceed the maximum tier 2 and supplementary annuity offset allowance.

(2) Maximum tier 2 and supplementary annuity offset allowance. For purposes of paragraph (d)(1) of this section, the maximum tier 2 and supplementary annuity offset allowance for a plan year is equal to 0.56 percent of the employee's railroad retirement covered compensation for the plan year.

(e) Additional rules--(1) Definitions. The following definitions govern for purposes of this section.

(i) "Railroad retirement taxable wage base" means the applicable base, as determined under section 3231(e)(2)(B)(ii), for purposes of the tax under section 3221(b) (the tier 2 tax).

(ii) "Railroad retirement covered compensation" for an employee means 12 multiplied by the average of the 60 highest monthly railroad taxable wage bases in effect for the employee's period of employment. The monthly railroad taxable wage base is determined by dividing the railroad taxable wage base for the calendar year in which the month occurs by

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12. An employee's railroad retirement covered compensation for the plan year is determined



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as of the beginning of the plan year. A plan must provide that an employee's railroad retirement covered compensation is automatically adjusted for each plan year. See §1.401(*l*)-1(b) for rules relating to prohibited decreases in an employee's accrued benefit within the meaning of section 411(d)(6) or section 411(b)(1)(G).

(2) Adjustments to 0.75-percent factor. The 0.75-percent factor in the maximum excess allowance and in the maximum offset allowance is subject to the reductions prescribed in §1.401(*l*)-3(d) and (e), except that in the case of an employee with at least 30 years of service with a railroad employer, the following tables are substituted for Tables I through III contained in §1.401(*l*)-3(e)(3).

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TABLE I

Social security retirement age 67

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 66 | 0.750 |
| 65 | 0.750 |
| 64 | 0.750 |
| 63 | 0.750 |
| 62 | 0.750 |
| 61 | 0.525 |
| 60 | 0.525 |
| 59 | 0.508 |
| 58 | 0.490 |
| 57 | 0.472 |
| 56 | 0.433 |
| 55 | 0.398 |

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TABLE II

Social security retirement age 66

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 65 | 0.750 |
| 64 | 0.750 |
| 63 | 0.750 |
| 62 | 0.750 |
| 61 | 0.563 |
| 60 | 0.563 |
| 59 | 0.544 |
| 58 | 0.525 |
| 57 | 0.506 |
| 56 | 0.488 |
| 55 | 0.447 |

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TABLE III

Social security retirement age 65

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 64 | 0.750 |
| 63 | 0.750 |
| 62 | 0.750 |
| 61 | 0.600 |
| 60 | 0.600 |
| 59 | 0.580 |
| 58 | 0.560 |
| 57 | 0.540 |
| 56 | 0.520 |
| 55 | 0.500 |

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(3) Adjustments to 0.56-percent factor. The 0.56-percent factor for defined benefit excess plan and offset plans under paragraphs (c) and (d) of this section respectively is subject to the reductions prescribed in §1.401(*l*)-3(d) and (e), except that, for purposes of applying this paragraph (e)(3)--

(i) "Railroad retirement covered compensation" is substituted for "covered compensation" in §1.401(*l*)-3(d),

(ii) The reductions under §1.401(*l*)-3(d) are made by multiplying the 0.56 factor by the ratio of the applicable factor from the table in §1.401(*l*)-(3)(d)(10) to 0.75, and

(iii) The following tables are substituted for Tables I through III set forth in §1.401(*l*)-3(e)(3).



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(A) Tables Applicable to 0.56% Factor for Employees Covered by Tier 2 of Railroad Retirement With 30 or More Years of Railroad Service

TABLE I

Social security retirement age 67

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 66 | 0.560 |
| 65 | 0.560 |
| 64 | 0.560 |
| 63 | 0.560 |
| 62 | 0.560 |
| 61 | 0.560 |
| 60 | 0.560 |
| 59 | 0.541 |
| 58 | 0.523 |
| 57 | 0.504 |
| 56 | 0.462 |
| 55 | 0.425 |

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TABLE II

Social security retirement age 66

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 65 | 0.560 |
| 64 | 0.560 |
| 63 | 0.560 |
| 62 | 0.560 |
| 61 | 0.560 |
| 60 | 0.560 |
| 59 | 0.541 |
| 58 | 0.523 |
| 57 | 0.504 |
| 56 | 0.485 |
| 55 | 0.445 |

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TABLE III

Social security retirement age 65

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 64 | 0.560 |
| 63 | 0.560 |
| 62 | 0.560 |
| 61 | 0.560 |
| 60 | 0.560 |
| 59 | 0.541 |
| 58 | 0.523 |
| 57 | 0.504 |
| 56 | 0.485 |
| 55 | 0.467 |

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(B) Tables Applicable to 0.56% Factor for Employees Covered by Tier 2 of Railroad Retirement With Less than 30 Years of Railroad Service

TABLE I

Social security retirement age 67

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 66 | 0.523 |
| 65 | 0.485 |
| 64 | 0.448 |
| 63 | 0.420 |
| 62 | 0.392 |
| 61 | 0.379 |
| 60 | 0.366 |
| 59 | 0.353 |
| 58 | 0.340 |
| 57 | 0.327 |
| 56 | 0.300 |
| 55 | 0.275 |

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TABLE II

Social security retirement age 66

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 65 | 0.523 |
| 64 | 0.485 |
| 63 | 0.448 |
| 62 | 0.420 |
| 61 | 0.392 |
| 60 | 0.378 |
| 59 | 0.364 |
| 58 | 0.350 |
| 57 | 0.336 |
| 56 | 0.322 |
| 55 | 0.295 |



TABLE III

Social security retirement age 65

| Age at which benefits commence | Annual factor in maximum excess allowance and maximum offset allowance (percent) |
|---|---|
| 64 | 0.523 |
| 63 | 0.485 |
| 62 | 0.448 |
| 61 | 0.418 |
| 60 | 0.388 |
| 59 | 0.373 |
| 58 | 0.358 |
| 57 | 0.343 |
| 56 | 0.329 |
| 55 | 0.314. |



(4) Overall permitted disparity. The overall permitted disparity rules of §1.401(*l*)-5 apply to employees who benefit under a plan maintained by a railroad employer.



§1.401(*l*)-5 Overall permitted disparity limits.

(a) Introduction--(1) In general. The maximum excess allowance and maximum offset allowance limit the disparity that can be provided under a plan for a plan year. The overall permitted disparity rules apply to limit the disparity provided for a plan year if an employee benefits under more than one plan maintained by the employer (the "annual overall permitted disparity limit") and to limit the disparity provided for an employee's total years of service, either in a single plan or in more than one plan of the employer (the "cumulative overall permitted disparity limit"). The overall permitted disparity rules take into account the disparity provided under a section 401(*l*) plan and the permitted disparity imputed under a plan that satisfies section 401(a)(4) by relying on §1.401(a)(4)-7. A plan that is not a section 401(*l*) plan is generally deemed to impute permitted disparity under §1.401(a)(4)-7 unless established otherwise. Paragraph (b) of this section provides rules on the annual overall permitted disparity limit. Paragraph (c) of this section provides rules on the cumulative overall permitted disparity limit.

(2) Plan requirements. In order to satisfy section 401(*l*), a plan must provide that the overall permitted disparity limits may not be exceeded and must specify how employer-provided contributions or benefits under the plan are adjusted, if necessary, to satisfy the overall permitted disparity limits. Any adjustments made to satisfy the overall permitted disparity limits must be made in a uniform manner for all employees..

(3) Plans taken into account. For purposes of this section, all plans of the employer are taken into account. In addition, all plans of any other employer are taken into account



for all periods of service with the other employer for which the employee receives credit for purposes of benefit accrual under any plan of the current employer.

(b) Annual overall permitted disparity limit--(1) In general. If, in the plan year, an employee benefits under more than one plan, the annual overall permitted disparity limit is satisfied only if the employee's total annual disparity fraction, as defined in paragraph (b)(2) of this section, does not exceed one. Paragraphs (b)(3) through (b)(8) of this section explain

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the determination of an employee's annual disparity fractions. Paragraph (b)(9) of this section provides examples.

(2) Total annual disparity fraction. An employee's total annual disparity fraction is the sum of the employee's annual disparity fractions, as defined in paragraphs (b)(3) through (b)(7) of this section. An employee's total annual disparity fraction is determined as of the end of the current plan year, based on the employee's annual disparity fractions under all plans with plan years ending in the current plan year.

(3) Annual defined contribution plan disparity fraction. For a plan year, the annual defined contribution plan disparity fraction for an employee benefiting under a defined contribution plan that is a section 401(*l*) plan is a fraction--

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under §1.401(*l*)-2(b)(2) for the plan year.



(4) Annual defined benefit excess plan disparity fraction. For a plan year, the annual defined benefit excess plan disparity fraction for an employee benefiting under a defined benefit excess plan that is a section 401(*l*) plan is a fraction--

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum excess allowance under §1.401(*l*)-3(b)(2) for the plan year.

(5) Annual offset plan disparity fraction. For a plan year, the annual offset plan disparity fraction for an employee benefiting under an offset plan that is a section 401(*l*) plan is a fraction--

(i) The numerator of which is the disparity provided under the plan for the plan year, and

(ii) The denominator of which is the maximum offset allowance under §1.401(*l*)-3(b)(3) for the plan year.

(6) Annual imputed disparity fraction. For a plan year, the annual imputed disparity fraction for an employee benefiting under a plan that imputes permitted disparity with respect to the employee under §1.401(a)(4)-7 is one.

(7) Annual nondisparate fraction. For a plan year, the annual nondisparate fraction for an employee benefiting under a plan that neither is a section 401(*l*) plan nor imputes permitted disparity under §1.401(a)(4)-7 is zero.

(8) Determination of fraction--(i) General rule. A separate annual disparity fraction is generally determined for each plan under which the employee benefits. Thus, for example,



if two plan are aggregated and treated as a single plan for purposes of section 401(a)(4), a single annual disparity fraction applies to the aggregated plan.

(ii) Multiple formulas. If a plan provides an allocation or benefit equal to the sum of two or more formulas, each formula is considered a separate plan for purposes of this section. If a plan provides an allocation or benefit equal to the greater of two or more formulas, an annual disparity fraction is calculated for the employee under each formula and the largest of the fractions is the employee's annual disparity fraction under the plan.

(iii) Offset arrangements--(A) In general. If an employee benefits under two plans of the employer described in paragraph (b)(8)(iii)(B) or (C) of this section, the employee's annual disparity fraction under both plans is the larger of the annual disparity fractions calculated separately under each plan.

(B) Defined benefit plans. The employee's employer-provided accrued benefit under a defined benefit plan is offset by the employee's total employer-provided accrued benefit under another defined benefit plan or by the actuarial equivalent (as defined in §1.401(a)(4)-12) of the employee's total account balance under a defined contribution plan that is attributable to employer contributions.

(C) Defined contribution plans. The amount allocated to the employee's account under a defined contribution plan is offset by the total amount allocated to the employee's account under another defined contribution plan.

(iv) Applicable percentages. The disparity provided under a plan is determined on the base and excess percentages under an excess plan and the offset percentage under an offset

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plan, regardless of whether the employee's plan year or average annual compensation exceeds the integration or offset level under the plan.

(9) Examples. The following examples illustrate this paragraph (b). Except as otherwise provided, each plan is a section 401(*l*) plan.

Example 1. (a) Employee A benefits for the plan year under a defined contribution excess plan, Plan X, and a defined benefit excess plan, Plan Y, of the employer. Plans X and Y have the same plan year. Employee A benefits under no other plan of the employer for the plan year of any other plan ending in the plan year of Plans X and Y. Plan X provides a base contribution percentage of 5 percent and an excess contribution percentage of 7 percent, thus providing Employee A with disparity of 2 percent for the plan year. The maximum excess allowance for the plan year under Plan X is 5 percent. Plan Y provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.35 percent, thus providing Employee A with disparity of 0.35 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 0.75 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined benefit excess plan disparity fraction under Plan Y for the plan year is 0.47 (0.35 percent divided by 0.75 percent). Employee A's total annual disparity fraction is the sum of 0.4 and 0.47 or 0.87. Because Employee A's total annual disparity fraction does not exceed one, the plans satisfy the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 2. (a) The facts are the same as in Example 1, except that Plan Y is a defined contribution plan, rather than a defined benefit plan. Plan X and Plan Y cover the same employees and are identical in their terms except for the base and excess contribution percentages provided under the plans. Plan Y provides a base contribution percentage of 3 percent and an excess contribution percentage of 6 percent, thus providing Employee A with disparity of 3 percent for the plan year. The maximum excess allowance for the plan year under Plan Y is 3 percent.

(b) Employee A's annual defined contribution plan disparity fraction under Plan X for the plan year is 0.4 (2 percent divided by 5 percent). Employee A's annual defined contribution plan disparity fraction under Plan Y for the plan year is 1 (3 percent divided by 3 percent). Because Employee A's total annual disparity fraction (the sum of 0.4 and 1 or 1.4) exceeds one, the plans do not satisfy the annual overall permitted disparity requirements with respect to Employee A for the plan year.

(c) Plan X and Plan Y are aggregated for purposes of section 401(a)(4) and form a single section 401(*l*) plan. Under the plan, the base contribution percentage is 8 percent (5



percent plus 3 percent), and the excess contribution percentage is 13 percent (7 percent plus 6 percent). A single annual defined contribution plan disparity fraction is determined for Employee A for the plan year, the numerator of which is the disparity of 5 percent provided under the plan (13 percent minus 8 percent), and the denominator of which is 5.7 percent, the maximum excess allowance that applies to the plan. Because Employee A's only annual disparity fraction of 0.88 (5 percent divided by 5.7 percent) does not exceed one, Employee A's total annual disparity fraction also does not exceed one. The plan thus satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 3. Assume the same facts as in Example 2, except that Plan X and Plan Y use different integration levels. Therefore, when Plan X and Plan Y are aggregated to form a single plan for purposes of section 401(a)(4), the single plan does not satisfy section 401(*l*). In applying the general test of §1.401(a)(4)-2(c), the plan imputes disparity under §1.401(a)(4)-7. Employee A's only annual disparity fraction is the annual imputed disparity fraction of one. Employee A's total annual disparity fraction is also one, and the plan satisfies the annual overall permitted disparity limit with respect to Employee A for the plan year.

Example 4. (a) Employee B participates in two plans: Plan M, which is a section 401(*l*) plan, and Plan N, which is subject to the general test under §1.401(a)(4)-3(b). Plan M provides that the disparity provided an employee for the plan year will be reduced to the extent necessary to satisfy the annual overall permitted disparity limits. The employer wishes to impute permitted disparity under §1.401(a)(4)-7 in order for Plan N to satisfy section 401(a)(4). Employee B's imputed disparity fraction under Plan N is therefore one, and Plan M provides no disparity provided for Employee B for the plan year. As a result, Plan M provides disparity that is neither uniform nor deemed uniform under §1.401(*l*)-3(c); Plan M therefore does not satisfy section 401(*l*).

(b) Assume instead that Plan M provides that the annual overall permitted disparity limits must be satisfied without reducing the disparity provided for an employee under Plan M, thus requiring a reduction in the employee's annual disparity fraction under another plan. In that case, the disparity provided under Plan M would be uniform for the plan year and Plan M would continue to satisfy section 401(*l*). However, imputation of permitted disparity with respect to Employee B would not be allowed under Plan N.

(c) Cumulative permitted disparity limit--(1) In general--(i) Employees who benefit under defined benefit plans. In the case of an employee who has benefited under one or more defined benefit plans for a plan year beginning after December 31, 1991, the cumulative permitted disparity limit is satisfied if the employee's cumulative disparity fraction, as defined in paragraph (c)(2) of this section, does not exceed 35.



(ii) Employees who do not benefit under defined benefit plans. In the case of an employee who has not benefited under a defined benefit plan for any plan year beginning after December 31, 1991, the cumulative permitted disparity limit is satisfied.

(iii) Certain plan years disregarded. For purposes of this paragraph (c), an employee is not treated as benefiting under a defined benefit plan for a plan year beginning after December 31, 1991, if the employer can establish that for that plan year the defined benefit plan was not a section 401(*l*) plan and did not impute permitted disparity under §1.401(a)(4)-7.

(iv) Determination of type of plan. For purposes of this paragraph (c), a target benefit plan that relies on the special rule of §1.401(a)(4)-8(b)(3) to satisfy section 401(a)(4)

and a DB/DC plan within the meaning of §1.401(a)(4)-9(a) are treated as defined benefit plans. Similarly, a cash balance plan that relies on the special rule of §1.401(a)(4)-8(c)(3) to satisfy section 401(a)(4) is treated as a defined contribution plan.

(2) Cumulative disparity fraction. An employee's cumulative disparity fraction is the sum of the employee's total annual disparity fractions, as defined in paragraph (b)(3) of this section, attributable to the employee's total years of service under all plans.

(3) Determination of total annual disparity fractions for prior years--(i) Pre-effective date years. For each of the employee's years of service under all plans as of the end of the last plan year beginning before January 1, 1989, the employee's total annual disparity fraction is one.

(ii) Option for any prior year. The total annual disparity fraction for each prior year of service (or for each prior year of service as of a single date specified in the plan) for each



employee may be treated as one. Thus, for example, in lieu of calculating annual disparity fractions for all plan years, the employer may choose to assume that the full annual disparity limit has been used in each prior plan year, including years after 1988.

(4) Examples. The following examples illustrate this paragraph (c). In each example the plan is noncontributory and, unless provided otherwise, is the only plan ever maintained by the employer. Each plan uses a normal retirement age of 65 and contains no provision that would require a reduction in the 0.75-percent factor under paragraph (b)(2) or (b)(3) of this section. Each example discusses the benefit formula applicable to an employee who has a social security retirement age of 65.

Example 1. Plan M is a defined benefit excess plan that provides a normal retirement benefit of 1 percent of average annual compensation up to covered compensation, plus 1.75 percent of average annual compensation above covered compensation, for each year of service without limit. The disparity provided under the plan for the plan year is 0.75 percent, the excess benefit percentage of 1.75 percent minus the base benefit percentage of 1 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is one. Because the plan contains no limit on the years of service taken into account under the plan, the sum of the total annual disparity fractions for a potential employee with more than 35 years of service will exceed 35. In addition, the plan does not provide that the overall permitted disparity limits may not be exceeded as required by paragraph (a)(2) of this section. The plan therefore does not satisfy the cumulative permitted disparity limit of this paragraph (c).

Example 2. Plan N is an offset plan that provides a normal retirement benefit of 2 percent of average annual compensation, minus 0.75 percent of final average compensation up to the lesser of covered compensation and average annual compensation, for each year of service up to 35. The disparity provided under the plan for the plan year is 0.75 percent, the offset percentage. The maximum offset allowance for the plan year is 0.75 percent. Thus, each employee's annual offset plan disparity fraction under the plan for each plan year is one. Because the plan limits the years of service taken into account under the plan to 35, the sum of the total annual disparity fractions for an employee cannot exceed 35. The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 3. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation, plus



1.25 percent of average annual compensation above covered compensation, for each year of service up to 45. The disparity provided under the plan for the plan year is 0.5 percent, the excess benefit percentage of 1.25 percent minus the base benefit percentage of 0.75 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is 0.67 (0.5 percent divided by 0.75 percent). Because the plan limits the years of service taken into account under the plan to 45, the sum of the total annual disparity fractions for an employee cannot exceed 30 (0.67 x 45). The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 4. (a) Plan P is a defined contribution excess plan. Plan P provides a base contribution percentage of 6 percent and an excess contribution percentage of 11.7 percent, thus providing disparity of 5.7 percent for the plan year. Because the maximum excess allowance for each plan year under Plan P is 5.7 percent, each employee's annual defined contribution excess plan disparity fraction under Plan P for each plan year is one. Plan Q is a defined benefit excess plan maintained by the same employer. Plan Q provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.75 percent for each year of service up to 35, thus providing disparity of 0.75 percent for the plan year. Because the maximum excess allowance for each plan year under Plan Q is 0.75 percent, each employee's annual defined benefit excess plan disparity fraction under Plan Q for each plan year is one.

(b) Employee A benefits under Plan P for the 1980 through the 1994 plan years. The sum of Employee A's total annual disparity fractions under Plan P is 15. (Under paragraph (c)(3)(i) of this section, Employee A's annual disparity fraction for each year of service as of the end of the 1988 plan year is one.) As of the 1995 plan year, Employee A no longer benefits under Plan P and begins to benefit under Plan Q for the first time. In order to satisfy the cumulative permitted disparity limit of this paragraph (c), Plan Q must provide that no disparity will be provided if the sum of an employee's total annual disparity fractions reaches 35, taking into account the employee's annual defined contribution plan disparity fractions under Plan P as well as the employee's annual defined benefit excess plan disparity fractions under Plan Q. Thus, after Employee A has benefited under Plan Q for 20 years, Plan Q may not provide any disparity in additional benefits accrued for Employee A.

(d) Additional rules. The Commissioner may prescribe additional rules under this section as the Commissioner considers appropriate. Additional rules may include (without being limited to) rules for computing the fractions described in this section with respect to terminated plans, rules for applying the overall permitted disparity limits to employees who

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benefit under plans maintained by railroad employers, and rules for determining which plans do not satisfy section 401(*l*) if the overall permitted disparity limits are not exceeded.



§1.401(*l*)-6 Effective dates and transition rules.

(a) In general. Section 401(a)(5)(C) is effective for plan years beginning after December 31, 1988, and section 401(*l*) is effective with respect to plan years, and benefits attributable to plan years, beginning after December 31, 1988. The preceding sentence is applicable to a plan without regard to whether the plan was in existence as of a particular date.

(b) Defined contribution plans. A defined contribution plan satisfies section 401(*l*) with respect to a plan year beginning after December 31, 1988, if it satisfies the applicable requirements of §§1.401(*l*)-1 through 1.401(*l*)-5 for the plan year.

(c) Defined benefit plans. A defined benefit excess plan or offset plan satisfies section 401(*l*) with respect to all plan years, and benefits attributable to all plan years, beginning after December 31, 1988, by satisfying the applicable requirements of §§1.401(*l*)-1 through 1.401(*l*)-5 and the requirements §1.401(a)(4)-13(c), using as the fresh-start date the last day of the last plan year beginning before January 1, 1989. A defined benefit excess plan or offset plan that does not satisfy section 401(*l*) with respect to all plan years, and benefits attributable to all plan years, beginning after December 31, 1988, may, under the rules of §1.401(a)(4)-13(c), satisfy section 401(*l*) for plan years beginning after a fresh-start date by satisfying the applicable



requirements of §§1.401(*l*)-1 through 1.401(*l*)-5 after the fresh-start date. See §1.401(a)(4)-13(c)(5)(iii) and (d), which allow increases in each employee's benefit accrued as of the fresh-start date to reflect increases in the employee's compensation if the plan uses a fresh-start date before the effective date applicable to the plan under §1.401(a)(4)-13(a) or (b).

(d) Collectively bargained plans. (1) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, sections 401(a)(5) and 401(*l*) are applicable for plan years beginning on or after the later of--

(i) January 1, 1989, or

(ii) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986). However, notwithstanding the preceding sentence, sections 401(a)(5) and 401(*l*) apply to plans described in this paragraph (d) no later than the first plan year beginning after January 1, 1991.

(2) For purposes of paragraph (d)(1)(ii) of this section, a change made after October 22, 1986, in the terms or conditions of a collectively bargained plan, pursuant to a collective bargaining agreement ratified before March 1, 1986, is not treated as a change in the terms and conditions of the plan.



(3) In the case of a collectively bargained plan described in paragraph (d)(1) of this section, if the date in paragraph (d)(1)(ii) of this section precedes November 15, 1988, then the date in this paragraph (d) is replaced with the date on which the last of any collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(*l*).

(4) Whether a plan is maintained pursuant to a collective bargaining agreement is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan is not treated as maintained under a col-

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lective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See §301.7701-17T of this chapter for other requirements for a plan to be considered to be collectively bargained. In the case of a collectively bargained plan described in paragraph (d)(1) of this section, if the date in paragraph (d)(1)(ii) of this section precedes November 15, 1988, then the date in this paragraph (d) shall be replaced with the

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date on which the last of any collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(l).

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Commissioner of Internal Revenue
Fred T. Goldberg, Jr.

Approved:

Kenneth W. Gideon
Assistant Secretary of the Treasury

August 30, 1991

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[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

T.D. 8361

RIN 1545-AO66

Definition of Compensation for Qualified Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the scope and meaning of the term "compensation" for tax-qualified retirement plans under section 414(s) of the Internal Revenue Code of 1986. These regulations reflect changes made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance necessary to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning on or after January 1, 1987, and are applied to those plan years except as set forth in §1.414(s)-1(i).

FOR FURTHER INFORMATION CONTACT: David Fuller at 202-377-9372 (not a toll-free number).

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SUPPLEMENTARY INFORMATION:

On May 14, 1990, the Internal Revenue Service published temporary regulations relating to the scope and meaning of the term "compensation" under sections 414(s) and 415(c)(3) of the Internal Revenue Code (Code) in the **Federal Register** (55 FR 19875). Those regulations provided guidance concerning the definition of compensation and conformed the regulations to section 1115 of the Tax Reform Act of 1986 and section 1011(j)(1) of the Technical and Miscellaneous Revenue Act of 1988. The text of those temporary regulations served as the comment document for a notice of proposed rulemaking also published in the **Federal Register** May 14, 1990 (55 FR 19945).

Written comments were received from the public on the proposed regulations. In addition, on September 26, 27, and 28, 1990, a public hearing was held concerning the regulations. After consideration of all of the written comments received and the statements made at the public hearing, the proposed and temporary regulations are adopted as modified by this Treasury Decision.

Background

Section 414(s) and these regulations provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s). For example,

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section 414(s) is explicitly referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). The amount of plan benefits or contributions, expressed as a percentage of compensation within the meaning of section 414(s), is generally one of the key factors in determining whether these nondiscrimination provisions are satisfied.



The temporary regulations implemented the section 414(s) definition of compensation by providing design-based safe harbor definitions of compensation under section 415(c)(3) and a design-based safe harbor alternative definition under section 414(s). In addition, the temporary regulations generally provided that any other reasonable definition of compensation would satisfy section 414(s) if the definition did not by design favor highly compensated employees and satisfied a nondiscrimination requirement. Finally, the temporary regulations provided rules that permitted compensation to include elective salary reduction contributions specified in section 414(s)(2), section 457 deferred compensation, and section 414(h) employer pick-up amounts.

Overview of development of final regulations

The Department of the Treasury and the Internal Revenue Service have received a number of comments on the proposed and temporary regulations under section 414(s) and the regulations under the related Code sections with which the section 414(s) regulations were published (in particular, sections 401(a)(4), 401(*l*), and 410(b)). This Treasury Decision reflects consideration of all of the comments received. In general, the final regulations retain the approach taken in the temporary regulations. In response to comments, revisions have been made to increase the utility of the design-based safe harbors, to increase the flexibility of the rules permitting reasonable nondiscriminatory definitions, and to simplify and clarify certain aspects of the temporary regulations.



Compensation Safe Harbors Under Section 415(c)(3) Applicable For Purposes Of Section 414(s)

1. 415(c)(3) safe harbor definitions.

The temporary regulations under section 414(s) provided that definitions of compensation that satisfied section 415(c)(3) also would constitute safe harbor definitions of compensation for purposes of section 414(s). The temporary regulations also clarified the regulations under section 415(c)(3) as to what amounts were included in compensation. In addition, the temporary regulations added two new section 415(c)(3) safe harbors generally based on wages as defined for FICA tax purposes and on wages as defined for income tax withholding purposes.

Commentators generally favored the addition of a safe harbor definition based on wages for purposes of income tax withholding. This safe harbor definition is retained without modification in the final regulations.

In contrast, many commentators found the new safe harbor definition based on FICA wages to be of limited utility from an administrative point of view. In addition, comments indicated that the use of FICA wages as an alternative compensation definition under section 415(c)(3) was being misinterpreted and misapplied. Moreover, commentators pointed out that often the data was not readily accessible because many employers do not keep a separate accounting of FICA wages after an employee's wages exceed the taxable wage base limitation.

A number of commentators requested a safe harbor definition based on wages reported in Box 10 on Form W-2, Wage and Tax Statement (Box 10 Compensation),



indicating that it would be a useful safe harbor definition of compensation. Box 10 Compensation does not precisely match either FICA wages or wages for income tax withholding purposes since it includes items that are not "wages" under either definition. However, the commentators noted that for many employers this is the most accessible individual employee compensation amount retained in their data bases.

In response to these comments and to further administrability, the final regulations eliminate the section 415(c)(3) safe harbor definition of compensation based on FICA wages

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and replace it with a new safe harbor definition for compensation required to be reported under sections 6041 and 6051. This safe harbor definition is intended to be a safe harbor for Box 10 Compensation. Employers may assume that, as long as the instructions to the Form W-2 concerning the amount to report in Box 10 remain the same as they are for the 1990 or 1991 Form W-2, the amount reported in Box 10 for any employee satisfies this safe harbor. In addition, the final regulations permit employers to adjust the Box 10 compensation amount by excluding moving expense reimbursements if it is reasonable to believe that a corresponding deduction is allowable under section 217.

2. Residents of certain U.S. possessions.

Sections 931 and 933 provide that the gross income of residents of American Samoa, Guam, the Northern Mariana Islands, or Puerto Rico does not include income derived from sources within these specified possessions or Puerto Rico, respectively. The temporary regulations under section 415(c)(3) provided that an item or amount is only compensation to the extent that it is includible in gross income. The final regulations clarify that the exclusions from gross income under sections 931 and 933 are disregarded for purposes of

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determining whether income from any of the specified possessions or Puerto Rico is compensation under section 415(c)(3). The final regulations also provide that similar principles are to be applied in determining compensation of self-employed individuals who are residents of specified possessions or Puerto Rico.

Compensation Under Section 414(s)

1. Definitions of compensation that satisfy section 414(s).

Under section 414(s)(3), the Secretary is granted authority to prescribe alternative definitions of compensation by regulation. Section 1.414(s)-1(c)(3) of the temporary regulations exercised that authority by prescribing a safe harbor alternative definition of compensation that automatically satisfies section 414(s). Under the safe harbor alternative definition, an employer may generally define compensation as including regular or base salary or wages, plus commissions, tips, overtime and other premium pay, and bonuses, and excluding all of the items specified in the regulation for this purpose (even if includible in gross income). These specified exclusions are reimbursements or other expense allowances, fringe benefits (whether cash or noncash), moving expenses, deferred compensation, and welfare benefits.

This safe harbor definition is retained in the final regulations. The final regulations also retain the rule permitting an employer to elect to modify a section 415(c)(3) definition or the safe harbor alternative definition to include the amount of certain elective contributions, section 457 deferred compensation, and section 414(h) employer pickup amounts, provided that all these amounts are included.

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Commentators asked that the safe harbor alternative definition be expanded to allow additional items to be excluded from the compensation of highly compensated employees. The final regulations amplify the temporary regulations by permitting an employer to modify any of the safe harbor definitions to permit additional items or amounts of compensation to be excluded on a uniform and consistent basis from the compensation of highly compensated employees, but not from the compensation of any nonhighly compensated employees. This modification is permitted to be made after the inclusion of elective contributions and deferred compensation. Thus, for example, a definition of compensation under section 415(c)(3) could be first modified to include all elective contributions, section 457 deferred compensation, and employer pick-up amounts, but then be further modified to exclude section 457 deferred compensation on a uniform consistent basis from the compensation of highly compensated employees.

2. Reasonable definition of compensation.

In addition to the safe harbor alternative definition, the temporary regulations provided that any other alternative definition of compensation would satisfy section 414(s) if the definition was reasonable, did not by design favor highly compensated employees, and satisfied a nondiscrimination requirement. This flexible approach was intended to accommodate employers' legitimate business needs while retaining the basic statutory

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requirement that the compensation definition must be nondiscriminatory. Comments on this approach were generally favorable, and, therefore, the final regulations retain this general rule. Commentators also asked for clarification on certain aspects of the rule. Thus, final regulations provide further guidance on circumstances under which a definition is not



reasonable. For example, under the final regulations, a definition of compensation is not reasonable if the definition includes an item or amount not includible under a safe harbor definition (e.g., business expenses substantiated to the payor under an accountable plan). In addition, a definition is not reasonable if it provides that each employee's compensation is a specified portion of the employee's total compensation (such as 90 percent) measured for the otherwise applicable determination period.

3. Use of rate-of-pay definition for purposes of section 414(s).

Commentators indicated that many plans use a rate-of-pay definition of compensation under the plan benefit formula and requested that the regulations permit use of a rate-of-pay definition as an alternative definition under section 414(s). Often an employer uses rate of pay in the benefit formula because it reduces data collection, is predictable, and is easily administered. The proposed regulations under section 401(a)(4) and the temporary regulations under section 414(s) did not preclude employers from retaining a rate-of-pay definition of compensation for purposes of applying the plan formula. However, a plan using a rate-of-pay benefit formula would have been required to use a different definition of compensation in testing for compliance with the nondiscrimination rules and could not have satisfied the nondiscrimination rules on a safe harbor basis.

Rate of pay as an alternative section 414(s) definition of compensation was not included in the temporary regulations because rate of pay is a projected figure, rather than a reflection of actual compensation. Thus, it appeared to be inconsistent with the underlying purpose of the definition of compensation under section 414(s). Nevertheless, the Treasury and the Service recognize that use of a rate-of-pay formula by a plan facilitates plan



administration and may, in fact, be reasonable and nondiscriminatory under specified conditions. Consequently, the final regulations permit rate of pay (referred to as rate of compensation in the regulations) as an alternative definition under section 414(s). However, to limit possible distortions, if rate-of-pay compensation is used for purposes of section 414(s), amounts based on the employee's rate of pay can only be credited under the formula for 30 days after an employee terminates employment (or is otherwise absent without pay). Of course, as with any section 414(s) definition of compensation other than one included in a safe harbor, the definition must be nondiscriminatory. By permitting rate of pay as an alternative section 414(s) definition of compensation, plans using a rate-of-pay benefit formula may be able to satisfy section 401(a)(4) on a safe harbor basis.

4. Crediting compensation during leaves of absence.

Commentators suggested that the permissible definitions of compensation under section 414(s) should allow crediting of compensation while an employee is on leave of absence in order to permit continued accruals under the plan. During the interim between the temporary regulations and the final regulations, attention was focused on this issue as a result of the Persian Gulf conflict. Specifically, employers asked whether compensation credited to reservists under employee benefit plans while on leave of absence due to active military duty would satisfy section 414(s) as a reasonable definition of compensation.

In response to these comments, the final regulations provide that compensation credited for benefit accrual purposes during an unpaid absence from service for a reason other than termination from employment can satisfy section 414(s). Under the final regulations, compensation may be credited indefinitely for absence from service due to



military duty or jury duty. In addition to absence from service for military duty and jury duty, the final regulations also permit compensation to be deemed to continue under this rule for other unpaid absence from service for a period not to exceed 6 months. No similar rule was necessary for absence from service due to long-term disability because any benefit based

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on deemed compensation credited during a disability period generally gives rise to a qualified disability benefit and thus is not included in nondiscrimination testing of benefit amounts. See section 411(a)(9)(B).

The regulations impose certain restrictions on the compensation that may be credited during absence from service for purposes of section 414(s) in order to ensure that the method used is nondiscriminatory. Specifically, the final regulations require that the compensation credited not exceed the compensation that would have been credited under the plan if services had continued (e.g., actual compensation at the time the leave of absence began or the rate of pay in effect while the employee is absent from service that is applicable to the employee's specific job grade). In addition, the final regulations require that any provisions in the plan for crediting compensation must be applied uniformly to all similarly situated employees and that the provisions for crediting compensation satisfy the effective availability requirements under section 401(a)(4). See §1.401(a)(4)-4(c).

5. Nondiscrimination requirement

The final regulations, like the temporary regulations, provide that an alternative definition of compensation is nondiscriminatory under section 414(s) if the average percentage of total compensation included under the alternative definition for an employer's highly compensated employees as a group does not exceed by more than a de minimis



amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group. The preamble to the temporary regulations stated that any reasonable method could be used for this purpose. Several commentators suggested that the final regulations should provide more guidance on appropriate methodologies for determining the average percentage for each group.

The final regulations continue to provide that any reasonable method may be used in determining the average percentages of total compensation included under the alternative definitions for the highly compensated employee group and the nonhighly compensated employee group, respectively. However, the final regulations also include a specific averaging calculation method that is treated as satisfying the reasonableness requirement. Under this method, an individual compensation percentage is calculated for each employee in the highly compensated employee group and in the nonhighly compensated employee group. An employee's compensation percentage is calculated by dividing the amount of the employee's compensation that is included in the alternative definition by the amount of the employee's total compensation. These individual compensation percentages are then averaged within the highly compensated and nonhighly compensated groups producing an average for each group. Any other reasonable method may be utilized to calculate the average-compensation percentages for either group provided the average percentage produced by the method is not reasonably expected to vary significantly from the average percentage using the individual-percentage method. Recognizing the factors that create a significant variance in the calculation of the average percentage may not be the same for both groups,



the final regulations do not require that the same method must be used to calculate the average percentage for each group.

In the case of a rate-of-pay definition of compensation or a definition of compensation that credits compensation during absence from service, the nondiscrimination requirement is modified to prevent distortions in the average percentage of total compensation included under the alternative definition for the highly compensated employee group and the nonhigly compensated employee group. A distortion may result if the imputed compensation credited to some employees for a year under the alternative definition exceeds actual compensation for those employees for the year. Therefore, the final regulations provide that, in the case of these definitions of compensation, solely for purposes of calculating the average percentages used in applying the nondiscrimination test, the compensation included for an employee under the alternative definition may not exceed the employee's total compensation.

6. Employees taken into account for nondiscrimination purposes.

The final regulations, like the temporary regulations, provide that the employees taken into account in determining whether a compensation definition is nondiscriminatory are the

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same employees taken into account in satisfying the applicable statutory provision. However, the temporary regulations permitted the nondiscrimination requirement to be satisfied taking into account all the nonexcludable employees of an employer unless use of that method could reasonably be expected to result in a distortion of the percentage that was more than de minimis given the compensation characteristics of the employer's work force. Concerns were raised that employers were reluctant to use this rule because of uncertainty as to whether their facts met the applicable standard. Thus, the rule has been modified to permit

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employers to take into account all employees in all plans of the employer for which the alternative definition is being used to determine whether the plan satisfies section 401(a)(4) for the plan year.

7. Availability of elective, employee, and matching contributions.

The temporary regulations contained a rule providing that, for the limited purposes of applying the nondiscriminatory availability requirements of the proposed regulations with respect to elective, employee, and matching contributions, any reasonable definition of compensation was treated as nondiscriminatory. This rule was deleted from the final regulations because the final section 401(k) and 401(m) regulations published in the **Federal Register** on August 15, 1991, and the final section 401(a)(4) regulations issued simultaneously with this regulation, clarify the application of the nondiscriminatory availability requirement under section 401(a)(4) to arrangements subject to sections 401(k) and 401(m), and make this rule unnecessary. See §1.401(k)-1(a)(4)(iv) and §1.401(m)-1(a)(2). Under these rules, employee, elective, and matching contributions are not required to be based on compensation determined under a definition that satisfies section 414(s). Rather, use of different definitions of compensation for purposes of the right to employee, elective, and matching contributions are treated as different benefits, rights, and features, each of which must separately satisfy the nondiscriminatory availability requirement of §1.401(a)(4)-4. In addition, employee, elective, and matching contributions that use a definition of compensation that has the effect of restricting access by nonhighly compensated employees may not satisfy the nondiscriminatory availability requirement of the final section

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401(a)(4) regulations, even where the same definition of compensation is used for all employees.

Effective Date

These regulations are effective for plan years beginning on or after January 1, 1987, except as set forth in §1.414(s)-1(i).

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Marjorie Hoffman and David Fuller of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

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List of Subjects in 26 CFR 1.401-0 through 1.419A-2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the citation



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for §1.414(s)-1T and adding the following citation to read as follows:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805. * * * §1.414(s)-1 also issued under 26 U.S.C. 414(s). * * *

Par. 2. New §1.414(s)-1 is added to read as follows:

§1.414(s)-1 Definition of compensation.

(a) Introduction--(1) In general. Section 414(s) and this section provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s) or this section. For example, section 414(s) is referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). In accordance with section 414(s)(1), this section defines compensation as compensation within the meaning of section 415(c)(3). It also implements the election provided in section 414(s)(2) to treat certain deferrals as compensation and exercises the authority granted to the Secretary in section 414(s)(3) to prescribe alternative nondiscriminatory definitions of compensation.

(2) Limitations on scope of section 414(s). Section 414(s) and this section do not apply unless a provision specifically refers to section 414(s) or this section. For example, even though a definition of compensation permitted under section 414(s) must be used in determining whether the contributions or benefits under a pension, profit sharing, or stock bonus plan satisfy a certain applicable provision (such as section 401(a)(4)), except as otherwise specified, the plan is not required to use a definition of compensation that satisfies



section 414(s) in calculating the amount of contributions or benefits actually provided under the plan.

(3) Overview. Paragraph (b) of this section provides rules of general application that govern a definition of compensation that satisfies section 414(s). Paragraph (c) of this section contains specific definitions of compensation that satisfy section 414(s) without satisfying any additional nondiscrimination requirement under section 414(s). Paragraph (d) of this section provides rules permitting the use of alternative definitions of compensation that satisfy section 414(s) as long as the nondiscrimination requirement and other requirements described in paragraph (d) of this section are satisfied. Paragraph (e) of this section provides special rules permitting, under certain limited circumstances, the use of imputed compensation rather than actual compensation under a definition of compensation that satisfies section 414(s). Paragraph (f) of this section provides other special rules, including a special rule for determining the compensation of a self-employed individual under an alternative definition of compensation. Paragraph (g) of this section provides definitions for certain terms used in this section.

(b) Rules of general application--(1) Use of a definition. Any definition of compensation that satisfies section 414(s) may be used when a provision explicitly refers to section 414(s) unless the reference or this section specifically indicates otherwise.

(2) Consistency rule. A definition of compensation selected by an employer for use in satisfying an applicable provision must be used consistently to define the compensation of all employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, although any definition of compensation that satisfies



section 414(s) may be used for section 401(a)(4) purposes, the same definition of compensation generally must be used consistently to define the compensation of all employees taken into account in determining whether a plan satisfies section 401(a)(4). Furthermore, a different definition of compensation that satisfies section 414(s) is permitted to be used to determine whether another plan maintained by the same employer separately satisfies the requirements of section 401(a)(4). Although a definition of compensation must be used consistently, an employer may change its definition of compensation for a subsequent determination period with respect to the applicable provision. Rules provided under any applicable provision may modify the consistency requirements of this paragraph (b)(2).

(3) Self-employed individuals. Notwithstanding paragraph (b)(1) of this section, self-employed individuals' compensation can only be determined under paragraph (c)(2) of this section (with or without the modification permitted by paragraph (c)(4) of this section) or by

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using an equivalent alternative compensation amount determined in accordance with paragraph (f)(1) of this section. These limitations on self-employed individuals do not affect their common-law employees. Thus, the compensation of common-law employees of a partnership or sole proprietorship may be defined using an alternative definition, provided the definition otherwise satisfies paragraph (c)(3), (d), or (e) of this section. If an alternative definition of compensation under paragraph (c)(3), (d), or (e) of this section is used for other employees to satisfy an applicable provision, the consistency requirement is only met if paragraph (f) of this section is used for the self-employed individuals.

(c) Specific definitions of compensation that satisfy section 414(s)--(1) General rules. The definitions of compensation provided in paragraphs (c)(2) and (c)(3) of this section



satisfy section 414(s) and need not satisfy any additional requirements under section 414(s). Paragraph (c)(2) of this section describes definitions of compensation within the meaning of section 415(c)(3). Paragraph (c)(3) of this section provides a safe harbor alternative definition that excludes certain additional items of compensation. Paragraph (c)(4) of this section permits any definition provided in paragraph (c)(2) or (c)(3) of this section to include certain types of elective contributions and deferred compensation. Paragraph (c)(5) of this section permits certain modifications to a definition otherwise provided under this paragraph (c).

(2) Compensation within the meaning of section 415(c)(3). A definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation satisfies section 414(s). Sections 1.415-2(d)(2) and (d)(3) provide rules for determining items of compensation included in and excluded from compensation within the meaning of section 415(c)(3). In addition, section 414(s) is satisfied by the safe harbor definitions provided in §1.415-2(d)(10) and (d)(11) and any additional definitions of compensation prescribed by the Commissioner under the authority provided in §1.415-2(d)(13) that are treated as satisfying section 415(c)(3).

(3) Safe harbor alternative definition. Under the safe harbor alternative definition in this paragraph (c)(3), compensation is compensation as defined in paragraph (c)(2) of this section, reduced by all of the following items (even if includible in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits.



(4) Inclusion of certain deferrals in compensation. Any definition of compensation provided in paragraph (c)(2) or (c)(3) of this section satisfies section 414(s) even though it is modified to include all of the following types of elective contributions and all of the following types of deferred compensation--

(i) Elective contributions that are made by the employer on behalf of its employees that are not includible in gross income under section 125, section 402(a)(8), section 402(h), and section 403(b);

(ii) Compensation deferred under an eligible deferred compensation plan within the meaning of section 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations); and

(iii) Employee contributions (under governmental plans) described in section 414(h)(2) that are picked up by the employing unit and thus are treated as employer contributions.

(5) Exclusions applicable solely to highly compensated employees. Any definition of compensation that satisfies paragraph (c)(2) or (c)(3) of this section, with or without the modification permitted by paragraph (c)(4) of this section, may be modified to provide for exclusion of additional items or amounts (including, for example, any one or more of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section) on a uniform basis from the compensation of the employer's highly compensated employees. This paragraph (c)(5) only permits modifications that apply to the compensation of highly compensated employees. See paragraph (d) of this section for requirements with respect to any modifications in defining the compensation of nonhighly compensated employees.

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(d) Alternative definitions of compensation that satisfy section 414(s)--(1) General rule. In addition to the definitions provided in paragraph (c) of this section, any definition of compensation satisfies section 414(s) with respect to employees (other than self-employed individuals treated as employees under section 401(c)(1)) if the definition of compensation does not by design favor highly compensated employees, is reasonable within the meaning of paragraph (d)(2) of this section, and satisfies the nondiscrimination requirement in paragraph (d)(3) of this section.

(2) Reasonable definition of compensation--(i) General rule. An alternative definition of compensation under this paragraph (d) is reasonable under section 414(s) if it is a definition of compensation provided in paragraph (c) of this section, modified to exclude any one or more of the types of compensation as permitted in paragraph (d)(2)(ii) of this section. See paragraph (e) of this section, however, for certain definitions of compensation that include amounts of imputed compensation that are not includible under any definition of compensation provided in paragraph (c) of this section.

(ii) Items that may be excluded. Subject to the applicable facts and circumstances, a reasonable definition of compensation is permitted, on a consistent basis, to exclude certain types of irregular or additional compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums); bonuses; or any one of the types of compensation excluded under the safe harbor alternative definition in paragraph (c)(3) of this section. A reasonable definition is also permitted to include, on a consistent basis, some, without being required to include all,



of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section.

(iii) Limits on the amount excluded from compensation. A definition of compensation is not reasonable if it provides that each employee's compensation is a specified portion of the employee's compensation measured for the otherwise applicable determination period under another definition. For example, a definition of compensation that specifically limits each employee's compensation for a determination period to 95 percent of the employee's compensation using a definition provided in paragraph (c) of this section is not reasonable. Similarly, a definition of compensation that limits each employee's compensation used to satisfy an applicable provision with a 12-month determination period to compensation under a definition provided in paragraph (c) of this section for one month is not a reasonable definition of compensation. However, a definition of compensation is not unreasonable merely because it excludes all compensation in excess of a specified dollar amount.

(3) Nondiscrimination requirement--(i) In general. An alternative definition of compensation under this paragraph (d) is nondiscriminatory under section 414(s) for a determination period if the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees as a group for the determination period does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group.

(ii) Total compensation. For purposes of this paragraph (d)(3), total compensation must be determined using a definition of compensation provided in paragraph (c)(2) of this



section, with or without the modification permitted by paragraph (c)(4) of this section. Total compensation taken into account for each employee (including, if added, the elective contributions and deferred compensation described in paragraph (c)(4) of this section) may not exceed the annual compensation limit of section 401(a)(17).

(iii) Employees taken into account--(A) General rule. In applying the requirement of this paragraph (d)(3), the employees taken into account are the same employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, in determining whether an alternative definition used to determine whether a plan satisfies section 401(a)(4) satisfies this paragraph (d)(3), all employees in the

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plan for the plan year are generally taken into account. If an employer is using the same alternative definition of compensation to determine whether more than one separate plan satisfies section 401(a)(4), the employer is permitted to take into account all the employees in all the plans in determining whether the alternative definition of compensation being used satisfies this paragraph (d)(3).

(B) Exclusion of self-employed individuals. In applying the requirement of this paragraph (d)(3), self-employed individuals are disregarded.

(iv) Calculation of average percentages--(A) General rule. To determine the average percentages described in paragraph (d)(3)(i) of this section, an individual compensation percentage must be calculated for each employee in a group, and then the average of the separately calculated compensation percentages for each employee in the group must be determined. The individual compensation percentage for an employee is calculated by



dividing the amount of the employee's compensation that is included under the alternative definition by the amount of the employee's total compensation.

(B) Other reasonable methods. Notwithstanding paragraph (d)(3)(iv)(A) of this section, any other reasonable method is permitted to be used to determine the average percentages described in paragraph (d)(3)(i) of this section for either or both of the groups (i.e., highly compensated employees and nonhighly compensated employees), provided that the method cannot reasonably be expected to create a significant variance from the average percentage for that group determined using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section. The same method is not required to be used for calculating the two average percentages. For example, to determine the average percentage for nonhighly compensated employees as a group, an employer may calculate an aggregate compensation percentage by dividing the aggregate amount of compensation of nonhighly compensated employees that is included under the alternative definition by the aggregate amount of total compensation of nonhighly compensated employees, provided the resulting percentage is not reasonably expected to vary significantly from the average percentage produced using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section because of the extra weight given employees with higher compensation.

(v) Facts and circumstances determination. The determination of whether the average percentage of total compensation included for the employer's highly compensated employees as a group for a determination period exceeds by more than a de minimis amount the average percentage of total compensation included for the employer's nonhighly compensated employees as a group is based on the applicable facts and circumstances. The differences



between the percentages for prior determination periods may be considered in determining whether the amount of the difference between the percentages is more than de minimis. In addition, an isolated instance of a more than de minimis difference between the compensation percentages that is due to an extraordinary unforeseeable event (such as overtime payments to employees of a public utility due to a major hurricane) will be disregarded if the amount of the difference in prior determination periods was de minimis.

(e) Imputed compensation--(1) In general--(i) Overview. Notwithstanding paragraph (d)(2)(i) of this section, a definition of compensation satisfies section 414(s) as a reasonable alternative definition of compensation under section 414(s) even though it includes imputed compensation that is not includible in compensation under any definition described in paragraph (c) of this section, but only if the definition satisfies the requirements of paragraph (e)(2) or (e)(3) of this section, or both paragraphs if applicable. Paragraph (e)(2) of this section specifies the requirements for alternative definitions of compensation that include compensation based on an employee's basic or regular rate of compensation. Paragraph (e)(3) of this section specifies the requirements for alternative definitions of compensation that credit imputed compensation during certain periods of absence from service. As an alternative definition of compensation, a definition of compensation that includes imputed compensation must satisfy the nondiscrimination requirement of paragraph (d)(3) of this section. Paragraph (e)(4) of this section provides special rules for determining whether a definition of compensation that includes imputed compensation satisfies the nondiscrimination requirement under paragraph (d)(3) of this section.

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(ii) Not applicable to certain contributions. This paragraph (e) does not apply to a definition of compensation used in determining whether elective deferrals (as defined in section 402(g)(3)), matching contributions (as defined in section 401(m)(4)), or employee contributions subject to section 401(m) satisfy any applicable provision. Thus, for example, a definition of compensation that includes imputed compensation may not be used to measure compensation for purposes of determining if a qualified cash or deferred arrangement satisfies the actual deferral percentage test in section 401(k)(3).

(2) Rate of compensation--(i) General rule. An alternative definition that defines compensation for a specified period (or series of specified periods) within a determination period based on the basic or regular rate of compensation of each employee as of a designated date in the specified period (or in each of the specified periods in the series) satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in paragraph (e)(2)(ii) of this section and otherwise satisfies the requirements of paragraph (d) of this section, including the nondiscrimination test in paragraph (d)(3) of this section as applied in paragraph (e)(4) of this section.

(ii) Requirements for definitions of compensation based on rate of compensation--(A) Benefit determination. The alternative definition of compensation must actually be used to calculate the benefits or contributions that are subject to the applicable provision. For example, the alternative definition may not be used to determine whether a plan satisfies section 401(a)(4) with respect to the amount of benefits or contributions, unless the benefits or contributions for each employee in the plan are determined using the alternative definition of compensation.



(B) Rate of compensation. The employee's rate of compensation must be based on an hourly pay scale, weekly salary, or similar unit of base or regular compensation applicable to the employee.

(C) Specified period. The specified period may be a week, month, year, or other period provided that the period does not exceed 12 months or the determination period, if shorter.

(D) Date for determining rate of compensation. Any date during the specified period may be designated as the date on which the rate of compensation is determined provided that the same date is used for all employees taken into account in satisfying the applicable provision. In addition, the date selected, by itself, must not cause the portion of total compensation included for any employee (or group of employees) to vary significantly from the portion of total compensation included for any other employee (or group of employees).

(E) Periods without compensation or with reduced compensation. An employee's compensation may generally only be determined using the employee's rate of compensation for employment periods during which the employer actually compensates the employee. However, if an employee terminates employment or is absent from service either without compensation or with reduced compensation (such as for a leave of absence, layoff, or similar event), the employer may continue to credit the employee with compensation based on the employee's rate of compensation for a period of up to 31 days after the event, provided the 31-day period does not extend into a subsequent determination period with respect to the applicable provision. Paragraph (e)(3) of this section contains special rules for crediting compensation during periods of absence from service extending beyond 31 days.



(3) Absence from service--(i) General rule. Solely for purposes of determining whether a defined benefit plan, as defined in §1.410(b)-9, satisfies section 401(a)(4) or 410(b), an alternative definition that includes imputed compensation credited to employees during a period of absence from service that is not otherwise includible in compensation within the meaning of section 415(c)(3) satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in paragraph (e)(3)(ii) of this section. In addition, the definition must otherwise be described in paragraph (c) of this section or must otherwise satisfy the requirements of paragraph (d) or (e)(2) of this section for alternative definitions of compensation, including the nondiscrimination test in paragraph (d)(3) of this section as applied by paragraph (e)(4) of this section.

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(ii) Requirements for definitions of compensation crediting compensation during absence from service--(A) Absent from service. For the period during which compensation is credited to an employee, the employee must be absent from service for a reason other than termination from employment with the employer maintaining the plan. If an employee continues to perform any services for the employer during the period, the employee is not absent from service.

(B) Benefit determination. The alternative definition of compensation must actually be used to calculate the benefits under the plan. For example, the alternative definition may not be used to determine whether a plan satisfies section 401(a)(4) with respect to the amount of benefits or equivalent allocations unless the benefits for each employee in the plan are determined using the alternative definition of compensation.

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(C) Uniformity. Any provisions in the plan for crediting imputed compensation while an employee is absent from service must be applied uniformly to all similarly situated employees in the plan.

(D) Effective availability. For purposes of applying the effective availability requirement of §1.401(a)(4)-4(c) to the right to imputed compensation credited under the plan, the manner in which the employer grants absences from service that give rise to imputed compensation is taken into account.

(E) Period of credited compensation. In the case of compensation credited for a period during which an employee is absent from service for any reason other than military duty or jury duty, the maximum period for which the compensation may be credited under the alternative definition is the shorter of 6 months or the duration of the absence. If an employee is absent from service for military duty or jury duty, compensation may be credited to the employee for the entire period of the military duty or jury duty, even if the period exceeds 6 months.

(iii) Reasonable method. Any reasonable method may be used to determine the amount of compensation to be credited during an absence from service, provided that the following requirements are satisfied--

(A) The terms of the alternative definition of compensation for imputing credited compensation during an absence from service (when applied to the compensation described in paragraph (e)(3)(iii)(B) of this section) are not more inclusive than the terms of the alternative definition as applied to compensation for actual service.

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(B) The amount credited is based on compensation that is reasonably representative of the compensation the employee would have received during the period if the employee had continued to perform services. Except as otherwise required by law, the compensation that the employee was receiving immediately before the absence from service began, or the rate of compensation in effect while the employee is absent from service that is applicable to the employee's specific job grade immediately before the absence from service began, will be the most representative compensation. For example, if an employee's compensation is determined under paragraph (c)(2) of this section for periods of actual service, the compensation credited for the employee during a period of absence from service might reasonably be based on the employee's compensation determined under paragraph (c)(2) of this section immediately before the absence began.

(4) Application of the nondiscrimination requirement to imputed compensation--(i) Safe harbor definitions. If the definition of compensation is otherwise described in paragraph (c) of this section, and the imputed compensation credited for periods of absence from service satisfies paragraph (e)(3) of this section, then the definition is deemed to satisfy paragraph (d) of this section (i.e., it is deemed to be nondiscriminatory), and thus need not satisfy any other nondiscrimination test under section 414(s).

(ii) Other definitions. The amount of each employee's compensation for a determination period (determined under an alternative definition that includes imputed compensation) that is taken into account in determining the average percentages in the nondiscrimination requirement of paragraph (d)(3) of this section must be limited to 100 percent of the employee's total compensation for that period. This rule applies even if the

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amount of compensation actually credited to the employee for the determination period under the alternative definition and, thus, used as compensation within the meaning of section 414(s), exceeds the employee's total compensation for the period.

(f) Special rules--(1) Self-employed individuals--(i) General rule. If an alternative definition of compensation under paragraph (c)(3), (d), or (e) of this section is used to satisfy an applicable provision, an equivalent alternative compensation amount must be determined for any self-employed individual who is in the group of employees for whom paragraph (b) of this section requires a single definition of compensation to be used. This equivalent alternative compensation amount is determined by multiplying the self-employed individual's total earned income (as defined in section 401(c)(2)) for the determination period by the percentage of total compensation (as defined in paragraph (d)(3)(ii) of this section) included under the alternative definition for the employer's nonhighly compensated common-law employees as a group (determined in a manner consistent with the rules in paragraph (d)(3)(iii) of this section and, if applicable, paragraph (e)(4)(ii) of this section). Thus, for purposes of this determination, highly compensated common-law employees must be disregarded. This equivalent alternative compensation amount will be treated as the self-employed individual's compensation under the alternative definition of compensation for the determination period.

(ii) Inclusion of elective contributions. If the alternative definition of compensation includes any types of elective contributions described in paragraph (c)(4) of this section, the self-employed individual's earned income for this determination must be increased by the amount of elective contributions made by the employer on behalf of the self-employed



individual, and the definition of total compensation for this determination must include all the types of elective contributions described in paragraph (c)(4) of this section made by the employer on behalf of common-law employees (other than highly compensated employees).

(2) Leased employees. [Reserved]

(g) Definitions. The following definitions apply for purposes of this section:

(1) Applicable provision. "Applicable provision" means a provision that specifically refers to section 414(s) or this section.

(2) Determination period. "Determination period" means a period during which the amount of compensation is measured for use in determining whether the requirements of an applicable provision are satisfied. If no period is provided under the applicable provision for measuring compensation, the determination period is the period for which the applicable provision must be satisfied. The applicable provision may provide additional rules concerning the determination period to be used for satisfying the nondiscrimination requirement in paragraph (d) of this section.

(3) Highly compensated employee. "Highly compensated employee" means an employee who is a highly compensated employee as defined in section 414(q).

(4) Nonhighly compensated employee. "Nonhighly compensated employees" means an employee who is not a highly compensated employee.

(5) Self-employed individual. "Self-employed individual" means self-employed individual as defined in section 401(c)(1).

(h) Additional rules. The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional rules for defining compensation within



the meaning of section 414(s), including additional definitions of compensation that satisfy section 414(s).

(i) Effective date--(1) General effective date. This §1.414(s)-1 applies to years beginning on or after January 1, 1987.

(2) Optional use of prior regulations. For years beginning before ~~[INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER]~~ September 19, 1991, employers may, in defining compensation for purposes of section 414(s), comply with the prior regulation provisions of §1.414(s)-1T. See §1.414(s)-1T as contained in the CFR edition revised as of April 1, 1991.

Par. 3. Section 1.414(s)-1T is removed.

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is amended by revising paragraph (d)

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Par. 4. Section 1.415-2 ~~is revised~~ to read as follows:

§1.415-2 Definitions and special rules.

* * * * *

(d) Compensation--(1) General definition. Except as otherwise provided, compensation within the meaning of section 415(c)(3) includes all remuneration described in paragraph (d)(2) of this section and excludes all other forms of remuneration. Paragraph (d)(3) of this section provides examples of types of remuneration not includible in compensation within the meaning of section 415(c)(3). Paragraphs (d)(4) and (d)(5) of this section provide rules regarding the payment of compensation in the limitation year. Paragraph (d)(6) of this section provides a special rule for determining the compensation of employees of controlled groups or affiliated service groups. Paragraph (d)(7) of this section provides a special rule for applying the limitations of section 415(c) when a section 403(b) annuity is aggregated with a qualified plan of a controlled employer. Paragraphs (d)(8) and (d)(9) of this section are reserved for special rules for leased employees and for permanent and total disability, respectively. Paragraphs (d)(10) and (d)(11) of this section provide additional definitions of compensation that are treated as satisfying section 415(c)(3). Paragraph (d)(12) of this section permits optional use of prior regulations. Paragraph (d)(13) of this section provides authority to the Commissioner to provide further additional definitions of compensation that satisfy section 415(c)(3).

(2) Items includible as compensation. For purposes of applying the limitations of section 415, the term "compensation" includes all of the following--

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(i) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in §1.62-2(c)).

(ii) In the case of an employee who is an employee within the meaning of section 401(c)(1) and the regulations thereunder, the employee's earned income (as described in section 401(c)(2) and the regulations thereunder).

(iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(iv) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

(v) The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.

(vi) The amount includible in the gross income of an employee upon making the election described in section 83(b).

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Paragraphs (d)(2)(i) and (d)(2)(ii) of this section include foreign earned income (as defined in section 911(b)), whether or not excludable from gross income under section 911. Compensation described in paragraph (d)(2)(i) of this section is to be determined without regard to the exclusions from gross income in sections 931 and 933. Similar principles are to be applied with respect to income subject to sections 931 and 933 in determining compensation described in paragraph (d)(2)(ii) of this section.

(3) Items not includible as compensation. The term "compensation" does not include items such as--

(i) Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed. In addition, employer contributions made on behalf of an employee to a

simplified employee pension described in section 408(k) are not considered as compensation for the taxable year in which contributed. Additionally, any distributions from a plan of deferred compensation are not considered as compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. However, any amounts received by an employee pursuant to an unfunded non-qualified plan is permitted to be considered as compensation for section 415 purposes in the year the amounts are includible in the gross income of the employee.

(ii) Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no



longer subject to a substantial risk of forfeiture (see section 83 and the regulations thereunder).

(iii) Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option.

(iv) Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee).

(4) Compensation in limitation year. The compensation (as defined in paragraph (d)(2) of this section) actually paid or made available to an employee within the limitation year is the compensation used for purposes of applying the limitations of section 415.

(5) Election to use compensation accrued during limitation year--(i) Years beginning after December 31, 1991. For limitation years beginning after December 31, 1991, an employer may not use accrued compensation. Any election previously made to use accrued compensation is not valid for limitation years beginning after December 31, 1991.

(ii) De minimis accrued compensation. Notwithstanding paragraph (d)(5)(i) of this section, an employer may include in compensation amounts earned but not paid in a year because of the timing of pay periods and pay days if these amounts are paid during the first few weeks of the next year, the amounts are included on a uniform and consistent basis with respect to all similarly situated employees, and no compensation is included in more than one



limitation period. No formal election is required to include the accrued compensation permitted under this de minimis rule. The rule described in this paragraph (d)(5)(ii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)).

(iii) Years beginning before January 1, 1992. For limitation years beginning before January 1, 1992, instead of using the compensation actually paid or made available to an employee during the limitation year, an employer may elect to use the compensation accrued for an entire limitation year for purposes of applying the limitations of section 415. In the case of a group of employers that constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) that are under common control (within the meaning of section 414(c) as modified by section 415(h)), the election to use accrued compensation must be made by all members of the group that maintain a qualified plan. Once an election is made, it remains in effect until it is revoked by the employer or group of employers. The rule described in this paragraph (d)(5)(iii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)). If, in a particular limitation year beginning before January 1, 1992, a previously effective election to use accrued compensation is revoked or an election to use accrued compensation is made, any amounts taken into account for compensation purposes for any preceding limitation year may not be counted again in determining compensation for the particular limitation year.

(6) Special rule for employees of controlled groups of corporations, etc. In the case of an employee of two or more corporations which are members of a controlled group of



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corporations (as defined in section 414(b) as modified by section 415(h)), the term "compensation" for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan. This special rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c) as modified by section 415(h)), to an employee of two or more members of an affiliated service group as defined in section 414(m), and to an employee of two or more members of any group of employers who must be aggregated and treated as one employer pursuant to section 414(o).

(7) Special rule when section 403(b) annuity is aggregated with qualified plan of controlled employer. If a section 403(b) annuity contract is combined or aggregated with a qualified plan of a controlled employer in accordance with either §1.415-7(h)(2)(i) or §1.415-8(d)(2), the following rules apply:

(i) In applying separately the limitations of section 415(b) or (c) to the qualified plan and the limitations of section 415(c) and the exclusion allowance of section 403(b)(2)(A) to the section 403(b) annuity, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity.

(ii) However, in applying the limitations of section 415(c) in connection with the combining of the section 403(b) annuity with a qualified defined contribution plan or section 415(e) in connection with the aggregating of the section 403(b) annuity with a qualified defined benefit plan, the total compensation from both employers may be taken into account.

(8) Special rules for leased employees. [Reserved]



(9) Special rules for permanent and total disability. [Reserved]

(10) Safe harbor rule with respect to plan's definition of compensation. If a plan defines compensation for purposes of applying the limitations of section 415 to include only those items specified in paragraph (d)(2)(i) of this section and to exclude all those items listed in paragraph (d)(3) of this paragraph, if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies section 415(c)(3).

(11) Alternative definition of compensation. In lieu of defining compensation in accordance with paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the limitations of section 415 in the case of employees other than self-employed individuals treated as employees within the meaning of section 401(c)(1), a plan may define compensation using either of the following definitions used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy section 415(c)(3):

(i) Information required to be reported under sections 6041 and 6051. Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d) and 6051(a)(3). See §§1.6041-1(a), 1.6041-2(a)(1) and 31.6051-1(a)(1)(i)(c). This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under section 217. Compensation under this paragraph (d)(11)(i)



must be determined without regard to any rules under section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(ii) Section 3401(a) wages. Compensation is defined as wages within the meaning of section 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

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(12) Optional use of prior regulations. For years beginning before September 19, 1991 ~~[INSERT THE DATE OF PUBLICATION OF THIS FINAL REGULATION IN THE FEDERAL REGISTER]~~, employers are permitted, in defining compensation for purposes of section 415(c)(3), to comply with either the provisions of this §1.415-2(d) or the prior regulation provisions of §1.415-2(d). See §1.415-2(d) as contained in the CFR edition revised as of April 1, 1991.

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(13) Additional rules. The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional definitions of compensation that are treated as satisfying section 415(c)(3).

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Commissioner of Internal Revenue
Fred T. Goldberg, Jr.

Approved:

Kenneth W. Gideon
Assistant Secretary of the Treasury

August 30, 1991

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[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

T.D. 8362

RIN 1545-AO62

Limitation on Annual Compensation for Qualified Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the $200,000 compensation limit for tax-qualified retirement plans under section 401(a)(17) of the Internal Revenue Code of 1986. These regulations reflect changes made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance necessary to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning on or after January 1, 1991, and are applied to those plan years except as set forth in §1.401(a)(17)-1(d).

FOR FURTHER INFORMATION CONTACT: David Fuller at 202-377-9372 (not a toll-free number).

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SUPPLEMENTARY INFORMATION:

Statutory Authority

This document contains final regulations under section 401(a)(17) of the Internal Revenue Code of 1986 (Code). These regulations conform the regulations to section 1106 of the Tax Reform Act of 1986 (TRA '86) and section 1011(d)(4) of the Technical and Miscellaneous Revenue Act of 1988. These regulations are issued under the authority contained in sections 401(a)(17) and 7805 of the Code.

Proposed regulations under section 401(a)(17) were published in the **Federal Register** May 14, 1990 (55 FR 19947). Written comments were received from the public on the proposed regulations. In addition, a public hearing on the proposed section 401(a)(17) regulations was held September 26, 27, and 28, 1990. After consideration of all of the written comments received and the statements made at the public hearing, the proposed regulations under section 401(a)(17) are adopted as modified by this Treasury Decision.

Explanation of Provisions

Overview

Section 401(a)(17) of the Code provides an annual compensation limit for each

employee under a qualified plan. This limit applies to a plan in two ways. First, a plan may not base contributions or benefits on compensation in excess of the annual limit. Thus, a plan does not satisfy section 401(a)(17) unless it provides that an employee's compensation in excess of the annual limit is not used in determining plan benefits or contributions for a plan year to which the annual limit applies. Second, the amount of an employee's annual compensation that may be taken into account in applying certain specified nondiscrimination



rules under the Code is subject to the annual limitation. Thus, in determining the allocation rates for defined contribution plans and the accrual rates for defined benefit plans, an employee's compensation in excess of the annual limit is disregarded in applying those nondiscrimination rules. The annual compensation limit applies separately to each group of plans that is treated as a single plan for purposes of the applicable nondiscrimination requirement.

1. Annual adjustment of compensation limit

The amount of the annual limit, which applies for plan years beginning after December 31, 1988, is $200,000 adjusted annually for calendar years after 1989 for increases in the cost of living at the same time and in the same manner as under section 415(d). The adjustment applies to plan years, or other 12-month periods used to determine compensation, commencing in the calendar year in which the adjustment is effective. In addition, any increase in the annual limit applies only to compensation taken into account for the year of the increase and subsequent years and does not apply to compensation for prior years that are used in determining an employee's benefit.

Commentators suggested that the annual adjustments to the compensation limit apply for plan years ending in the year to which the limit applies as provided in the regulations under section 415(d) and further suggested that, once the limit is increased for a year, the adjusted limit should be permitted to be taken into account with respect to prior years as well. After careful consideration of these comments, the final regulations retain the rules provided in the proposed regulations. The Treasury and the Service continue to believe this



result best implements the statute and Congressional intent as expressed in the Conference Report to TRA '86. See H.R. Rep. No. 99-841, Vol.II, 99th Cong., 2d Sess. II-478 (1986).

2. Proportional reduction in limit.

Under the proposed regulations, a proportional reduction was required when a plan determines compensation on a period of time that contains fewer than 12 calendar months. The proposed regulations did not require proration solely because employees are covered under a plan for less than 1 full year if the plan formula for allocations or benefit accruals is based on compensation for a period of at least 12 months. The final regulations retain the proration rule in the proposed regulations. In addition, the final regulations clarify that no proration is required where the plan formula provides that the allocation or accrual for each employee is based on compensation for the portion of the plan year during which the employee is a participant.

3. Multiemployer and multiple employer plans.

Compensation limit.

Several commentators requested guidance on the manner in which the compensation limit would apply where an employee worked for two or more unrelated employers who maintain the same multiple employer or multiemployer plan. In response to these comments, the final regulations provide that, in the case of multiple employer and multiemployer plans, the annual compensation limit applies separately with respect to the compensation received by an employee from each unrelated employer maintaining the plan rather than to the total compensation from all employers maintaining the plan. Thus, for example, during a year in which the compensation limit was $200,000, assume that an employee participating in a



multiemployer plan was employed by three of the employers maintaining the plan and received compensation for a year of $75,000 from one employer maintaining the plan, $40,000 from another employer maintaining the plan, and $95,000 from the third employer. On these facts, the plan would be permitted to take into account the full $210,000 of the

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employee's compensation from the three employers for the plan year without violating section 401(a)(17).

Correction of plans maintained by more than one employer.

Multiple employer plans must satisfy section 401(a)(17) on an employer-by-employer basis. Failure to satisfy section 401(a)(17) with respect to any component of this testing process may result in disqualification of the plan for all participating employers. The final regulations, like the proposed regulations, do not provide an exception to this rule. However, where a multiemployer plan or a multiple employer plan fails to satisfy section 401(a)(17), in a proper case, the Commissioner could retain the plan's qualified status for innocent employers by requiring corrective and remedial action with respect to the plan, such as allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have knowledge of the disqualifying event or was otherwise notified by the Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events.

4. Compensation of self-employed individuals subject to the limit.

The proposed regulations provided that the amount of compensation subject to the annual limit for a self-employed individual was determined by subtracting the deduction allowed by section 404 to the individual for contributions to the plan on the individual's



behalf from the amount otherwise treated as compensation. This rule was not included in the final regulations because the result intended by the rule may be reached if a plan simply defines compensation of self-employed individuals used in the plan's allocation formula as earned income within the meaning of section 401(c)(2). The subtraction described in the proposed regulations is included automatically in the determination of earned income. Therefore, instead of a specific rule applicable to self-employed individuals, the final regulations contain two examples illustrating the application of section 401(a)(17) to the compensation of self-employed individuals.

5. Effective date and transition rules.

Section 401(a)(17) is generally effective for plan years beginning on or after January 1, 1989. A special effective date is provided for collectively bargained plans. The final regulations under section 401(a)(17) are effective for plan years beginning on or after January 1, 1991. For plan years beginning before that date but on or after the date that section 401(a)(17) first applies to a plan, the plan must be operated in accordance with a reasonable, good faith interpretation of the requirements of section 401(a)(17). Whether compliance is reasonable and in good faith will be determined on the basis of all the facts and circumstances, including the extent to which the employer has resolved unclear issues in its favor. Reasonable, good faith interpretation will be deemed to exist, however, if a plan is operated in accordance with the proposed regulations published in the **Federal Register** on May 14, 1990, or these final regulations.

A special effective date is provided for governmental plans within the meaning of section 414(d) to provide governments with adequate time to amend their plans to comply



with section 401(a)(17). Thus, the regulations provide that governmental plans described in section 414(d) will automatically satisfy the requirements of section 401(a)(17) for plan years beginning before January 1, 1993.

The final regulations provide, as in the proposed regulations, that the benefits or contributions accrued under a plan for plan years prior to the effective date of section 401(a)(17) are not subject to the annual compensation limit. Thus, an employee's allocations or benefit accruals prior to the 1989 plan year, that are based on compensation in excess of the annual compensation limit, need not reduce or affect the employee's allocations or benefit accruals in subsequent years.

As provided in the proposed regulations, the final regulations provide generally that benefits or contributions accruing or allocated for plan years beginning on or after the section 401(a)(17) effective date may not take into account compensation for any plan year in excess of the annual compensation limit applicable to that plan year. The proposed regulations

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provided examples illustrating the application of this rule to a high average pay defined benefit plan. In determining the high average pay used in calculating accruals for plan years to which section 401(a)(17) applies, the example showed that there are three general options for implementing this rule. The first is to apply the plan benefit formula (after amendment to satisfy section 401(a)(17)) to all years of service. This method provides for a gradual wear-away of the pre-effective date benefit, the calculation of which took into account compensation exceeding the section 401(a)(17) annual limit. The second option is to apply the plan formula (after amendment to comply with section 401(a)(17)) only to years of service beginning on or after the section 401(a)(17) effective date and simply add those

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benefits to the benefits that accrued before the effective date. The third option combines the first two options such that the plan formula provides the employee with the larger of the two benefit amounts. All three methods essentially require the amount of an employee's accrued benefit as of the section 401(a)(17) effective date ("pre-effective date benefit") to be fixed.

Commentators requested more guidance with respect to the transition rules than was provided in the examples in the proposed regulations. For example, they inquired whether adjustments were permitted to the pre-effective date benefits to take into account increases in the section 415 dollar limits and whether ad hoc cost-of-living adjustments were permitted to be made to the benefits of former employees whose benefits were originally calculated taking into account compensation in excess of the annual compensation limits.

The final regulations generally retain the examples provided in the proposed regulations illustrating possible methods that may be used to transition into section 401(a)(17) compliance. In addition, the final regulations reflect modifications to coordinate the transition rules under section 401(a)(17) with the transition rules provided in the final regulations under section 401(a)(4) (issued simultaneously with these regulations). Thus, these final regulations incorporate the fresh-start rules in §1.401(a)(4)-13(c) and (d) into the section 401(a)(17) transition rules to the extent applicable, with appropriate modifications.

The fresh-start rules in the final section 401(a)(4) regulations generally parallel the examples in the proposed regulations under section 401(a)(17). Thus, under the section 401(a)(4) fresh-start rules, an employee's accrued benefit generally must be fixed ("frozen") as of a certain date selected by an employer ("fresh-start date"), and an employee's benefit accruals for plan years after that date must be determined under the formula in effect for that

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plan year applied either to years of service after the fresh-start date or all the employee's years of service. The fresh-start rules permit certain adjustments to be made to the frozen accrued benefit, including certain adjustments for increases in the employee's compensation, adjustments due solely to increases in the limits under section 415(d), and certain benefit accruals on behalf of former employees. Consistent with the final section 401(a)(4) regulations, the fresh-start rules in these final regulations also generally permit similar adjustments to be made to the pre-effective date benefit that are permitted to be made under the fresh-start rules to frozen accrued benefits to extent that they are consistent with the implementation of section 401(a)(17).

Finally, in order to permit employers to implement changes required by TRA'86 and the related regulations in a consistent manner, the final regulations under section 401(a)(17) permit a fresh-start date not later than the last day of the last plan year beginning before January 1, 1992.

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Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

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Drafting Information

The principal authors of these regulations are Marjorie Hoffman and David Fuller of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury participated in their development.

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List of Subjects in 26 CFR 1.401-0 through 1.419A-2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * §1.401(a)(17)-1 also issued under 26 U.S.C. 401(a)(17). * * *

Par. 2. A new §1.401(a)(17)-1 is added to read as follows:

§1.401(a)(17)-1 Limitation on annual compensation.

(a) Compensation limit requirement--(1) In general. In order to be a qualified plan, a plan must satisfy section 401(a)(17). Section 401(a)(17) provides an annual compensation limit for each employee under a qualified plan. This limit applies to a qualified plan in two ways. First, a plan may not base allocations, in the case of a defined contribution plan, or benefit accruals, in the case of a defined benefit plan, on compensation in excess of the annual limit. Second, the amount of an employee's annual compensation that may be taken into account in applying certain specified nondiscrimination rules under the Internal Revenue Code is subject to the annual limitation. These two limitations are set forth in paragraphs (b) and (c) of this section, respectively.

(2) Annual compensation limit. For purposes of this section, "annual compensation limit" means $200,000, adjusted annually by the Commissioner. The amount of the annual compensation limit is adjusted at the same time and in the same manner as under section 415(d). The base period for the annual adjustment is 1989; the first adjustment is effective on January 1, 1990; and the dollar increase in effect on January 1 is effective for any plan

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year beginning in the calendar year. For example, if a plan has a plan year beginning July 1, 1989, and ending June 30, 1990, the annual compensation limit in effect on January 1, 1989 ($200,000), applies to the plan for the entire plan year. In addition, if compensation for any plan year beginning prior to the effective date that section 401(a)(17) first applies to a plan is used for determining allocations or benefit accruals, or when applying any nondiscrimination rule, in any year subject to section 401(a)(17), then the annual compensation limit for that prior year is the annual compensation limit for 1989 ($200,000).

(b) Plan limit on compensation--(1) General rule. A plan does not satisfy section 401(a)(17) unless it provides that the compensation taken into account for any employee in determining plan allocations or benefit accruals for any plan year is limited to the annual compensation limit. For purposes of this rule, allocations and benefit accruals under a plan include all benefits provided under the plan, including ancillary benefits.

(2) Plan-year-by-plan-year requirement. For purposes of this paragraph (b), the limit in effect for the current plan year applies only to the compensation for that year that is taken into account in determining plan allocations or benefit accruals for the year. The compensation for any prior plan year taken into account in determining an employee's allocations or benefit accruals for the current plan year is subject to the applicable annual compensation limit in effect for that prior year. Thus, increases in the annual compensation limit apply only to compensation taken into account for the plan year in which the increase is effective. For example, if an employer has a defined benefit plan that bases benefits on the

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average of an employee's compensation for the three plan years during which the average of the employee's compensation is the highest, compensation for each of the plan years used in



the average must be limited to the annual compensation limit in effect for the respective years.

(3) Application of limit to a plan year--(i) In general. For purposes of applying this paragraph (b), the annual compensation limit is applied to the compensation for the plan year on which allocations or benefit accruals for that plan year are based.

(ii) Compensation for the plan year. A plan may determine compensation used in determining allocations or benefit accruals for a plan year based on compensation for the plan year. In this case, the annual compensation limit that applies to the compensation for the plan year is the limit in effect for the calendar year in which the plan year begins. Alternatively, a plan may determine compensation used in determining allocations or benefit accruals for the plan year for all employees on the basis of a 12-consecutive-month period, or periods, ending no later than the last day of the plan year. If compensation is based on these alternative 12-month periods, the annual compensation limit applies to compensation for each of those periods based on the annual compensation limit in effect for the respective calendar year in which each 12-month period begins.

(iii) Compensation for a period of less than 12-months--(A) Proration required. If compensation for a period of less than 12 months is used for a plan year, then the otherwise applicable annual compensation limit is reduced in the same proportion as the reduction in the 12-month period. For example, if a defined benefit plan provides that the accrual for each month in a plan year is separately determined based on the compensation for that month and the plan year accrual is the sum of the accrual for all months, then the annual compensation limit for each month is 1/12th of the annual compensation limit for the plan



year. In addition, if the period for determining compensation used in calculating an employee's allocation or accrual for a plan year is a short plan year (i.e., shorter than 12 months), the annual compensation limit is an amount equal to the otherwise applicable annual compensation limit multiplied by the fraction, the numerator of which is the number of months in the short plan year, and the denominator of which is 12.

(B) No proration required for participation for less that a full plan year. Notwithstanding paragraph (b)(3)(iii)(A) of this section, a plan is not treated as limiting the compensation used in determining an employee's allocations or benefit accruals to a specified portion of the employee's annual compensation merely because the plan formula provides that the allocation or accrual for each employee is based on compensation for the portion of the plan year during which the employee is a participant in the plan. In addition, no proration is required merely because an employee is covered under a plan for less than a full plan year, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least 12 months.

(4) Limits on multiple employer and multiemployer plans. For purposes of this paragraph (b), in the case of a plan described in section 413(c) or 414(f) (a plan maintained by more than one employer), the annual compensation limit applies separately with respect to the compensation of an employee from each employer maintaining the plan rather than the total compensation from all employers maintaining the plan.

(5) Family aggregation. [Reserved]

(6) Examples. The following examples illustrate the rules in this paragraph (b).

Example 1. Plan X is a defined benefit plan and bases benefits on the average of an employee's high 3 consecutive years' compensation. Section 401(a)(17) applies to Plan X in



1989. Employee B's high 3 consecutive years' compensation prior to the application of the annual compensation limits is $215,000 (1989), $200,000 (1988), and $185,000 (1987). To satisfy this paragraph (b), Plan X cannot base plan benefits for Employee B in 1989 on compensation in excess of $195,000 (the average of $200,000 (B's 1989 compensation capped by the annual compensation limit), $200,000 (B's 1988 compensation), and $185,000 (B's 1987 compensation)). For purposes of determining the 1989 accrual, each year (1989, 1988, and 1987), not the average of the 3 years, is subject to the 1989 annual compensation limit of $200,000.

Example 2. Assume the same facts as in Example 1. Also assume that Employee B's compensation in 1990 is $230,000, and that the 1990 annual compensation limit is $209,200. Plan X cannot base plan benefits for Employee B in 1990 on compensation in excess of $203,067 (the average of $209,200 (B's 1990 compensation capped by the 1990 limit),



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$200,000 (B's 1989 compensation capped by the 1989 limit), and $200,000 (B's 1988 compensation)). In calculating plan benefits in 1990, the 1990 annual compensation limit applies to the 1990 year only. The 1989 year is capped by the 1989 annual compensation limit. Each year used in the average, including the 1988 plan year, is subject to the applicable annual compensation limit for that year.

Example 3. Assume the same facts as Example 1, except that Employee B's high 3 consecutive years' compensation prior to the application of the limits is $230,000 (1989), $220,000 (1988), and $210,000 (1987). To satisfy this paragraph (b), Plan X cannot base plan benefits for Employee B in 1989 on compensation in excess of $200,000 (the average of $200,000 (B's 1989 compensation capped by the 1989 annual compensation limit), $200,000 (B's 1988 compensation capped by the $200,000 annual compensation limit applicable to all years before 1989), and $200,000 (B's 1987 compensation capped by the $200,000 annual compensation limit applicable to all years before 1989).

Example 4. Plan Z is a defined benefit plan that bases benefits on an employee's high consecutive 36 months of compensation ending within the plan year. Employee C's high 36 months are the period September 1989 to August 1992, in which Employee C earned $50,000 in each month. The annual compensation limit is $200,000, $209,200, and $222,220 in 1989, 1990, and 1991, respectively. To satisfy this paragraph (b), Plan Z cannot base plan benefits for Employee C on compensation in excess of $210,473 for the 1992 plan year. This amount is determined by applying the applicable annual compensation limit to compensation for each of the three 12-consecutive-month periods. The September 1989 to August 1990 period is capped by the annual compensation limit of $200,000 for 1989, the September 1990 to August 1991 period is capped by the annual compensation limit of $209,200 for 1990, and the September 1991 to August 1992 period is capped by the annual compensation limit of $222,220 for 1991. The average of these capped amounts is the annual compensation limit for determining benefits for the 1992 year.

Example 5. (a) Employer X is a partnership. Employer X maintains Plan M, a profit-sharing plan that provides for an annual allocation of employer contributions of 15



percent of plan year compensation for employees other than self-employed individuals, and 13.0435 percent of plan year compensation for self-employed individuals. In order to satisfy section 401(a)(17), the plan provides that the plan year compensation used in determining the allocation of employer contributions for each employee may not exceed the annual limit in effect for the plan year. The plan year of Plan M is the calendar year. Plan M defines compensation for self-employed individuals (employees within the meaning of section 401(c)(1)) as the self-employed individual's net profit from self-employment attributable to Employer X minus the amount of the self-employed individual's deduction under section 164(f) for one-half of self-employment taxes. Plan M defines compensation for all other employees as wages within the meaning of section 3401(a). Employee A and Employee B are partners of Employer X and thus are self-employed individuals. Neither Employee A nor Employee B owns an interest in any other business. For the 1991 calendar year, Employee A has net profit from self-employment of $150,000, and Employee B has net profit from self-employment of $230,000. The deduction for each employee under section 164(f) for one-half of self-employment taxes is $5,123.

(b) The plan year compensation under the plan formula for Employee A is $144,877 ($150,000 minus $5,123). The allocation of employer contributions under the plan allocation formula for 1991 for Employee A is $18,897 ($144,877 (Employee B's plan year compensation for 1991) multiplied by 13.0435%). The plan year compensation under the plan formula before application of the annual limit under section 401(a)(17) for Employee B is $224,877 ($230,000 minus $5,123). After application of the annual limit, the plan year compensation for the 1991 plan year for Employee A is $222,220 (the annual limit for 1991). Therefore, the allocation of employer contributions under the plan allocation formula for 1991 for Employee B is $28,985 ($222,220 (Employee B's plan year compensation after application of the annual limit for 1991) multiplied by 13.0435%).

Example 6. The facts are the same as in Example 5, except that Plan M provides that plan year compensation for self-employed individuals is defined as earned income within the meaning of section 401(c)(2) attributable to Employer X. In addition, Plan M provides for an annual allocation of employer contributions of 15 percent of plan year compensation for all employees in the plan. The net profit from self-employment for Employee A and the net profit from self-employment for Employee B are the same as provided in Example 5. However, the earned income of Employee A determined in accordance with section 401(c)(2) is $125,980 ($150,000 minus $5123 minus $18,897). The earned income of Employee B determined in accordance with section 401(c)(2) is $195,545 ($230,000 minus $5,123 minus $29,332). Therefore, the allocation of employer contributions under the plan allocation formula for 1991 for Employee A is $18,897 ($125,980 (Employee A's plan year compensation for 1991) multiplied by 15%). Employee B's earned income for 1991 does not exceed the 1991 annual limit of $222,220. Therefore, the allocation of employer contributions under the plan allocation formula for 1991 for Employee B is $29,332 ($195,545 (Employee B's plan year compensation for 1991) multiplied by 15%).



(c) Limit on compensation for nondiscrimination rules--(1) General rule. The annual compensation limit applies for purposes of applying the nondiscrimination rules under sections 401(a)(4), 401(a)(5), 401(*l*), 401(k)(3), 401(m)(2), 403(b)(12), and 410(b)(2). The limit also applies in determining whether an alternative method of determining compensation impermissibly discriminates under section 414(s)(3). This paragraph (c) provides rules for applying the annual compensation limit for these purposes. For purposes of this paragraph (c), "compensation" means the compensation used in applying the applicable nondiscrimination rule.

(2) Plan-year-by-plan-year requirement. For purposes of this paragraph (c), when applying an applicable nondiscrimination rule for a plan year, the compensation for each plan year taken into account is limited to the applicable annual compensation limit in effect for that year, and an employee's compensation for that plan year in excess of the limit is disregarded. Thus, if the nondiscrimination provision is applied on the basis of compensation determined over a period of more than one year (for example, high average compensation) the annual compensation limit in effect for each of the plan years used in the average applies to the respective plan year's compensation taken into account in determining the average.



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(3) Plan-by-plan limit. For purposes of this paragraph (c), the annual limit applies separately to each plan (or group of plans treated as a single plan) of an employer for purposes of the applicable nondiscrimination requirement. For this purpose, the plans included in the testing group taken into account in determining whether the average benefit percentage test of §1.410(b)-5 is satisfied are generally treated as a single plan.

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(4) Application of limit to a plan year. The rules provided in paragraph (b)(3) of this section regarding the application of the limit to a plan year apply for purposes of this paragraph (c).

(5) Limits on multiple employer and multiemployer plans. The rule provided in paragraph (b)(4) of this section regarding the application of the limit to multiple employer and multiemployer plans applies for purposes of this paragraph (c).

(d) Effective date--(1) Statutory effective date--(i) General rule. Except as otherwise provided in this paragraph (d)(1), section 401(a)(17) applies to allocations and benefit accruals for plan years beginning on or after January 1, 1989.

(ii) Exception for collectively bargained plans. In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, section 401(a)(17) applies to allocations and benefit accruals for plan years beginning on or after the earlier of--

(A) January 1, 1991, or

(B) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension or renegotiation of any agreement occurring on or after March 1, 1986). For purposes of this paragraph (d)(2)(ii), any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is disregarded in determining the date on which the agreement terminates.

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(iii) Exception for governmental plans. Section 401(a)(17) is considered satisfied for plan years beginning before January 1, 1993, in the case of governmental plans described in section 414(d).

(2) Regulatory effective date. This §1.401(a)(17)-1 applies to plan years beginning on or after January 1, 1991. For plan years beginning before that date, and on or after the first day of the first plan year to which section 401(a)(17) applies, a plan must be operated in accordance with a reasonable, good faith interpretation of section 401(a)(17). Whether a plan is operated in accordance with a reasonable, good faith interpretation of section 401(a)(17) is generally determined based on all the relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan is deemed to be operated in accordance with a reasonable, good faith interpretation of section 401(a)(17) if it is operated in accordance with the terms of this section.

(3) Pre-effective date benefits--(i) In general. For purposes of this paragraph (d), allocations or benefits accrued under a plan for plan years beginning before the statutory effective date applicable to the plan under paragraph (d)(1) of this section are not subject to the annual compensation limits.

(ii) Allocations for years before the effective date. Allocations for plan years beginning before the statutory effective date applicable to the plan under paragraph (d)(1) of this section include all amounts allocated or treated as allocated to the account of an employee for those plan years, including employer contributions, forfeitures, elective contributions, employee contributions, and matching contributions, plus earnings, expenses, gains, and losses attributable to those amounts. In the case of a defined contribution plan

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subject to section 412, the amount of employer contributions treated as allocated for the plan year is the amount of employer contributions required to be allocated under the plan to the employee's account for the plan year, even if all or part of any required contribution is not actually made.

(iii) Benefits accrued for years before the effective date. The benefits accrued for plan years beginning before the statutory effective date applicable to the plan under



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paragraph (d)(1) of this section by any employee are the employee's benefits accrued under the plan, determined as if those benefits had been frozen (as defined in §1.401(a)(4)-12) as of the last day of the last plan year beginning before the statutory effective date, disregarding any amendments adopted after the date that the employee's benefits under the plan are treated as frozen. Thus, benefits accrued for those plan years do not include any benefits accrued under an amendment granting past service that is adopted after the date that the employee's benefits under the plan must be treated as frozen. Nonetheless, service for the employer after that date continues to be taken into account for purposes of determining an employee's nonforfeitable percentage and eligibility for benefits, rights, and features under the plan with respect to the benefits treated as frozen under this paragraph (d)(3)(iii).

(e) Determination of post-effective-date accrued benefits--(1) In general. The plan formula that is used to determine the amount of allocations or benefit accruals for plan years beginning on or after the statutory effective date must comply with section 401(a)(17). However, in determining whether an allocation or benefit accrual under the plan formula for plan years beginning on or after the statutory effective date satisfies section 401(a)(17), a plan is not required to take into account any allocations or benefit accruals described in

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paragraph (d)(3) of this section. This paragraph (e) provides rules for applying section 401(a)(17) in the case of section 401(a)(17) employees who accrue additional benefits in a plan year beginning on or after the statutory effective date. Paragraph (e)(2) of this section contains definitions used in applying this paragraph (e). Paragraphs (e)(3) and (e)(4) of this section explain the application of the fresh-start rules in §1.401(a)(4)-13 to the determination of the accrued benefits of section 401(a)(17) employees.

(2) Definitions. For purposes of this paragraph (e), the following definitions apply:

(i) "Statutory effective date" means the first day of the first plan year beginning on or after the statutory effective date applicable to the plan under paragraph (d)(1) of this section.

(ii) "Section 401(a)(17) employee" means an employee with accrued benefits in plan years beginning before the statutory effective date that were determined taking into account compensation that exceeded the annual compensation limit for any year.

(iii) "Section 401(a)(17) fresh-start date" means a fresh-start date as defined in §1.401(a)(4)-12 not earlier than the last day of the last plan year beginning before the statutory effective date and not later than the last day of the last plan year beginning before January 1, 1992 (or January 1, 1993, in the case of governmental plans described in section 414(d)).

(iv) "Section 401(a)(17) frozen accrued benefit" means the accrued benefit for any section 401(a)(17) employee frozen (as defined in §1.401(a)(4)-12) as of the last day of the last plan year beginning before the statutory effective date, determined in the same manner as provided in paragraph (d)(3)(iii) of this section.

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(3) Application of fresh-start rules--(i) General rule. In order to satisfy section 401(a)(17), the plan must determine the accrued benefit of each section 401(a)(17) employee by applying the fresh-start rules in §1.401(a)(4)-13(c). The fresh-start rules must be applied using a section 401(a)(17) fresh-start date and using the plan benefit formula after amendment to comply with section 401(a)(17) and this section as the formula applicable to benefit accruals in the current plan year.

(ii) Fresh start for section 401(a)(17) employees only. The fresh-start rules in §1.401(a)(4)-13(c) may be applied in accordance with paragraph (e)(3)(i) of this section to determine the accrued benefits of all section 401(a)(17) employees in the plan but not the accrued benefit of other employees in the plan in lieu of applying the rules to determine the benefits of all employees in the plan as otherwise required under the consistency rule in §1.401(a)(4)-13(c)(ii).

(iii) Consistency rules in §1.401(a)(4)-13(c) and (d)--(A) General rule. In applying the fresh-start rules of §1.401(a)-13(c) and (d) to section 401(a)(17) employees, the consistency rules of those sections govern, unless otherwise provided. Thus, for example, if the plan is using a fresh-start date applicable to all employees and not adjusting frozen accrued benefits under §1.401(a)(4)-13(d) for employees other than section 401(a)(17) employees, frozen accrued benefits may not be adjusted for section 401(a)(17) employees after the fresh-start date under §1.401(a)(4)-13(d) or this paragraph (e) either.



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Notwithstanding the foregoing, if the fresh-start rules provided in paragraph (e)(3)(i) of this section are applied to determine benefits of section 401(a)(17) employees only, the consistency rules in §1.401(a)(4)-13(c) and (d) are applied as if the section 401(a)(17)



employees were the only employees in the plan. For example, if the fresh-start rules are applied using the section 401(a)(17) fresh-start date to determine benefits of section 401(a)(17) employees only, the same formula in §1.401(a)(4)-13(c)(2), (c)(3), or (c)(4) must be applied to determine the accrued benefits of all section 401(a)(17) employees in the plan after the section 401(a)(17) fresh-start date.

(B) Determination of adjusted accrued benefit. If the fresh-start rules of §1.401(a)(4)-13(c) and (d) are applied to determine the benefits of all employees after a fresh-start date, the plan will not fail to satisfy the uniformity requirement of §1.401(a)(4)-13(c)(5) merely because the plan makes the adjustment described in §1.401(a)(4)-13(d)(5) and (d)(6) to the frozen accrued benefits of employees who are not section 401(a)(17) employees, but does not make the adjustment to the frozen accrued benefits of section 401(a)(17) employees. In addition, the plan does not fail the uniformity requirement of §1.401(a)(4)-13(c)(5) merely because the plan makes the adjustment described in §1.401(a)(4)-13(d)(6) for section 401(a)(17) employees on the basis of the old compensation fraction (as required by paragraph (e)(4)(iii) of this section), but for employees who are not section 401(a)(17) employees on the basis of the new compensation fraction or the reconstructed compensation fraction.

(4) Permitted adjustments to frozen accrued benefit of section 401(a)(17) employees--(i) General rule. Except as otherwise provided in paragraphs (e)(4)(ii) and (iii) of this section, the rules in §1.401(a)(4)-13(c)(5) permitting certain adjustments to frozen accrued benefits apply to section 401(a)(17) frozen accrued benefits.

(ii) Optional forms of benefit. After the section 401(a)(17) fresh-start date, a plan may be amended to provide a new optional form of benefit or to make an optional form



available with respect to the section 401(a)(17) frozen accrued benefit provided that the optional form of benefit is not subsidized. An optional form is not subsidized only if it is the actuarial equivalent of the employee's accrued benefit using a reasonable interest rate and reasonable mortality assumptions. A standard interest rate and a standard mortality table (as defined in §1.401(a)(4)-12) are deemed to be reasonable for this purpose.

(iii) Determining adjusted section 401(a)(17) accrued benefit--(A) Fresh start as of statutory effective date. For purposes of §1.401(a)(4)-13(d), if the plan uses a section 401(a)(17) fresh-start date that is the last day of the last plan year beginning before the statutory effective date, the section 401(a)(17) frozen accrued benefit of each section 401(a)(17) employee may be adjusted in accordance with §1.401(a)(4)-13(d)(6), if applicable, with the following modifications--

(1) The adjustment must be made using the old compensation fraction described in §1.401(a)(4)-13(d)(6)(i)(A).

(2) The numerator of the old compensation fraction in §1.401(a)(4)-13(d)(6)(i)(A) must be determined after applying the section 401(a)(17) compensation limit for the current plan year, and the denominator of the fraction must be determined as of the last day of the last year before the statutory effective date without regard to the section 401(a)(17) compensation limit.

(B) Fresh starts after statutory effective date. For purposes of §1.401(a)(4)-13(d), if the plan uses a section 401(a)(17) fresh-start date or any other fresh-start date that is later than the last day of the last plan year beginning before the statutory effective date, the adjusted accrued benefit (within the meaning of section §1.401(a)(4)-13(d)) for each section



401(a)(17) employee must be determined after the fresh-start date under the following bifurcated method--

(1) Determine the section 401(a)(17) employee's frozen accrued benefit in accordance with §1.401(a)(4)-13(c)(1)(i) as of the fresh-start date.

(2) Determine the employee's section 401(a)(17) frozen accrued benefit adjusted in accordance with paragraph (e)(4)(iii)(A) of this section, if applicable, through the fresh-start date.

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(3) Subtract from the frozen accrued benefit determined in paragraph (e)(4)(iii)(B)(1) of this section the employee's adjusted section 401(a)(17) frozen accrued benefit determined in paragraph (e)(4)(iii)(B)(2) of this section. This is the employee's post-effective date frozen accrued benefit.

(4) Adjust the employee's post-effective date frozen accrued benefit in accordance with §1.401(a)(4)-13(d)(6) under the normal rules applicable to employees who are not section 401(a)(17) employees. Thus, in determining the numerator and the denominator of the fraction used to adjust the post-effective date frozen accrued benefit, the annual compensation limit under section 401(a)(17) applies.

(5) Adjust the section 401(a)(17) frozen accrued benefit in paragraph (e)(4)(iii)(B)(2) of this section in accordance with §1.401(a)(4)-13(d)(6), as modified by paragraph (e)(4)(iii)(A) of this section.

(6) The adjusted accrued benefit of the section 401(a)(17) employee after the fresh-start date is the sum of the amounts in paragraphs (e)(4)(iii)(B)(4) and (5) of this section.

(5) Examples. The following examples illustrate the rules in this paragraph (e).

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Example 1. (a) Plan Y is a calendar year defined benefit plan providing an annual benefit for each year of service equal to 2 percent of compensation averaged over an employee's high 3 consecutive calendar years' compensation. Plan Y is not a collectively bargained plan or a governmental plan. As of the close of the last plan year beginning before January 1, 1989 (i.e., the 1988 plan year), Employee A, with 5 years of service, had accrued a benefit of $25,000 which equals 10 percent (2 percent multiplied by 5 years of service) of average compensation of $250,000. Effective for plan years after December 31, 1988, Plan Y is amended to provide that in determining an employee's benefit, compensation taken into account is subject to the annual compensation limit under section 401(a)(17), and that, for section 401(a)(17) employees, the employee's accrued benefit is the greater of the employee's benefit under the plan formula after the plan formula is amended to comply with section 401(a)(17) as applied to the employee's total years of service, and the employee's accrued benefit as of December 31, 1988, determined as though the employee terminated employment on that date without regard to any plan amendments after that date. Employer X decides not to amend Plan Y to provide for the adjustments permitted under §1.401(a)(4)-13(d)(6) to the accrued benefit of section 401(a)(17) employees as of December 31, 1988.

(b) Under Plan Y's formula, Employee A's accrued benefit at the end of 1989 is $25,000, which is the greater of Employee A's accrued benefit as of the last day of the 1988 plan year ($25,000), and $24,000, which is Employee A's benefit based on the plan's formula applied to Employee A's total years of service ($200,000 multiplied by (2 percent multiplied by 6 years of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)-13(c)(3) (formula with wear-away). The fresh-start formula is applied using a benefit formula that satisfies section 401(a)(17) and this section and is applied using December 31, 1988, as the section 401(a)(17) fresh-start date. Thus, Plan Y, as amended, satisfies paragraph (e)(3)(i) of this section.

Example 2. Assume the same facts as in Example 1, except that the plan formula provides that effective January 1, 1989, for section 401(a)(17) employees, the employee's benefit will equal the sum of an employee's accrued benefit as of December 31, 1988 (determined as though he terminated employment on that date and without regard to any amendments after that date), and 2 percent of compensation averaged over an employee's high 3 consecutive years' compensation times years of service taking into account only years of service after December 31, 1988. Thus, under Plan Y's formula, Employee A's accrued benefit at the end of 1989 is $29,000, which is equal to the sum of $25,000 (Employee A's accrued benefit at the end of 1988) plus $4,000 ($200,000 multiplied by (2 percent multiplied by 1 year of service)). The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)-13(c)(2) (formula without wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section and is applied using December 31, 1988, as the section 401(a)(17) fresh-start date. Thus, Plan Y, as amended, satisfies paragraph (e)(1) of this section.

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Example 3. Assume the same facts as in Example 1, except that the plan formula provides that effective January 1, 1989, an employee's benefit equals the greater of the plan formulas in Example 1 and Example 2. Thus, under Plan Y's formula, Employee A's accrued benefit at the end of 1989 is $29,000, which is equal to the greater of $25,000 and $29,000. The formula of Plan Y applicable to section 401(a)(17) employees for calculating their accrued benefits for years after the section 401(a)(17) fresh-start date is the formula in §1.401(a)-13(c)(4) (formula with extended wear-away). The fresh-start formula is applied using a benefit formula for the 1989 plan year that satisfies section 401(a)(17) and this section and is applied using December 31, 1988, as the section 401(a)(17) fresh-start date. Thus, Plan Y, as amended, satisfies paragraph (e)(1) of this section.

Example 4. Assume the same facts as in Example 3. As of December 31, 1995, Employee A's average annual compensation under the plan compensation formula, disregarding the amendment to comply with section 401(a)(17) is equal to $300,000. Assume that the annual compensation limit is adjusted to $260,000, $270,000, and 280,000 for plan years beginning on or after January 1, 1993, 1994, and 1995, respectively. The compensation that may be taken into account for the 1995 plan year cannot exceed $270,000 (the average of $260,000, $270,000, and $280,000). Therefore, at the end of December 31 1995, the amount using formula with wear-away would be $64,800 ($270,000 multiplied by (2 percent multiplied by 12 years of service)). The amount using formula without wear-away would be $62,800 which is equal to $25,000 (Employee A's section 401(a)(17) frozen accrued benefit) plus $37,800 ($270,000 multiplied by (2 percent multiplied by 7 years of service)). Thus, because Employee A's accrued benefit is being determined using formula with extended wear-away, the accrued benefit is equal to the greater of the two amounts. Employee A's accrued benefit at the end of 1995 is $64,800.

Example 5. (a) Assume the same facts as in Example 4, except that Plan Y satisfies §1.401(a)(4)-13(d)(2) through (d)(5) and that the amendment to Plan Y effective for plan years beginning after December 31, 1988, also provided for adjustments in accordance with §1.401(a)(4)-13(d)(6) to the frozen accrued benefit of section 401(a)(17) employees. No other fresh-start date applies to the calculation of benefits under Plan Y.



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(b) The numerator of Employee A's old compensation fraction is $270,000 (the average of Employee A's annual compensation for 1993, 1994, and 1995, as limited by the respective annual limit for each of those years). The denominator of Employee A's old compensation fraction determined in accordance with the modification in paragraph (e)(4)(iii)(A)(2) of this section is $250,000 (the average of Employee A's high 3 consecutive year's annual compensation as of December 31, 1988, determined without regard to section 401(a)(17)). Therefore, Employee A's old compensation fraction is $270,000/$250,000. Employee A's adjusted section 401(a)(17) frozen accrued benefit adjusted through December 31, 1995, is $27,000 (($270,000 divided by $250,000) multiplied by $25,000). Therefore, the accrued benefit using the formula without wear-away would also be $64,800 ($27,000 (Employee A's adjusted section 401(a)(17) accrued benefit) plus $37,800 ($270,000 multiplied by (2 percent multiplied by 7 years of service))).



Example 6. (a) Assume the same facts as in Example 2 (example illustrating formula without wear-away), except that as of December 31, 1991, Employer X amends Plan Y to increase benefits to 3 percent of each employee's average annual compensation using the average of the 5 consecutive calendar years out of the last 10 consecutive calendar years during which the average of the employee's compensation is the highest. (After amendment, Plan Y satisfies the requirements of §1.401(a)(4)-3(b)(3).) Employer X applies the fresh-start rules in §1.401(a)(4)-13(c) using the formula in §1.401(a)(4)-13(c)(2) (formula without wear-away) to all employees. Plan Y satisfies the requirements of §1.401(a)(4)-13(d)(2) through (5) and the amendment increasing benefits also provides for the frozen accrued benefit of each employee to be adjusted in accordance with §1.401(a)(4)-13(d)(6) using the new compensation fraction in §1.401(a)(4)-13(d)(6)(i)(B). In applying the new compensation formula, Plan Y provides that average annual compensation will be determined using the plan's compensation formula. However, Plan Y provides that the adjusted accrued benefits of section 401(a)(17) employees are to be determined using the bifurcated method in paragraph (e)(4)(iii)(B) of this section. Employee A's calendar year compensation exceeds the section 401(a)(17) limit for every year through 1992. Assume that the annual limit for 1992 is $245,000.

(b) Employee's A's frozen accrued benefit as of December 31, 1991, determined under the fresh-start rules of §1.401(a)(4)-13(c)(2) (formula without wear-away) is $37,628 ($25,000 plus $12,628 (($210,473 (the average of $200,000, $209,200, and $222,220) multiplied by 2 percent) multiplied by 3 years)). Employee A's frozen accrued benefit adjusted through December 31, 1992, determined in accordance with paragraph (e)(4)(iii)(B) of this section is calculated as follows:

(1) Employee A's post-effective date frozen accrued benefit is $12,628 ((Employee A's frozen accrued benefit as of December 31, 1991) ($37,628) minus (Employee A's section 401(a)(17) frozen accrued benefit ($25,000))).

(2) The numerator of Employee A's new compensation fraction is $215,284 (the average of $200,000, $200,000, $209,200, $222,220, and $245,000). The denominator of Employee A's new compensation fraction is $206,284 (the average of $200,000, $200,000, $200,000, $209,200, and $222,220).

(3) Employee A's post-effective date frozen accrued benefit adjusted through December 31, 1992, is $13,179 (($215,284 divided by $206,284) multiplied by $12,628).

(4) Employee A's section 401(a)(17) frozen accrued benefit adjusted through December 31, 1992, remains $25,000. The old compensation fraction determined in accordance with the modification in paragraph (e)(4)(iii)(A) of this section is less than one ($225,473 (the average of $209,200, $222,220, and $245,000) divided by $250,000).

(5) Employee A's adjusted accrued benefit as of December 31, 1992, equals $38,179 (the sum of the amounts from paragraphs (b)(3) and (b)(4) of this Example).



(f) Additional rules. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate concerning the annual limits on compensation under section 401(a)(17).

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Commissioner of Internal Revenue
Fred T. Goldberg, Jr.

Approved:

Kenneth W. Gideon
Assistant Secretary of the Treasury

August 30, 1991

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[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

T.D. 8363

RIN 1545-AK41

Minimum Coverage Requirements

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the minimum coverage requirements of section 410(b) of the Internal Revenue Code of 1986. They reflect changes made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance necessary to comply with the law and affect



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sponsors of, and participants in, tax-qualified retirement plans and certain other employee benefit plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning on or after January 1, 1989, and applied to those plan years except as set forth in §1.410(b)-10.

FOR FURTHER INFORMATION CONTACT: Rebecca Wilson at 202-377-9372 (not a toll-free number).

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SUPPLEMFNTARY INFORMATION:

Proposed regulations under section 410(b) of the Internal Revenue Code (Code) were published in the **Federal Register** May 18, 1989 (54 FR 21437). The proposed regulations were supplemented and modified by proposed regulations published in the **Federal Register** on May 14, 1990 (55 FR 19897, 19931, and 55 FR 19947, 19958), September 14, 1990 (55 FR 37888, 37901), December 3, 1990 (55 FR 49906, 49908), and February 1, 1991 (56 FR 3988).

Written comments were received from the public on the proposed regulations. In addition, a public hearing on the proposed section 410(b) regulations was held November 20, 1989; a public hearing on the May 14, 1990, and September 14, 1990, proposed regulations was held September 26, 27, and 28, 1990; and a public hearing on the February 1, 1991, proposed regulations was held on May 16, 1991. After consideration of all the written comments received and the statements made at the public hearings, the proposed regulations under section 410(b) are adopted as modified by this Treasury Decision.

Explanation of Provisions:

Section 410(b) Minimum Coverage Requirement

1. The minimum coverage requirement.

The proposed regulations provided that a plan could meet the section 410(b) minimum coverage requirement by satisfying either of two tests, the section 410(b)(1)(A) and (B) ratio percentage test or the section 410(b)(2) average benefit test. These provisions are retained in the final regulations. To satisfy the ratio percentage test for a plan year, a plan must have a ratio percentage of at least 70 percent. A plan's ratio percentage is the percentage of the

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employer's nonhighly compensated employees who benefit under the plan divided by the percentage of the employer's highly compensated employees who benefit under the plan.

To satisfy the average benefit test, two requirements must be met--the nondiscriminatory classification test of section 410(b)(2)(A)(i) and the average benefit percentage test of section 410(b)(2)(A)(ii). The nondiscriminatory classification test requires a plan to benefit employees who qualify under a reasonable employer-determined classification that does not discriminate in favor of highly compensated employees. The average benefit percentage test requires that the average benefit percentage for nonhighly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees. Both of these requirements are discussed in greater detail below.

2. Plans automatically meeting the minimum coverage requirement.

The final regulations retain provisions under which certain plans automatically satisfy the minimum coverage requirement. These include plans that benefit only nonhighly compensated employees, plans maintained by employers that have only highly compensated employees, and collectively bargained plans or portions of plans (including governmental plans described in section 414(d)). The proposed regulations also provided that a plan with no accruals for a plan year automatically satisfied section 410(b). This remains true but the provision has been deleted in the final regulations because any plan that automatically satisfies section 410(b) under this rule also satisfies section 410(b) automatically because it is a plan that benefits no highly compensated employees for a plan year.

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3. Benefiting under a plan.

As provided in the proposed regulations, the final regulations provide that an employee benefits under a plan for a plan year only if the employee receives an allocation or an accrual for that plan year. Thus, for example, an employee who has an accrued benefit under a defined benefit plan but does not receive an accrual for the plan year because the

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employee worked less than the 1,000 hour minimum service requirement under the plan in that year is not benefiting under the plan for the plan year. Or, for example, an employee who is a participant in a defined contribution plan but does not receive an allocation because the employee is not employed by the employer on the last day of the plan year is not benefiting under the plan for the plan year. To the extent that Rev. Rul. 76-250, 1976-2 C.B. 124, and Rev. Rul. 81-210, 1981-2 C.B. 89, conflict with this general rule, they are superseded.

The final regulations also retain the special rule for section 401(k) and section 401(m) plans. Thus, an employee benefits under these plans for purposes of section 410(b) if the employee is eligible to make elective contributions (in the case of the section 401(k) feature) or to make after-tax employee contributions or to receive matching contributions (in the case of the section 401(m) feature), regardless of whether the employee actually elects to participate.

The final regulations retain and clarify the general rule that a former employee benefits under a plan for a plan year only if the plan provides additional benefit accruals for the former employee for that plan year. Thus, for example, a former employee is benefiting under a plan for a plan year if the plan is amended to provide an ad hoc cost-of-living



increase in the former employee's benefits, and the amendment is first effective in the plan year.

4. Nondiscriminatory classification test.

The section 410(b)(2)(A)(i) nondiscriminatory classification test requires a plan to benefit a group of employees that constitutes an employer-determined classification that is both reasonable and nondiscriminatory. The final regulations, like the proposed regulations, require that, in order to be a reasonable classification, the classification must be based on objective business criteria that identify the category of employees who benefit under the plan.

The final regulations, like the proposed regulations, provide that the nondiscrimination requirement under the nondiscriminatory classification test may be met by satisfying either a safe harbor or a facts-and-circumstances test. While the safe harbor in the final regulations is unchanged, the presentation of the requirements has been revised to improve clarity. As revised, the first step in determining whether the safe harbor is satisfied is to determine the plan's ratio percentage in the same manner as the ratio percentage calculation described above in the discussion of the ratio percentage test. Under an incremental scale set forth in a chart in the regulations, a plan satisfies the safe harbor if the ratio percentage of the plan is 50 percent (or, as the concentration of nonhighly compensated employees in the employer's workforce increases, a lesser percentage). For example, if 64 percent of an employer's employees are nonhighly compensated employees, the safe harbor ratio percentage for the employer's plans is 47 percent. If 96 percent of an employer's employees are nonhighly compensated employees, the safe harbor ratio percentage for the employer's plans is 23 percent.



The regulations also provide an incremental scale un-safe harbor beginning at a ratio percentage of 40 percent and decreasing to 20 percent as the concentration of nonhighly compensated employees in the employer's workforce increases. Thus, any plan with a ratio percentage below 20 percent necessarily falls within an unsafe harbor and does not satisfy the minimum coverage requirement of section 410(b).

As in the proposed regulations, the final regulations provide that a plan with a ratio percentage between the safe harbor and the unsafe harbor ratio percentages may satisfy the nondiscrimination requirement of the nondiscriminatory classification test on the basis of facts and circumstances. Relevant facts and circumstances include the underlying business reason for the classification, the percentage of employees benefiting under the plan, whether the number of employees benefiting under the plan in each salary range is representative of the total in that range, how close the plan's ratio percentage is to the employer's safe harbor percentage, and the extent to which the plan's average benefit percentage exceeds 70 percent. The list of relevant facts and circumstances was revised in the final regulations to add the average benefit percentage factor. The revised list continues to provide only examples and is

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not intended to be exhaustive of all potentially relevant facts and circumstances for purposes of this nondiscrimination determination.

5. Average benefit percentage test.

As in the proposed regulations, satisfaction of the average benefit percentage test requires that the employer determine an employee benefit percentage for each employee taken into account for testing purposes and then separately average the percentages of all employees in the highly compensated and nonhighly compensated groups. In general, the



test is satisfied if the benefits provided to nonhighly compensated employees under all plans of the employer (expressed as a percentage of compensation) are at least 70 percent as great, on average, as the benefits provided to the employer's highly compensated employees (expressed as a percentage of compensation).

The proposed regulations permitted benefit percentages to be determined on either a contributions or a benefits basis, using the approach provided under the proposed section 401(a)(4) regulations to determine accrual and allocation rates under aggregated plans. The final regulations generally continue this approach, but revise it to reflect changes made in the testing methods provided in the final regulations under section 401(a)(4) that are being issued simultaneously with these final regulations. In addition, in response to comments, a new method is provided for determining employee benefit percentages that allows an employee's employee benefit percentage to be calculated as the sum of the employee's allocation and accrual rates (as determined for purposes of section 401(a)(4)) under all plans in which the employee participates, provided the rates are determined on a consistent basis. This optional simplified method will in many cases permit employers to use the rates they have already calculated for purposes of section 401(a)(4) for purposes of the average benefit percentage test as well.

While, in general, all plans of the employer must be aggregated into a single testing group for purposes of the average benefits percentage test, this rule does not apply to aggregate collectively bargained plans with noncollectively bargained plans; to aggregate plans of different lines of business where the employer is treated as operating separate lines of business under section 414(r); or to aggregate plans maintained by different employers. In



response to comments, however, and in the limited context of the average benefit percentage test, a special rule has been added to the final regulations to permit benefits provided to collectively bargained employees and noncollectively bargained employees to be considered together where the benefits are provided under a single plan covering both collectively bargained and noncollectively bargained employees. The special rule is only available to such a plan if the plan as a whole satisfies the ratio percentage test, and both groups of employees are covered under the same benefit formula. Under this special rule, a plan meeting these requirements is deemed to satisfy the average benefit percentage test. The special rule is applicable only to the average benefit percentage test prong of the average benefit test in §1.410(b)-2(b)(3). Therefore, both groups must still separately satisfy the nondiscriminatory classification test of §1.410(b)-4.

6. Retroactive correction mechanism.

In response to comments, these final regulations, like the final regulations under section 401(a)(4) being issued simultaneously with these regulations, permit retroactive correction within a period extending through the fifteenth day of the tenth month after the end of the plan year. This approach, which is similar to that contained in section 401(b) with respect to certain disqualifying provisions, provides the employer with a significant period within which to run any necessary tests and take corrective action.

In order to permit employers to make practical choices based on administrative concerns, use of the retroactive correction period is not conditioned on a demonstration that the plan actually failed to satisfy the nondiscrimination requirements, including the minimum coverage requirements. In addition, the correction is not limited to amendments correcting



disqualifying defects. The final regulations do require, however, that any retroactive amendment be nondiscriminatory standing alone and be consistent with the anti-cutback rules of section 411(d)(6).

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7. Excludable employees.

Generally, in applying the minimum coverage requirements, all employees of the employer are taken into account. However, the final regulations, like the proposed regulations, provide that the following employees are excluded from consideration: employees who do not meet the plan's minimum age and service conditions, employees covered by a collective bargaining agreement (when testing the noncollectively bargained portion of the plan), employees of other qualified separate lines of business (when testing a plan of a given qualified separate line of business), and terminated employees with not more than 500 hours of service.

The final regulations revise the employee exclusion rules in five additional respects. First, the exclusion for terminated employees with not more than 500 hours or service, which was mandatory in the proposed regulations, is permissive in the final regulations and is further modified to make the rule available to plans using the elapsed time method of determining years of service.

Second, in response to comments, the final regulations provide special rules to accommodate situations in which employees move into and out of collectively bargained status within a limited period of time while continuing to receive benefits pursuant to a collective bargaining agreement. Under these rules, the employer may, in certain situations,



temporarily continue to treat these individuals as collectively bargained employees for purposes of satisfying section 410(b).

Third, because section 401(k)(4)(B) generally precludes state and local governments and tax-exempt organizations from maintaining section 401(k) plans for their employees, commentators requested that employees of these entities be excludable where the other employees of the controlled group are eligible to participate in a section 401(k) plan. Thus, an exclusion was added to the final regulations for employees of governmental or tax-exempt entities if those employees are precluded statutorily from benefiting under a section 401(k) plan and if more than 95 percent of the employees who are not precluded statutorily from participating in the section 401(k) plan benefit under the section 401(k) plan for the plan year.

Fourth, in response to comments, the final regulations clarify that an employee is treated as meeting a plan's age and service requirements on the date any employee with the same age and service would be eligible to commence participation in the plan. This conforms to the provision of section 410(b)(4)(C).

Finally, employees who are nonresident aliens and who receive no U.S. source earned income are excluded even if they are benefiting under the plan. The exclusion of nonresident aliens who receive no U.S. source income is required by section 410(b)(3)(C) and was included in the proposed regulations. A rule has been added to the final regulations permitting an employer to exclude nonresident aliens who receive U.S. source income if that income is exempt from U.S. income tax under an applicable income tax convention and if the employer excludes all employees in this category.



8. Definition of plan and rules of disaggregation and aggregation.

In general, under the proposed regulations, each single plan (determined under the rules of section 414(*l*)) is a separate plan for purposes of section 410(b). In addition, the proposed regulations required certain single plans under section 414(*l*) to be disaggregated into two or more separate plans, each of which must satisfy section 410(b). These rules apply, for example, to separate the collectively bargained portion of a plan from the non-bargained portion, the employee stock ownership plan (ESOP) portion from the non-ESOP portion, and the qualified cash or deferred arrangement under section 401(k) (CODA) from the non-CODA portion. Several commentators requested exceptions from mandatory disaggregation of collectively bargained and noncollectively bargained portions of plans. In general, the final regulations retain the mandatory disaggregation rules, as they are consistent with the mandatory testing exclusions applicable to collectively bargained and noncollectively bargained employees in section 410(b). A limited exception in the context of the average benefit percentage test is provided in the final regulations and discussed in the context of that



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test above. Some commentators also requested guidance on the treatment of the defined contribution portion of a defined benefit plan that provides benefits described in section 414(k) based on separate accounts. The final regulations clarify that the defined benefit and defined contribution portions of such a plan are treated as separate plans.

The final regulations continue to provide permissive aggregation rules under which two or more plans that are not mandatorily disaggregated may be treated as a single plan for purposes of the ratio percentage and nondiscriminatory classification tests. The final regulations also continue to provide rules for determining the testing group of plans taken



into account in determining whether a plan satisfies the average benefit percentage test. The final regulations clarify, however, that, except in certain limited circumstances such as the determination of excludable employees, the plans in the testing group are not actually treated as a single plan.

9. Other rules.

a. Former employees. The final regulations, like the proposed regulations, require that a plan satisfy the minimum coverage requirements separately for employees and former employees for each plan year. If no former employee receives an additional benefit accrual for a plan year, the plan automatically satisfies section 410(b) with respect to former employees. The proposed regulations included a special rule under which a defined benefit plan satisfied section 410(b) with respect to former employees for a plan year if (i) it benefits at least five former employees and (ii) 60 percent of benefiting former employees are nonhighly compensated employees. The final regulations retain this special rule, but add an alternative under which the second prong of the test is satisfied if 95 percent of all former employees with accrued benefits under the benefit under the plan.

b. Plans maintained by more than one employer. Multiple employer plans must satisfy section 410(b) on an employer-by-employer basis rather than on the basis of participating employers in the aggregate. Any noncollectively bargained portion of a multiemployer plan is tested as a multiple employer plan. Failure to satisfy section 410(b) with respect to any component of this testing process may result in disqualification of the plan for all participating employers. The final regulations, like the proposed regulations, do not provide an exception to this rule. However, where a multiemployer plan or a multiple



employer plan fails to satisfy section 410(b), in a proper case, the Commissioner could retain the plan's qualified status for innocent employers by requiring corrective and remedial action with respect to the plan, such as allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have knowledge of the disqualifying event or was otherwise notified by the Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events.

c. Special rules for governmental plans, church plans, and tax-sheltered annuities. In general, except for certain plans that provide section 403(b) tax-sheltered annuities, governmental plans and church plans must satisfy section 401(a)(3), as in effect prior to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), in lieu of satisfying section 410(b). The final regulations clarify, however, that, for purposes of this requirement, a plan that satisfies section 410(b) will be treated as satisfying pre-ERISA section 401(a)(3).

Governmental plans and church plans that provide nonelective contributions under section 403(b) must, pursuant to section 403(b)(12), satisfy section 410(b). Because section 410(c) does not apply to such plans, satisfaction of pre-ERISA section 401(a)(3) will not satisfy section 403(b)(12). Of course, such plans may continue to rely on the safe harbors published in Notice 89-23, 1989-1 C.B. 654, until further guidance is issued.

Under the proposed regulations, section 410(b) was considered to be satisfied in the case of governmental plans for plan years beginning before 1993. This provision is retained in the final regulations. In addition, the final regulations provide that, if the governing body



with authority to amend the plan does not meet continuously, section 410(b) will be





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considered satisfied for plan years beginning before 90 days after the opening of the first legislative session beginning after December 31, 1992.

The Treasury and the Service recognize that governmental plans may have come unique features that arise because the sponsoring employer is a governmental entity. Comments are specifically requested from governmental employers regarding the appropriate modifications to the regulations to take into account the operation of governmental plans.

d. Special rule for certain dispositions or acquisitions. Section 410(b)(6)(C) and the proposed regulations provide a transition rule for certain dispositions or acquisitions, under which a plan is treated as satisfying section 410(b) for a limited period. In response to comments, the final regulations clarify that this rule applies to asset as well as stock transactions as long as the transaction involves a change in employer of the employees of a trade or business. See §1.410(b)-2(f).

e. Definition of employee. In response to comments, a provision has been added to clarify that an individual is treated as an employee rather than a former employee if the plan credits the individual with imputed compensation or service during a period in which the individual is not performing services.

f. Annual testing option. Under the proposed regulations, a plan was generally required to satisfy section 410(b) on every day of the plan year. Under certain conditions, a plan could, however, be deemed to satisfy section 410(b) for a plan year if it satisfied section 410(b) on a selected day in each quarter. The final regulations retain and clarify these minimum coverage testing rules in the proposed regulations. In addition, the final



regulations add an annual testing option. Under this new testing option, a plan will satisfy section 410(b) for a plan year if it satisfies §1.410(b)-2 as of the last day of the plan year. If this option is used, the employer must take into account all employees (or former employees) who were employees (or former employees) on any day during the plan year. This new annual method is required to be used in testing plans subject to section 401(k) or section 401(m), and for purposes of the average benefit percentage test.

g. Other modifications. The final regulations have also been clarified in certain respects and modified in conjunction with the final section 401(a)(4) regulations. For example, the definitions of compensation used are generally the same as those applicable under section 401(a)(4). As another example, a rule has been added to the final regulations to provide that all percentages are calculated to the nearest hundredth of a percentage point and all other numbers are calculated to the nearest hundredth.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.



Drafting Information

The principal authors of these regulations are Rebecca Wilson and Nancy J. Marks, Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

List of Subjects in 26 CFR 1.401-0 through 1.419A-2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * §§1.410(b)-2 through 1.410(b)-10 also issued under 26 U.S.C. 410(b)(6). * * *

Par. 2. New section §1.410(b)-0 is added to read as follows:

§1.410(b)-0 Table of Contents.

This section contains a listing of the headings of §§1.410(b)-1 through 1.410(b)-10.













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(3) Quarterly testing option.
(4) Annual testing option.
(5) Example.
(b) Family member aggregation rule.

§1.410(b)-9 Definitions.
Collectively bargained employee.
Defined benefit excess plan.
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Employee.
Employer.
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Excess benefit percentage.
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Offset plan.
Plan year.
Plan year compensation.
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Section 401(k) plan.
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Section 401(m) plan.

§1.410(b)-10 Effective dates and transition rules.
(a) General rule.
(b) Transition rules.
(1) Nondiscriminatory classification test.
(2) Average benefit percentage test.
(c) Employees who benefit under a plan.



(d) Aggregation of two or more plans.
(e) Special rule for certain collective bargaining agreements.
(1) In general.
(2) Example.
(3) Plan maintained pursuant to a collective bargaining agreement.



Par. 3. Section 1.410(b)-1 is amended by revising the heading and paragraph (a) to read as follows:

§1.410(b)-1 Minimum coverage requirements (before 1989).

(a) In general. A plan is not a qualified plan (and a trust forming a part of the plan is not a qualified trust) unless the plan satisfies section 410(b)(1). For plan years prior to the applicable effective date set forth in §1.410(b)-10, a plan satisfies section 410(b)(1) if it satisfies the requirements of paragraph (b)(1) or (b)(2) of this section. See also §1.410(b)-2 for plan years beginning on or after the applicable effective date set forth in §1.410(b)-10.

* * * * *



Par. 4. New §§1.410(b)-2 through 1.410(b)-10 are added to read as follows:

§1.410(b)-2 Minimum coverage requirements (after 1988).

(a) In general. A plan is a qualified plan for a plan year only if the plan satisfies section 410(b) for the plan year. A plan satisfies section 410(b) for a plan year if and only if it satisfies paragraph (b) of this section with respect to employees for the plan year and paragraph (c) of this section with respect to former employees for the plan year. The rules in paragraphs (a), (b), and (c) of this section apply to all plans as a condition of qualification, including plans under which no employee is able to accrue any additional benefits (for example, frozen plans). Paragraphs (d), (e), and (f) of this section provide special rules for nonelective section 403(b) plans subject to section 403(b)(12)(A)(i), for governmental and church plans subject to section 410(c), and for certain acquisitions or dispositions, respectively. See §1.410(b)-7 for rules for determining the "plan" subject to section 410(b).

(b) Requirements with respect to employees--(1) In general. A plan satisfies this paragraph (b) for a plan year if and only if it satisfies at least one of the tests in paragraphs (b)(2) through (b)(7) of this section for the plan year.

(2) Ratio percentage test--(i) In general. A plan satisfies this paragraph (b)(2) for a plan year if and only if the plan's ratio percentage for the plan year is at least 70 percent. This test incorporates both the percentage test of section 410(b)(1)(A) and the ratio test of section 410(b)(1)(B). See §1.410(b)-9 for the definition of ratio percentage.

(ii) Examples. The following examples illustrate the ratio percentage test of this paragraph (b)(2).

Example 1. For a plan year, Plan A benefits 70 percent of the employer's nonhighly compensated employees and 100 percent of an employer's highly compensated employees. The plan's ratio percentage for the year is 70 percent (70 percent/100 percent), and thus the plan satisfies the ratio percentage test.

Example 2. For a plan year, Plan B benefits 40 percent of the employer's nonhighly compensated employees and 60 percent of the employer's highly compensated employees. Plan B fails to satisfy the ratio percentage test because the plan's ratio percentage is only 66.67 percent (40 percent/60 percent).

(3) Average benefit test. A plan satisfies this paragraph (b)(3) for a plan year if and only if the plan satisfies both the nondiscriminatory classification test of §1.410(b)-4 and the average benefit percentage test of §1.410(b)-5 for the plan year.

(4) Certain tax credit employee stock ownership plans. A plan satisfies this paragraph (b)(4) for a plan year if and only if the plan--

(i) Is a tax credit employee stock ownership plan (as defined in section 409(a)),

(ii) Is the only plan of the employer that is intended to qualify under section 401(a), and

(iii) Is a plan that satisfies the rule set forth in section 410(b)(6)(D).

This paragraph (b)(4) is available only for plan years for which the tax credit employee stock ownership plan receives contributions for which the employer is allowed a tax credit under section 41 (as in effect prior to its repeal by the Tax Reform Act of 1986) or section 48(n) (as in effect prior to its amendment by the Tax Reform Act of 1984). The requirement of this paragraph (b)(4) that the plan be the only plan of the employer that is intended to qualify under section 401(a) is not satisfied if the employer has only one plan, but that plan is treated as two or more separate plans under the mandatory disaggregation rules of §1.410(b)-7(c).



(5) Employers with no nonhighly compensated employees. A plan satisfies this paragraph (b)(5) for a plan year if the plan is maintained by an employer that has no nonhighly compensated employees at any time during the plan year.

(6) Plans benefiting no highly compensated employees. A plan satisfies this paragraph (b)(6) for a plan year if the plan benefits no highly compensated employees for the plan year.

(7) Plans benefiting collectively bargained employees. A plan that benefits solely collectively bargained employees for a plan year satisfies this paragraph (b)(7) for the plan year. If a plan (within the meaning of §1.410(b)-7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, §1.410(b)-7(c)(5) provides that the portion of the plan that benefits collectively bargained employees is treated as a separate plan from the portion of the plan that benefits noncollectively bargained employees. Thus, the mandatorily disaggregated portion of the plan that benefits the collectively bargained employees automatically satisfies this paragraph (b)(7) for the plan year and hence section 410(b). See §1.410(b)-9 for the definitions of collectively bargained employee and noncollectively bargained employee, respectively.

(c) Requirements with respect to former employees--(1) Former employees tested separately. Former employees are tested separately from employees for purposes of section 410(b). Thus, former employees are disregarded in applying the ratio percentage test, the nondiscriminatory classification test, and the average benefit percentage test with respect to the coverage of employees under a plan, and employees are disregarded in applying this section with respect to the coverage of former employees under a plan.



(2) Testing former employees--(i) In general. A plan satisfies section 410(b) with respect to former employees if it satisfies one of the tests in paragraphs (b)(2) through (b)(7) of this section with respect to former employees. For this purpose, these tests are applied by substituting "former employee" for "employee," "nonhighly compensated former employee" for "nonhighly compensated employee," and "highly compensated former employee" for "highly compensated employee," whenever those terms are used.

(ii) Special rule. A defined benefit plan satisfies section 410(b) with respect to former employees for a plan year if the plan benefits at least five former employees, and if either--

(A) More than 95 percent of all former employees with accrued benefits under the plan benefit under the plan for the plan year, or

(B) At least 60 percent of the former employees who benefit under the plan for the plan year are nonhighly compensated former employees.

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(d) Nonelective contributions under section 403(b) plans. For plan years beginning on or after January 1, 1993, a plan subject to section 403(b)(12)(A)(i) with respect to nonelective contributions (i.e., contributions not made pursuant to a salary reduction agreement) is treated as a plan subject to the requirements of this section. For this purpose, a plan described in the preceding sentence must satisfy the requirements of this section without regard to section 410(c) and paragraph (e) of this section. For plan years beginning before January 1, 1993, any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section.

(e) Certain governmental and church plans. The requirements of section 410(b) do not apply to a plan described in section 410(c)(1) (other than a plan subject to section



403(b)(12)(A)(i) or a plan with respect to which an election has been made under section 410(d)). Such a plan must satisfy section 401(a)(3) as in effect on September 1, 1974. For this purpose, a plan that satisfies section 410(b) (without regard to this paragraph (e)) is treated as satisfying section 401(a)(3) as in effect on September 1, 1974. For plan years beginning before January 1, 1993, any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies section 401(a)(3) as in effect on September 1, 1974.

(f) Certain acquisitions or dispositions. Section 410(b)(6)(C) (relating to certain acquisitions or dispositions) provides a special rule whereby a plan may be treated as satisfying section 410(b) for a limited period of time after an acquisition or disposition. Section 410(b)(6)(C) does not apply to acquisitions or dispositions that occurred prior to the first plan year to which section 410(b), as amended by the Tax Reform Act of 1986, applies. For purposes of section 410(b)(6)(C) and this paragraph (f), the terms "acquisition" and "disposition" refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(g) Additional rules. The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum coverage requirements of section 410(b), including (without limitation) additional rules limiting or expanding the methods in §1.410(b)-5(d) and (e) for determining employee benefit percentages.



§1.410(b)-3 Employees and former employees who benefit under a plan.

(a) Employees benefiting under a plan--(1) In general. Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if for that plan year, in the case of a defined contribution plan, the employee receives an allocation taken into account under §1.401(a)(4)-2(c)(2)(ii), or in the case of a defined benefit plan, the employee receives an increase in the dollar amount of a benefit accrued or treated as an accrued benefit under section 411(d)(6).

(2) Exceptions to allocation or accrual requirement--(i) Section 401(k) and 401(m) plans. Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee under the plan as defined in §1.401(k)-1(g)(4) for the plan year. Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in §1.401(m)-1(f)(4) for the plan year.

(ii) Section 415 limits. In determining whether an employee is treated as benefiting under a plan for a plan year, plan provisions that implement the limits of section 415 are disregarded. Any plan provision that provides for increases in an employee's accrued benefit (which would have been greater but for the application of section 415(b)) due solely to adjustments under section 415(d)(1) is also disregarded, but only if such provision applies uniformly to all employees in the plan.

(iii) Certain plan limits. An employee is treated as benefiting under a plan for a plan year if the employee satisfies all of the applicable conditions for accruing a benefit for the plan year but fails to accrue the benefit solely because of a benefit limit under the plan that is



uniformly applicable to all employees in the plan. Thus, for example, if a defined benefit plan takes into account only the first 30 years of service for accrual purposes, a participant

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who has completed more than 30 years of service is still treated as benefiting under the plan.

(iv) Benefit offset arrangements. An employee is treated as benefiting under a plan for a plan year even if the employee's current benefit accrual under the plan is offset by the contributions or benefits provided on behalf of the employee under another qualified plan, if the employee has satisfied all other conditions for a current benefit accrual under the plan. If the other plan is maintained by another employer, the employee whose benefits are subject to the offset must have become an employee of the employer maintaining the plan pursuant to a transaction described in §1.410(b)-2(f) (regarding certain acquisitions and dispositions) between the two employers.

(v) Post-normal retirement age adjustments. An employee is treated as benefiting under a defined benefit plan for a plan year if the employee has attained normal retirement age and fails to accrue a benefit solely because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(3) Examples. The following examples illustrate the determination of whether an employee is benefiting under a plan for purposes of section 410(b).

Example 1. An employer has 35 employees who are eligible under a defined benefit plan. The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer maintains a section 401(k) plan. Only employees who are at least age 21 and who complete one year of service are eligible employees under the plan within the meaning of §1.401(k)-1(g)(4). Under the rule of paragraph (a)(2)(i) of this



section, only employees who have satisfied these age and service conditions are treated as benefiting under the plan.

Example 3. The facts are the same as in Example 2, except that the employer also maintains a section 401(m) plan that provides matching contributions contingent on elective contributions under the section 401(k) plan. The matching contributions are contingent on employment on the last day of the plan year. Under §1.401(m)-1(f)(4), because matching contributions are contingent on employment on the last day of the plan year, not all employees who are eligible employees under the section 401(k) plan are eligible employees under the section 401(m) plan. Thus, employees who have satisfied the age and service conditions but who do not receive a matching contribution because they are not employed on the last day of the plan year are treated as not benefiting under the section 401(m) portion of the plan.

(b) Former employees benefiting under a plan--(1) In general. A former employee is treated as benefiting for a plan year if and only if the plan provides an allocation or benefit increase described in paragraph (a)(1) of this section to the former employee for the plan year. Thus, for example, a former employee benefits under a defined benefit plan for a plan year if the plan is amended to provide an ad hoc cost-of-living adjustment in the former employee's benefits. In contrast, because an increase in benefits payable under a plan pursuant to an automatic cost-of-living provision adopted and effective before the beginning of the plan year is previously accrued, a former employee is not treated as benefiting in a subsequent plan year merely because the former employee receives an increase pursuant to such an automatic cost-of-living provision. Any accrual or allocation for an individual during the plan year that arises from the individual's status as an employee is treated as an accrual or allocation of an employee. Similarly, any accrual or allocation for an individual during the plan year that arises from the individual's status as a former employee is treated as an accrual or allocation of a former employee. It is possible for an individual to accrue a benefit both as an employee and as a former employee in a given plan year. During the plan



year in which an individual ceases performing services for the employer, the individual is treated as an employee in applying section 410(b) with respect to employees and is treated as a former employee in applying section 410(b) with respect to former employees.

(2) Examples. The following examples illustrate the determination of whether a former employee benefits under a plan for purposes of section 410(b).

Example 1. Employer A amends its defined benefit plan in the 1995 plan year to provide an ad hoc cost-of-living increase of 5 percent for all retirees. Former employees who receive this increase are treated as benefiting under the plan for the 1995 plan year.

Example 2. Employer B maintains a defined benefit plan with a calendar plan year. In the 1995 plan year, Employer B amends the plan to provide that an employee who has reached early retirement age under the plan and who retires before July 31 of the 1995 plan year will receive an unreduced benefit, even though the employee has not yet reached normal retirement age. This early retirement window benefit is provided to employees based on their status as employees. Thus, although individuals who take advantage of the benefit become former employees, the window benefit is treated as provided to employees and is not treated as a benefit for former employees.

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Example 3. The facts are the same as Example 2, except that on September 1, 1995, Employer B also amends the defined benefit plan to provide an ad hoc cost-of-living increase effective for all former employees. An individual who ceases performing services for the employer before July 31, 1995, under the early retirement window, and then receives the ad hoc cost-of-living increase, is treated as benefiting for the 1995 plan year both as an employee with respect to the early retirement window, and as a former employee with respect to the ad hoc COLA.



§1.410(b)-4 Nondiscriminatory classification test.

(a) In general. A plan satisfies the nondiscriminatory classification test of this section for a plan year if and only if, for the plan year, the plan benefits the employees who qualify under a classification established by the employer in accordance with paragraph (b) of this section, and the classification of employees is nondiscriminatory under paragraph (c) of this section.

(b) Reasonable classification established by the employer. A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

(c) Nondiscriminatory classification--(1) General rule. A classification is nondiscriminatory under this paragraph (c) for a plan year if and only if the group of employees included in the classification benefiting under the plan satisfies the requirements of either paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) Safe harbor. A plan satisfies the requirement of this paragraph (c)(2) for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage, as defined in paragraph (c)(4)(i) of this section. See §1.410(b)-9 for the definition of a plan's ratio percentage.



(3) Facts and circumstances--(i) General rule. A plan satisfies the requirements of this paragraph (c)(3) if and only if--

(A) The plan's ratio percentage is greater than or equal to the unsafe harbor percentage, as defined in paragraph (c)(4)(ii) of this section, and

(B) The classification satisfies the factual determination of paragraph (c)(3)(ii) of this section.

(ii) Factual determination. A classification satisfies this paragraph (c)(3)(ii) if and only if, based on all the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following--

(A) The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.

(B) The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory.

(C) Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is to be nondiscriminatory.



(D) The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

(E) The extent to which the plan's average benefit percentage (determined under §1.410(b)-5) exceeds 70 percent.



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(4) Definitions--(i) Safe harbor percentage. The safe harbor percentage of an employer is 50 percent, reduced by 3/4 of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. See paragraph (c)(4)(iv) for a table that illustrates the safe harbor percentage and unsafe harbor percentage.

(ii) Unsafe harbor percentage. The unsafe harbor percentage of an employer is 40 percent, reduced by 3/4 of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent.

(iii) Nonhighly compensated employee concentration percentage. The nonhighly compensated employee concentration percentage of an employer is the percentage of all the employees of the employer who are nonhighly compensated employees. Employees who are excludable employees for purposes of the average benefit test are not taken into account.

(iv) Table. The following table sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage:



| Nonhighly compensated employee concentration percentage | Safe harbor percentage | Unsafe harbor percentage |
|---|---|---|
| 0-60 | 50.00 | 40.00 |
| 61 | 49.25 | 39.25 |
| 62 | 48.50 | 38.50 |
| 63 | 47.75 | 37.75 |
| 64 | 47.00 | 37.00 |
| 65 | 46.25 | 36.25 |
| 66 | 45.50 | 35.50 |
| 67 | 44.75 | 34.75 |
| 68 | 44.00 | 34.00 |
| 69 | 43.25 | 33.25 |
| 70 | 42.50 | 32.50 |
| 71 | 41.75 | 31.75 |
| 72 | 41.00 | 31.00 |
| 73 | 40.25 | 30.25 |
| 74 | 39.50 | 29.50 |
| 75 | 38.75 | 28.75 |
| 76 | 38.00 | 28.00 |
| 77 | 37.25 | 27.25 |
| 78 | 36.50 | 26.50 |
| 79 | 35.75 | 25.75 |
| 80 | 35.00 | 25.00 |
| 81 | 34.25 | 24.25 |
| 82 | 33.50 | 23.50 |
| 83 | 32.75 | 22.75 |
| 84 | 32.00 | 22.00 |
| 85 | 31.25 | 21.25 |
| 86 | 30.50 | 20.50 |
| 87 | 29.75 | 20.00 |
| 88 | 29.00 | 20.00 |
| 89 | 28.25 | 20.00 |
| 90 | 27.50 | 20.00 |
| 91 | 26.75 | 20.00 |
| 92 | 26.00 | 20.00 |
| 93 | 25.25 | 20.00 |
| 94 | 24.50 | 20.00 |
| 95 | 23.75 | 20.00 |
| 96 | 23.00 | 20.00 |
| 97 | 22.25 | 20.00 |
| 98 | 21.50 | 20.00 |
| 99 | 20.75 | 20.00 |



(5) Examples. The following examples illustrate the rules in this paragraph (c).

Example 1. Employer A has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Employer A maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees. Thus, the plan's ratio percentage is 55.56 percent ([60/120] / [72/80] = 50%/90% = 0.5556), which is below the percentage necessary to satisfy the ratio percentage test of §1.410(b)-2(b)(2). The employer's nonhighly compensated employee concentration percentage is 60 percent (120/200); thus, Employer A's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 2. The facts are the same as in Example 1, except that the plan benefits only 40 nonhighly compensated employees. The plan's ratio percentage is thus 37.03 percent ([40/120] / [72/80] = 33.33%/90% = 0.3703). Under these facts, the plan's classification is below the unsafe harbor percentage and is thus considered discriminatory.

Example 3. The facts are the same as in Example 1, except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is thus 41.67 percent ([45/120] / [72/80] = 37.50%/90% = 0.4167), above the unsafe harbor percentage (40 percent) and below the safe harbor percentage (50 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

Example 4. Employer B has 10,000 nonexcludable employees, of whom 9,600 are nonhighly compensated employees and 400 are highly compensated employees. Employer B maintains a plan that benefits 600 nonhighly compensated employees and 100 highly compensated employees. Thus, the plan's ratio percentage is 25.00 percent ([600/9,600] / [100/400] = 6.25%/25% = 0.2500), which is below the percentage necessary



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to satisfy the ratio percentage test of §1.410(b)-2(b)(2). Employer B's nonhighly compensated employee concentration percentage is 96 percent (9,600/10,000); thus, Employer B's safe harbor percentage is 23 percent, and its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (25.00 percent) is greater than the safe harbor percentage (23.00 percent), the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 5. The facts are the same as in Example 4, except that the plan benefits only 400 nonhighly compensated employees. The plan's ratio percentage is thus 16.67 percent ([400/9,600] / [100/400] = 4.17%/25% = 0.1667). The plan's ratio percentage is below the unsafe harbor percentage and thus the classification is considered discriminatory.

Example 6. The facts are the same as in Example 4, except that the plan benefits 500 nonhighly compensated employees. The plan's ratio percentage is thus 20.83 percent



([500/9,600] / [100/400] = 5.21%/25% = 0.2083), above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the facts and circumstances.



§1.410(b)-5 Average benefit percentage test.

(a) General rule. A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) Determination of average benefit percentage. The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) Determination of actual benefit percentage. The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) Determination of employee benefit percentages--(1) Overview. This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for additional optional rules for determining employee benefit percentages.

(2) Employee contributions and employee-provided benefits disregarded. Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee



contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages. For this purpose, the amount of benefits derived from employee contributions that are not allocated to separate accounts must be determined under the method in §1.401(a)(4)-6(b)(1) (section 411(c) method), (b)(4) (grandfather rule for plans in existence on May 14, 1990), (b)(5) (government plan method), or (b)(6) (cessation-of-employee-contributions method). See paragraph (e)(5) of this section, however, for a rule allowing the safe harbor methods in §1.401(a)(4)-6(b)(2) (composition-of-workforce method) and (b)(3) (minimum benefit method) to be used if certain conditions are satisfied.

(3) Plans and plan years taken into account--(i) Testing group. All plans included in the testing group under §1.410(b)-7(e)(1), and only those plans, are taken into account in determining an employee's employee benefit percentage. See paragraph (e)(3) of this section, however, for an optional rule permitting employee benefit percentages to be determined separately with respect to defined benefit plans and defined contribution plans in the testing group.

(ii) Testing period. An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the "relevant plan years" or, in the aggregate, as the "testing period." See paragraph (e)(9) of this section, however, for an optional rule permitting employee benefit percentages to be determined over a three-year averaging period.

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(4) Contributions or benefits basis. Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group. See paragraph (e)(3) of this section, however, for an optional rule permitting employee benefit percentages to be determined separately with respect to defined benefit plans and defined contribution plans in the testing group.

(5) Determination on a contributions basis. If employee benefit percentages for a testing group are determined on a contributions basis for a testing period, each employee's employee benefit percentage is determined as follows--

(i) Determine the dollar amount of the allocations taken into account with respect to the employee under §1.401(a)(4)-2(c)(2)(ii) for the relevant plan year for each defined contribution plan to which the permitted disparity rules of section 401(*l*) are available.

(ii) Determine the actuarial present value of the increase in the employee's normalized accrued benefit for the relevant plan year under each defined benefit plan to which the permitted disparity rules of section 401(*l*) are available, using the method prescribed in §1.401(a)(4)-8(c)(2)(i)(A) through (C).

(iii) Add the allocations and equivalent allocations determined in paragraphs (d)(5)(i) and (ii) of this section, and divide the total by the employee's plan year compensation for any one of the relevant plan years in the testing period. A relevant plan year may not be used for this purpose unless the employee actually benefitted under the plan for that plan year. In addition, a relevant plan year may not be used if it is a short plan year, unless it is the longest of any plan year in the testing period. Plan year compensation may not be limited to



an employee's period of plan participation during a relevant plan year unless the period of participation taken into account includes the employee's longest period of participation in any plan in the testing group during that year. Plan year compensation for this purpose must be determined by applying the requirements of section 401(a)(17) as if all plans in the testing group were a single plan.

(iv) Adjust the amount determined in paragraph (d)(5)(iii) of this section by imputing permitted disparity to the extent allowed under the rules of §1.401(a)(4)-7 using the method in §1.401(a)(4)-7(b). This adjustment is permitted, but not required. If it is made with respect to any nonhighly compensated employee's employee benefit percentage under the testing group for a testing period, however, it must be made with respect to all highly compensated employees' employee benefit percentages under the testing group for the testing period. In determining an employee's adjusted allocation rate under §1.401(a)(4)-7(b), the percentage amount determined under paragraph (d)(5)(iii) of this section is substituted for the employee's unadjusted allocation rate.

(v) Add the employee's allocations and equivalent allocations for the relevant plan year under any defined contribution or defined benefit plans to which the permitted disparity rules of section 401(*l*) are not available, using the rules in paragraphs (d)(5)(i) and (d)(5)(ii) of this section, and divide the total by the employee's plan year compensation used in paragraph (d)(5)(iii) of this section.

(vi) Add the rate determined in paragraph (d)(5)(v) of this section to the rate determined in paragraph (d)(5)(iv) of this section (or paragraph (d)(5)(iii) of this section, if



permitted disparity is not taken into account). This is the employee's employee benefit percentage for the testing period with respect to the testing group.

(6) Determination on a benefits basis. If employee benefit percentages for a testing group are determined on a benefits basis for a testing period, each employee's employee benefit percentage is determined as follows--

(i) Determine the increase in the employee's normalized accrued benefit determined under §1.401(a)(4)-3(d)(2)(i)(E) for the relevant plan year under each defined benefit plan to which the permitted disparity rules of section 401(*l*) are available.

(ii) Determine the dollar amount of the allocations taken into account with respect to the employee under §1.401(a)(4)-2(c)(2)(ii) for the relevant plan year for each defined contribution plan to which the permitted disparity rules of section 401(*l*) are available, and

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convert these allocations into equivalent accruals using the method prescribed in §1.401(a)(4)-8(b)(2)(i)(A) and (B).

(iii) Add the accruals and equivalent accruals determined in paragraphs (d)(6)(i) and (d)(6)(ii) of this section, and divide the total by the employee's plan year compensation for any one of the relevant plan years in the testing period. A relevant plan year may not be used for this purpose unless the employee actually benefitted under the plan for that plan year. In addition, a relevant plan year may not be used if it is a short plan year, unless it is the longest of any plan year in the testing period. Plan year compensation may not be limited to an employee's period of plan participation during a relevant plan year unless the period of participation taken into account includes the employee's longest period of participation in any plan in the testing group during that year. Plan year compensation for



this purpose must be determined by applying the requirements of section 401(a)(17) as if all plans in the testing group were a single plan.

(iv) Adjust the amount determined in paragraph (d)(6)(iii) of this section by imputing permitted disparity to the extent allowed under the rules under the rules of §1.401(a)(4)-7 using the annual method in §1.401(a)(4)-7(c)(4)(iv)(C). This adjustment is permitted, but not required. If it is made with respect to any nonhighly compensated employee's employee benefit percentage under the testing group for a testing period, however, it must be made with respect to all highly compensated employees' employee benefit percentages under the testing group for the testing period. In determining an employee's adjusted accrual rate under §1.401(a)(4)-7(c), the percentage amount determined under paragraph (d)(6)(iii) of this section is substituted for the employee's unadjusted accrual rate.

(v) Add the employee's accruals and equivalent accruals for the relevant plan year under any defined benefit or defined contribution plans to which the permitted disparity rules of section 401(*l*) are not available, using the rules in paragraphs (d)(6)(i) and (d)(6)(ii) of this section, and divide the total by the employee's plan year compensation used in paragraph (d)(6)(iii) of this section.

(vi) Add the rate determined in paragraph (d)(6)(v) of this section to the rate determined in paragraph (d)(6)(iv) of this section (or paragraph (d)(6)(iii) of this section, if permitted disparity is not taken into account). This is the employee's employee benefit percentage for the testing period with respect to the testing group.

(7) Requirements for certain plans providing early retirement benefits--(i) General rule. If any defined benefit plan in the testing group provides for early retirement benefits in



addition to normal retirement benefits to any highly compensated employee, and the average actuarial reduction for any one of these benefits commencing in the 5 years prior to the plan's normal retirement age is less than 4 percent per year, then the increase in the normalized accrued benefit used in paragraphs (d)(5)(ii), (d)(5)(v), (d)(6)(i), and (d)(6)(v) of this section must be replaced by the largest amount determined under §1.401(a)(4)-3(d)(2)(ii)(A) through (G).

(ii) Exception. Paragraph (d)(7)(i) of this section does not apply if early retirement benefits with average actuarial reductions described in that paragraph are currently available, within the meaning of §1.401(a)(4)-4(b), under plans in the testing group to a percentage of nonexcludable nonhighly compensated employees that is at least 70 percent of the percentage of nonexcludable highly compensated employees to whom these benefits are currently available.

(8) Use of optional methods provided in section 401(a)(4) regulations--(i) General rule. Except as otherwise provided in this paragraph (d), any optional methods or rules for determining allocations, accruals, compensation, and other items that are used in determining employee benefit percentages under this section that would be available in determining whether a plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) may be used in determining employee benefit percentages under this section, provided that the optional methods or rules selected are applied on a consistent basis to all employees in the testing group. Thus, for example, employee benefit percentages may generally be calculated using any of the alternative methods of determining plan year compensation under §1.401(a)(4)-12, and using any underlying definition of compensation that satisfies section



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414(s). On the other hand, employee benefit percentages may not be calculated using the projected method in §1.401(a)(4)-3(d)(4), the grouping rules in §1.401(a)(4)-3(d)(6)(iv), or the floor on most valuable accrual rates in §1.401(a)(4)-3(d)(6)(v), for example, since those rules relate exclusively to the determination of accrual rates, and not to the determination of allocations, accruals, compensation, or other items actually used in determining employee benefit percentages under this section.

(ii) Certain restrictions on options involving defined benefit plans. Optional methods or rules described in paragraph (d)(8)(i) of this section that may not be used in determining whether a DB/DC plan (within the meaning of §1.401(a)(4)-9(a)) satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) also may not be used in determining employee benefit percentages, regardless of whether such percentages are determined on a contributions or benefits basis. See §1.401(a)(4)-9(b)(2)(v)(B). Thus, for example, alternative actuarial assumptions available under §1.401(a)(4)-3(d)(5)(iv)(B) may not be used unless they are standard interest rates or mortality assumptions based on a standard mortality table (as defined in §1.401(a)(4)-12) plan provisions providing for actuarial increases after normal retirement age under §1.401(a)(4)-3(f)(3) may not be disregarded, and benefits may not be determined other than on a plan-year basis under §1.401(a)(4)-3(f)(6). Further, as noted in paragraph (d)(2) of this section, the amount of benefits derived from employee contributions not allocated to a separate account must be determined under the method in §1.401(a)(4)-6(b)(1) (section 411(c) method), (b)(4) (grandfather rule for plans in existence on May 14, 1990), (b)(5) (government plan method), or (b)(6) (cessation-of-employee-contributions method). See paragraph (e)(5) of this section,



however, for an optional rule permitting certain of these optional methods and rules to be used when employee benefit percentages are determined separately with respect to defined benefit and defined contribution plans in the testing group.

(9) Determination of testing age--(i) General rule. For purposes of this section, an employee's testing age must be determined under this definition of testing age in §1.401(a)(4)-12 as if all plans in the testing group were a single plan. Thus, for example, in determining the increase in an employee's normalized accrued benefit for a relevant plan year for purposes of paragraph (d)(6)(i) of this section, benefits must be normalized to the same testing age for all employees, and the same testing age must be used in determining the employee's equivalent accruals for purposes of paragraph (d)(6)(ii) of this section.

(ii) Different ages permitted under certain conditions. Notwithstanding paragraph (d)(9)(i) of this section, employee benefit percentages may be determined using the respective testing ages determined for each plan in the testing group, if it is reasonable to believe that use of the different testing ages for different plans does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using a single testing age for all plans in the testing group.

(e) Additional optional rules--(1) Overview. This paragraph (e) contains various optional rules that may be used, alone or in combination, by an employer in determining employee benefit percentages for a testing period. Except as specifically provided, each optional rule used for a testing period must be applied, to the extent possible, on a consistent basis in determining the employee benefit percentages of all employees under all plans in the testing group for that testing period. It is not necessary, however, that a rule be used



consistently from testing period to testing period. The rules in this paragraph (e) supplement and do not replace the rules in paragraph (d) of this section. Thus, for example, unless otherwise provided, the rules of paragraph (d)(7) of this section (regarding plans providing subsidized early retirement benefits) and of paragraph (d)(8) of this section (restricting the use of optional methods provided in the section 401(a)(4) regulations) continue to apply.

(2) Determination of employee benefit percentages as sum of separately determined rates--(i) General rule. If employee benefit percentages are determined on a contributions basis, an employer may substitute the sum of an employee's separately-determined allocation or equivalent allocation rates for the testing period under all plans in the testing group for the percentage amount determined in paragraph (d)(5)(vi) of this section. Similarly, if employee

benefit percentages are determined on a benefits basis, an employer may substitute the sum of an employee's separately-determined accrual or equivalent accrual rates for the testing period under all plans in the testing group for the percentage amount determined in paragraph (d)(6)(vi) of this section.

(ii) Determination of rates. For purposes of this paragraph (e)(2), an employee's allocation and accrual rates are determined under the rules of §§1.401(a)(4)-2(c)(2) and 1.401(a)(4)-3(d)(2)(i), respectively, and an employee's equivalent accrual and allocation rates are determined under the rules of §§1.401(a)(4)-8(b)(2)(i) and (c)(2)(i), respectively. If paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, an employee's most valuable accrual and most valuable equivalent allocation rates, as determined under §§1.401(a)(4)-3(d)(2)(ii) and



1.401(a)(4)-8(c)(2)(ii), must be substituted for the employee's accrual and equivalent allocation rates.

(iii) Treatment of permitted disparity. Permitted disparity may be taken into account in determining an employee's actual or equivalent accrual or allocation rates to the extent allowed under the rules of §1.401(a)(4)-7. If permitted disparity is taken into account in determining an employee's actual or equivalent accrual or allocation rate under any one plan in the testing group, it may not be taken into account in determining the employee's actual or equivalent accrual or allocation rates under any other plan in the testing group.

(iv) Determination of compensation--(A) Plan year compensation used as testing compensation. If employee benefit percentages are determined on a benefits basis, an employee's plan year compensation must be used for purposes of §1.401(a)(4)-3(e)(3)(i) as the employee's testing compensation in determining the employee's actual or equivalent accrual rates for purposes of this paragraph (e)(2).

(B) Consistency requirement. Under the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, the same period must generally be used to determine each employee's plan year compensation used in determining the employee's actual and equivalent allocation and accrual rates under paragraph (e)(2)(ii) of this section under all plans in the testing group. This consistency requirement is not treated as violated, however, merely because the periods for determining employees' plan year compensation differ for different plans in the testing group because the plans have different plan years. Furthermore, this consistency requirement is not treated as violated merely because different optional determination periods permitted under the definition of plan year compensation in



§1.401(a)(4)-12 (e.g., the plan year or a 12-month period ending in the plan year) are used in determining employees' actual or equivalent accrual or allocation rates under one or more plans in the testing group, provided that the period is actually used in determining whether the plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) for the relevant plan year.

(3) Determination of employee benefit percentages without regard to plans of a different type--(i) General rule. An employer may determine employee benefit percentages under plans of one type (i.e., defined benefit or defined contribution plans) without regard to plans of a different type (i.e., defined contribution or defined benefit plans, respectively), using the method provided in this paragraph (e)(3). If this method is used to determine whether a defined benefit plan satisfies the average benefit percentage test, employee benefit percentages under all defined benefit plans in the testing group must be determined on a benefits basis, and all allocations under any defined contribution plans in the same testing group must be treated as zero. Thus, for example, if all of the defined contribution plans in a testing group satisfy the ratio percentage test of §1.410(b)-2(b)(2), these plans are not required to satisfy the average benefit percentage test, and are also disregarded in determining whether any defined benefit plans in the testing group satisfy the average benefit percentage test. If this method is used to determine whether a defined contribution plan satisfies the average benefit percentage test, employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis, and all benefits under any defined benefit plans in the same testing group must be treated as zero. Employees may not be treated as excludable employees solely because they are deemed to

receive no benefit accrual or allocation under a plan under this optional method. This optional method may not be used for a testing period if any of the plans in the testing group relies on any of the cross-testing methods provided in §1.401(a)(4)-8(b)(2) or (c)(2) to satisfy section 401(a)(4) for a relevant plan year.

(ii) Effect of use of separate testing group determination method. A plan does not satisfy the average benefit percentage test using the method provided in this paragraph (e)(3) unless each of the plans of the employer of a different type (i.e., defined benefit plan or defined contribution plan) than the plan being tested satisfies the average benefit test of §1.410(b)-2(b)(3) using this method or satisfies the ratio percentage test of §1.410(b)-2(b)(2).

(iii) Treatment of permitted disparity--(A) Plans of both types using method. If the method provided in this paragraph (e)(3) is used to determine whether one or more defined benefit plans and one or more defined contribution plans in a testing group satisfy the average benefit percentage test, permitted disparity may generally be taken into account, to the extent permitted under this section, in determining employee benefit percentages with respect to both the group of defined benefit plans in the testing group and the group of defined contribution plans in the testing group. If any employee benefits under both a defined benefit and a defined contribution plan in the testing group in the testing period, however, permitted disparity may be taken into account for any employee in any plan in the testing group only with respect to the group of defined benefit plans in the testing group, or with respect to the group of defined contribution plans in the testing group, but not both.

(B) Plans of only one type using method. If the method in this paragraph (e)(3) is used to determine whether one or more defined benefit plans or one or more defined



contribution plans in a testing group, but not plans of both types, satisfy the average benefit percentage test (for example, where each plan in one group of plans satisfies the ratio percentage test of §1.410(b)-2(b)(2)), permitted disparity may be taken into account in determining employee benefit percentages under the group of plans subject to the average benefit percentage test only for those employees with respect to whom permitted disparity is not taken into account (i.e., either under section 401(*l*) or §1.401(a)(4)-7), in testing any plans in the other group for nondiscrimination under section 401(a)(4). For this purpose, permitted disparity is treated as taken into account with respect to all employees benefiting under a section 401(*l*) plan.

(iv) Consistency rules. If the method in this paragraph (e)(3) is used, the consistency requirement of paragraphs (d)(8) and (e)(1) of this section may be applied separately with respect to the group of defined benefit plans and the group of defined contribution plans in the testing group.

(v) Example. Employer A maintains two defined benefit plans, neither of which covers a group of employees that satisfies the ratio percentage test of §1.410(b)-2(b)(2), and a profit-sharing plan and a section 401(k) plan, each of which benefits a group of employees that satisfies the ratio percentage test of §1.410(b)-2(b)(2). The defined benefit plans will satisfy the average benefit percentage test if the ratio of the actual benefit percentages of all nonexcludable nonhighly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan, is at least 70 percent of the actual benefit percentage of all nonexcludable highly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan.

(4) Accrued-to-date method--(i) General rule. An employer may use the accrued-to-date method to determine an employee's employee benefit percentage on a benefits basis under paragraph (d)(6) of this section. If this method is used, the accrual used in paragraph (d)(6)(i) and (v) of this section is replaced with the amount determined for the employee



under §1.401(a)(4)-3(d)(3)(i)(A) through (C) (or, if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, the largest amount determined for the employee under §1.401(a)(4)-3(d)(3)(ii)(A) through (E)). Also, the allocations used in paragraphs (d)(6)(ii) and (d)(6)(v) of this section are replaced by the employee's adjusted account balance, as defined in §1.401(a)(4)-8(b)(2)(ii)(C), divided by the employee's testing service, as defined in §1.401(a)(4)-12. Finally, the employee's plan year compensation (modified as provided in §1.401(a)(4)-3(e)(3)(ii)) is used in lieu of the employee's plan year compensation in paragraphs (d)(6)(iii) and (d)(6)(v) of this section.

(ii) Application to separate rate method. If the accrued-to-date method provided in this paragraph (e)(4) is used in combination with the optional rule for determining employee benefit percentages as the sum of separately determined rates provided in paragraph (e)(2) of this section, an employee's actual and equivalent accrual rates must be determined using the accrued-to-date method in §§1.401(a)(4)-3(d)(3)(i) (or, if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, §1.401(a)(4)-3(d)(3)(ii)) and 1.401(a)(4)-8(b)(2)(ii), respectively.

(iii) Treatment of permitted disparity. If the accrued-to-date method provided in this paragraph (e)(4) is used, disparity must be imputed, if at all, using the accrued-to-date method in §1.401(a)(4)-7(c)(4)(iv)(D). In imputing permitted disparity for this purpose, the employee's plan year compensation, modified as provided in §1.401(a)(4)-3(e)(3)(ii), must be used, notwithstanding §1.401(a)(4)-7(c)(4)(vi) (generally requiring the use of average annual compensation).

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(iv) Uniform testing service assumption. If the average of the testing service as defined in §1.401(a)(4)-12 for the nonhighly compensated employees in a plan in the testing group is no greater than the average of the testing service for the highly compensated employees in that plan, an employer may assume that all employees in that plan have the same number of years of testing service for purposes of dividing an employee's benefit or adjusted account balance under that plan by the employee's testing service in paragraph (e)(4)(i) of this section. The years of testing service selected must be a reasonable approximation of the average testing service of either the highly compensated employees or the nonhighly compensated employees, or an amount in between.

(v) Fresh-start alternative. The consistency requirements of paragraphs (d)(8) and (e)(1) of this section are not violated merely because the option to disregard allocations made or benefits accrued for plan years that begin before a fresh-start date described in §§1.401(a)(4)-3(d)(6)(vii) or 1.401(a)(4)-8(b)(2)(ii)(B) is used by some but not all plans in the testing group, or if different fresh-start dates are used by different plans in the testing group. In applying §1.401(a)(4)-3(d)(6)(vii) to determine an employee's employee benefit percentage, any adjustments provided for under §1.401(a)(4)-13(d) are not included in the frozen accrued benefit as of the fresh-start date under §1.401(a)(4)-3(d)(6)(vii)(B)(2) (or §1.401(a)(4)-3(d)(6)(vii)(C)(2) if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking into account early retirement benefits), unless the only plans included in the testing group are defined benefit plans, or the option provided in this paragraph (e)(4) is applied solely to defined benefit plans tested under the method in paragraph (e)(3) of this section.

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(5) Optional computation methods provided under section 401(a)(4). If the only plans included in the testing group are defined benefit plans (or the option is applied solely to defined benefit plans tested under the method in paragraph (e)(3) of this section), and if employee benefit percentages under these defined benefit plans are determined on a benefits basis, then, notwithstanding the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, any of the optional methods for determining the accruals, compensation and other items that are used in determining employee benefit percentages under this section that would be available in determining whether a plan satisfies the nondiscriminatory amount requirement of §1.401(a)(4)-1(b)(2) may also be used for purposes of this section. Thus, for example, if the conditions on use of the option in this paragraph (e)(5) are satisfied, employee benefit percentages may be determined using any of the alternative actuarial assumptions permitted under §1.401(a)(4)-3(d)(5)(iv)(B); plan provisions providing for an actuarial increase in benefits after normal retirement age under §1.401(a)(4)-3(f)(3) may be disregarded; and accruals may be determined other than on a plan year basis under §1.401(a)(4)-3(f)(6). In addition, if the conditions on use of the option in this paragraph (e)(5) are satisfied, the safe harbor methods of §1.401(a)(4)-6(b)(2) (composition-of-workforce method) or (b)(3) (minimum benefit method) may be used in determining employees' accrual rates for purposes of paragraph (e)(2)(ii) of this section. As noted in paragraph (d)(8)(i) of this section, except as otherwise provided in this section, optional



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methods for adjusting employees' actual or equivalent normal or most valuable accrual rates are not available in determining employee benefit percentages.

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(6) Alternative annual method for determining employee benefit percentages for certain defined benefit plans. An employer may substitute for the increase in an employee's normalized accrued benefit under a plan for the relevant plan year in paragraphs (d)(6)(i) and (v) of this section an amount determined by: determining the ratio of the normalized accrued benefit in §1.401(a)(4)-3(d)(2)(i)(D) to the employee's testing compensation as defined in §1.401(a)(4)-3(e)(3) for the prior relevant plan year, and the ratio of the normalized accrued benefit in §1.401(a)(4)-3(d)(2)(i)(C) to the employee's testing compensation for the current relevant plan year; determining the excess (if any) of the second ratio over the first ratios; and multiplying the difference by the employee's testing compensation for the current relevant plan year. If paragraph (d)(7)(i) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, the employer must substitute the largest of the sums of the normalized QJSAs and QSUPPs determined for each age in §1.401(a)(4)-3(d)(2)(ii)(C) for the normalized accrued benefit for the current relevant plan year, and the largest of the sums of the normalized QJSAs and QSUPPs determined for each age in §1.401(a)(4)-3(d)(2)(ii)(D) for the normalized accrued benefit for the prior relevant plan year in the previous sentence. If this method is used, the testing compensation used in determining the increase in an employee's normalized accrued benefit must also be used, subject to the requirements of paragraph (e)(10) of this section, for purposes of paragraph (d)(6)(iii) of this section. This method may not be used unless the only plans included in the testing group are defined benefit plans (or the method is applied to defined benefit plans tested under the method in paragraph (e)(3) of this section), and

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employee benefit percentages under these defined benefit plans are determined on a benefits basis.

(7) Alternative method for converting benefits to contributions. An employer may convert an employee's most valuable accruals under a defined benefit plan for a relevant plan year into equivalent most valuable allocations for purposes of paragraph (d)(5)(ii) and (v) of this section using the method used by the employer for determining any increase in current liability (as defined in section 412(*l*)(7)) that are attributable to the employee for the year. For this purpose, current liability may include amounts attributable to projected accruals for the relevant plan year for which the determination of current liability is being made, if the projections are made on a reasonable basis applied consistently from year to year. Thus, for example, an employer may treat any increase in current liability attributable to an employee under a plan from one relevant plan year to the next as the employee's equivalent most valuable allocation for the second year.

(8) Imputation of permitted disparity--(i) Use of excess benefit and gross benefit percentages. An employee's excess benefit percentage under a defined benefit excess plan, or gross benefit percentage under an offset plan, multiplied by the employee's average annual compensation used under the plan in determining benefit accruals, may be substituted for the amount determined under paragraph (d)(6)(i) of this section as provided in this paragraph (e)(8)(i). If the option in paragraph (e)(2) of this section is used, permitted disparity may be taken into account under paragraph (e)(2)(iii) of this section by substituting an employee's excess benefit percentage or gross benefit percentage for the rate that would otherwise be

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determined under paragraph (e)(2)(iii) of this section. Neither of these methods may be used unless--

(A) The only plans included in the testing group are defined benefit plans (or the method is applied to defined benefit plans tested under the method in paragraph (e)(3) of this section, and those plans are allowed to impute permitted disparity under that paragraph), and employee benefit percentages under these defined benefit plans are determined on a benefits basis.

(B) Employee benefit percentages under the plans in the testing group are not required to be determined by taking into account early retirement benefits under paragraph (d)(7) of this section.

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(C) The defined benefit excess plan or offset plan either is a section 401(*l*) plan that satisfies the ratio percentage test of §1.410(b)-2(b)(2), or consists exclusively of component plans (as defined in §1.401(a)(4)-9(c)) each of which is a section 401(*l*) plan that separately satisfies the ratio percentage test of §1.410(b)-2(b)(2).

(D) Permitted disparity is imputed, to the extent possible, under paragraph (d)(6)(iv) of this section (or paragraph (e)(2)(iii) of this section, if applicable) with respect to all other defined benefit plans in the testing group, but only for employees not benefiting under the defined benefit excess plan or offset plan.

(ii) Uniform compensation assumption. For purposes of imputing disparity under paragraphs (d)(5)(iv) and (d)(6)(iv) of this section, the compensation of an employee who is benefiting only under one or more plans in the testing group that do not determine benefit accruals or allocations by reference to individual employees' compensation (for example,



plans granting flat dollar accruals for each year of service) may be deemed to be equal to the average compensation of all nonexcludable employees benefiting under such plans. This average must be determined using the method actually used to determine the employee's compensation for purposes of this section, or, if none, any other uniform method permitted under this section. In addition, the covered compensation of the employee may be determined based on the average age of all such nonexcludable employees benefiting under such plans. Covered compensation is defined in §1.401(*l*)-1(c)(7).

(9) Three-year averaging period--(i) General rule. An employer may determine an employee's employee benefit percentage for a testing period as the average of the employee's employee benefit percentages determined separately for the testing period and for the immediately preceding one or two testing periods (referred to in this section as an "averaging period").

(ii) Consistency rule. Employee benefit percentages of a particular employee that are averaged together within an averaging period must be determined on a consistent basis. Thus, for example, they must be determined as a percentage of the same definition of compensation.

(10) Alternative methods of determining compensation--(i) Use of average annual compensation. If employee benefit percentages are determined on a benefits basis (or the option provided in this paragraph (e)(10)(i) is applied exclusively to defined benefit plans tested on a benefits basis under the method in paragraph (e)(3) of this section), an employee's average annual compensation as defined in §1.401(a)(4)-3(e)(2) may be used in



lieu of plan year compensation for purposes of paragraph (d)(6)(iii), (e)(2), or (e)(4) of this section.

(ii) Rules for determining whether alternative definitions are discriminatory. As under section 401(a)(4), an underlying definition of compensation that is not a definition described in §1.414(s)-1(c) may not be used in determining employee benefit percentages unless the definition satisfies the requirements of §1.414(s)-1(d) applicable to alternative definitions of compensation, including the nondiscrimination requirement of §1.414(s)-1(d)(3). All employees taken into account in determining whether the average benefit percentage test is satisfied who benefit under one or more plans in the testing group are taken into account in determining whether this nondiscrimination requirement is satisfied. See §1.414(s)-1(d)(3)(iii). The nondiscrimination requirement of §1.414(s)-1(d)(3) is deemed to be met for purposes of the average benefit percentage test, however, if it is reasonable to believe that the definition used does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using a definition that actually satisfies the nondiscrimination requirement in §1.414(s)-1(d)(3) taking into account all employees in all plans in the testing group.

(iii) Use of different definitions for different groups of employees. Notwithstanding the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, different periods for determining compensation otherwise permitted under this section, and different underlying definitions of compensation, may be used to determine employee benefit percentages for employees benefiting under different plans or groups of plans in the testing group, if both of the following requirements are satisfied--



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(A) It is reasonable to believe that use of different methods of determining compensation, or different underlying definitions of compensation, for different groups of employees does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using the same method of determining compensation, and the same underlying definition of compensation, to determine the employee benefit percentages for all employees in all plans in the testing group.

(B) If any of the underlying definitions of compensation used to measure the compensation of employees in a plan or group of plans is not described in §1.414(s)-1(c), and thus must satisfy the nondiscrimination requirement of §1.414(s)-1(d)(3), the definition would satisfy that nondiscrimination requirement if the only employees taken into account were the employees in the plan or group of plans to which the definition is applied. The special rule in paragraph (e)(10)(ii) of this section for determining whether those requirements are satisfied may not be used for this purpose.

(f) Special rule for certain collectively bargained plans. A plan (as determined without regard to the mandatory disaggregation rule of §1.410(b)-7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefit percentage test of this section if--

(1) The provisions of the plan applicable to each employee in the plan are identical to the provisions of the plan applicable to every other employee in the plan, including the plan benefit or allocation formula, any optional forms of benefit, any ancillary benefit, and any other right or feature under the plan, and

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(2) The plan would satisfy the ratio percentage test of §1.410(b)-2(b)(2), if §§1.410(b)-6(d) and 1.410(b)-7(c)(5) (the excludable employee and mandatory disaggregation rules for collectively bargained and noncollectively bargained employees) did not apply.

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§1.410(b)-6 Excludable employees.

(a) Employees--(1) In general. For purposes of applying section 410(b) with respect to employees, all employees of the employer, other than the excludable employees described in paragraphs (b) through (h) of this section, are taken into account. Excludable employees are not taken into account with respect to a plan even if they are benefiting under the plan, except as otherwise provided in paragraph (b) of this section.

(2) Rules of application. Except as specifically provided otherwise, excludable employees are determined separately with respect to each plan for purposes of testing that plan under section 410(b). Thus, in determining whether a particular plan satisfies the ratio percentage test of §1.410(b)-2(b)(2), paragraphs (b) through (h) of this section are applied solely with reference to that plan. Similarly, in determining whether two or more plans that are permissively aggregated and treated as a single plan under §1.410(b)-7(d) satisfy the ratio percentage test of §1.410(b)-2(b)(2), paragraphs (b) through (h) of this section are applied solely with reference to the deemed single plan. In determining whether a plan satisfies the average benefit percentage test of §1.410(b)-5, the rules of this section are applied by treating all plans in the testing group as a single plan.

(b) Minimum age and service exclusions--(1) In general. If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date any

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employee with the same age and service would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(2) Multiple age and service conditions. If a plan, including a plan for which an employer chooses the treatment under paragraph (b)(3) of this section, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees. Except as provided in paragraph (b)(3) of this section, an employee who satisfies any one of the different sets of conditions is not an excludable employee.

(3) Plans benefiting certain otherwise excludable employees--(i) In general. An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. See §1.410(b)-7(c)(3) regarding permissive disaggregation of plans benefiting otherwise excludable employees. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be treated as excludable employees with respect to the plan. This treatment is available only if the plan satisfies section 410(b) and §1.410(b)-2 with respect to these otherwise excludable employees in the manner described in paragraph (b)(3)(ii) of this section.

(ii) Testing portion of plan benefiting otherwise excludable employees. In determining whether the plan that benefits employees who would otherwise be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B))



satisfies section 410(b) and §1.410(b)-2, employees who have satisfied the greatest permissible minimum age and service conditions with respect to the plan are excludable employees. In addition, if the plan being tested applies minimum age and service conditions and those conditions are less than the maximum permissible minimum age and service conditions, employees who have not satisfied the lower minimum age and service conditions actually provided for in the plan are excludable employees. Thus, for example, if the plan requires attainment of age 18 and 3 months of service, employees who have not attained age 18 or 3 months of service with the employer are excludable employees.

(4) Examples. The following examples illustrate the minimum age and service condition rules of this paragraph (b). In each example, the employer is not treated as operating qualified separate lines of business under section 414(r).

Example 1. An employer maintains Plan A for hourly employees and Plan B for salaried employees. Plan A has no minimum age or service condition. Plan B has no minimum age condition and requires 1 year of service. The employer treats Plans A and B as a single plan for purposes of section 410(b). Because Plan A imposes no minimum age or service condition, all employees of the employer automatically satisfy the minimum age and service conditions of Plan A. Therefore, no employees are excludable under this paragraph (b) in testing Plans A and B for purposes of section 410(b).

Example 2. An employer maintains three plans. Plan C benefits employees in Division C who satisfy the plan's minimum age and service condition of age 21 and 1 year of service. Plan D benefits employees in Division D who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan E benefits employees in Division E who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. The employer treats Plans D and E as a single plan for purposes of section 410(b). In testing Plan C under the ratio percentage test or the nondiscriminatory classification test of section 410(b), employees who are not at least age 21 or who do not have at least 1 year of service are excludable employees under paragraph (b)(1) of this section. In testing Plans D and E, employees who do not satisfy the age and service requirements of either of the two plans are excludable employees under paragraph (b)(2) of this section. Thus, an employee is excludable with respect to Plans D and E only if the employee is not at least age 18 with at least 1 year of service or is not at least age 21 with at least 6 months of service. Thus, an



employee who is 19 years old and has 11 months of service is excludable. Similarly, an employee who is 17 years old and has performed 2 years of service is also excludable.

Example 3. An employer maintains three plans. Plan F benefits all employees in Division F (the plan does not apply any minimum age or service condition). Plan G benefits employees in Division G who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan H benefits employees in Division H who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. In testing the employer's plans under the average benefit percentage test provided in §1.410(b)-5, Plans F, G, and H are treated as a single plan and, as such, use the lowest minimum age and service condition under the rule of paragraph (b)(2) of this section. Therefore, because Plan F does not apply any minimum age or service condition, no employee is excludable under this paragraph (b).

Example 4. An employer maintains Plan J, which does not apply any minimum age or service conditions. Plan J benefits all employees in Division 1 but does not benefit employees in Division 2. Although Plan J has no minimum age or service condition, the employer wants to exclude employees whose age and service is below the permissible minimums provided in section 410(b)(1)(A). The employer has 110 employees who either do not have 1 year of service or are not at least age 21. Of these 110 employees, 10 are highly compensated employees and 100 are nonhighly compensated employees. Five of these highly compensated employees, or 50 percent, work in Division 1 and thus benefit under Plan J. Thirty-five of these nonhighly compensated employees, or 35 percent, work in Division 1 and thus benefit under Plan J. Plan J satisfies the ratio percentage test of section 410(b) with respect to employees who do not satisfy the greatest permissible minimum age and service requirement because the ratio percentage of that group of employees is 70 percent. Thus, in determining whether or not Plan J satisfies section 410(b), the 110 employees may be treated as excludable employees in accordance with paragraph (b)(3)(i) of this section.

(c) Certain nonresident aliens--(1) General rule. An employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who receives no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from



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sources within the United States (within the meaning of section 861(a)(3)) is treated as an excludable employee.

(2) Special treaty rule. In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within

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the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (c)(2) applies only if all employees described in the preceding sentence are so excluded.

(d) Collectively bargained employees--(1) General rule. A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. If a plan (within the meaning of §410(b)-7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, §1.410(b)-7(c)(5) provides that the portion of the plan that benefits the collectively bargained employees is treated as a separate plan from the portion of the plan that benefits the noncollectively bargained employees. Thus, a collectively bargained employee is always an excludable employee with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees.

(2) Definition of collectively bargained employee--(i) In general. A collectively bargained employee is an employee who is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers. An employee is a collectively bargained employee regardless of whether the employee benefits under any plan of the employer. See

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section 7701(a)(46) and §301.7701-17T (Temporary) of this Chapter for additional requirements applicable to the collective bargaining agreement.

(ii) Special rules for certain employees who cease to be collectively bargained employees--(A) Employees who were collectively bargained employees in prior plan year. An employee who was a collectively bargained employee throughout the prior plan year, but who ceases to be a collectively bargained employee during the current plan year, may be treated as a collectively bargained employee until the end of the current plan year if the collective bargaining agreement that covers the unit of employees of which the employee was a member in the prior plan year requires the employee to benefit, in the current plan year, under a multiemployer plan maintained pursuant to the collective bargaining agreement. For plan years beginning before January 1, 1992, any employee may be treated as a collectively bargained employee for a plan year if a collective bargaining agreement required the employee to benefit, for that year, under a multiemployer plan maintained pursuant to the collective bargaining agreement.

(B) Employees who were collectively bargained employees during a portion of the current plan year. An employee who performs services for an employer that is a party to a collective bargaining agreement that requires the employee to benefit under a multiemployer plan both as a collectively bargained employee and as a noncollectively bargained employee during a plan year may be treated as a collectively bargained employee with respect to all of the employee's hours of service during the plan year provided that at least half of the employee's hours of service during the plan year are performed as a collectively bargained employee.

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(C) Consistency requirement. The rules in paragraphs (d)(2)(i) and (ii) of this section must be applied to all employees on a reasonable and consistent basis for the plan year.

(iii) Covered by a collective bargaining agreement--(A) General rule. For purposes of paragraph (d)(2)(i) of this section, an employee is included in a unit of employees covered by

a collective bargaining agreement if and only if the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement under which the plan is maintained. Thus, for example, an employee of either a plan or the employee representative that is a party to the collective bargaining agreement under which the plan is maintained is not included in a unit of employees covered by the collective bargaining agreement under which the plan is maintained merely because the employee is covered under the plan pursuant to an agreement entered into by the plan or employee representative on behalf of the employee (other than in the capacity of an employee representative with respect to the employee). This is the case even if all of such employees benefiting under the plan constitute only a de minimis percentage of the total employees benefiting under the plan.

(B) Plans covering professional employees--(1) In general. An employee is not considered included in a unit of employees covered by a collective bargaining agreement for a plan year for purposes of paragraph (d)(2)(iii)(A) of this section if, for the plan year, more than 2 percent of the employees who are covered pursuant to the agreement are professionals. This rule applies to all employees under the agreement, nonprofessionals as well as professionals. Thus, no employees covered by such an agreement are excludable employees with respect to employees who are not covered by a collective bargaining agreement.

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(2) Multiple collective bargaining agreements. This paragraph (d)(2)(iii)(B) is applied separately with respect to each collective bargaining agreement. Thus, for example, if a plan benefits two groups of employees, one included in a unit of employees covered by collective bargaining agreement X, more than 2 percent of whom are professionals, and another included in a unit of employees covered by collective bargaining agreement Y, none of whom are professionals, the group covered by agreement X is not considered covered by a collective bargaining agreement and the group covered by agreement Y is considered covered by a collective bargaining agreement.

(3) Application of minimum coverage tests. If a plan covers more than 2 percent professional employees, no employees in the plan are treated as covered by a collective bargaining agreement. A plan that covers more than 2 percent professional employees must satisfy section 410(b) without regard to section 413(b) and the special rule in §1.410(b)-2(b)(7) of this section (regarding collectively bargained plans). In such cases, all nonexcludable employees must be taken into account. For this purpose, employees included in other collective bargaining units are excludable employees. However, the employees who are not covered by a collective bargaining agreement and the employees who are covered by an agreement that has more than 2 percent professionals are not excludable employees.

(iv) Examples. The following examples illustrate the collective bargaining unit rules of this section.

Example 1. An employer has 700 collectively bargained employees (none of whom is a professional employee) and 300 noncollectively bargained employees (200 of whom are highly compensated employees). For purposes of applying the ratio percentage test of §1.410(b)-2(b)(2) to Plan X, which benefits only the 300 noncollectively bargained employees, the 700 collectively bargained employees are treated as excludable employees pursuant to paragraph (d) of this section.

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Example 2. (i) An employer has 1,500 employees in the following categories:

| | Noncollectively Bargained Employees | Collectively Bargained Employees | Total |
|---|---|---|---|
| Highly Compensated Employees | 100 | 100 | 200 |
| Nonhighly Compensated Employees | 900 | 400 | 1,300 |
| Total | 1,000 | 500 | 1,500 |

The employer maintains Plan Y, which benefits 1,100 employees, including all of the noncollectively bargained employees (except for 100 nonhighly compensated employees who are noncollectively bargained employees), and 200 of the collectively bargained employees (including the 100 highly compensated employees who are collectively bargained employees). There are no professional employees covered by the collective bargaining agreement. In accordance with §1.410(b)-7(c)(5), the employer must apply the ratio percentage test of §1.410(b)-2(b)(2) to Plan Y as if the plan were two separate plans, one benefiting the noncollectively bargained employees and the other benefiting the collectively bargained employees.

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(ii) In testing the portion of Plan Y that benefits the noncollectively bargained employees, the collectively bargained employees are excludable employees. That portion's ratio percentage is 88.89 percent ([800/900] / [100/100] = 88.89%/100% = 0.8889), and thus it satisfies the ratio percentage test. The portion of Plan Y that benefits collectively bargained employees automatically satisfies section 410(b) under the special rule in §1.410(b)-2(b)(7).

(e) Employees of qualified separate lines of business. If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), in testing a plan that benefits the employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. The rule in this paragraph (e) does not apply for purposes of satisfying the nondiscriminatory classification requirement of section 410(b)(5)(B).

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(f) Certain terminating employees--(1) In general. An employee may be treated as an excludable employee for a plan year with respect to a particular plan if--

(i) The employee does not benefit under the plan for the plan year,

(ii) The employee is eligible to participate in the plan,

(iii) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(iv) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(v) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (f)(1)(v), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(vi) If this paragraph (f) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(2) Hours of service. For purposes of this paragraph (f), the term "hours of service" has the same meaning as provided for such term by 29 CFR 2530.200b-2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29

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CFR 2530.200b-3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(3) Examples. The following examples illustrate the provision of this paragraph (f).

Example 1. An employer has 35 employees who are eligible to participate under a defined contribution plan. The plan provides that an employee will not receive an allocation of contributions for a plan year unless the employee is employed by the employer on the last day of the plan year. Only 30 employees are employed by the employer on the last day of the plan year. Two of the five employees who terminated employment before the last day of the plan year had 500 or fewer hours of service during the plan year, and the remaining three had more than 500 hours of service during the year. Of the five employees who were no longer employed on the last day of the plan year, the two with 500 hours of service or less during the plan year are treated as excludable employees for purposes of section 410(b), and the remaining three who had over 500 hours of service during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer has 30 employees who are eligible to participate under a defined contribution plan. The plan requires 1,000 hours of service to receive an allocation of contributions or forfeitures. Ten employees do not receive an allocation because of their failure to complete 1,000 hours of service. Three of the 10 employees who failed to satisfy the minimum service requirement completed 500 or fewer hours of service and terminated their employment. Two of the employees completed more than 500, but fewer than 1,000 hours of service and terminated their employment. The remaining five employees did not terminate employment. Under the rule in paragraph (f) of this section, the three terminated employees who completed 500 or fewer hours of service are treated as excludable employees for the portion of the plan year they are employed. The other seven employees who do not receive an allocation are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 3. An employer maintains two plans, Plan A for salaried employees and Plan B for hourly employees. Of the 100 salaried employees, two do not receive an allocation under Plan A for the plan year because they terminate employment before completing 500 hours of service. Of the 300 hourly employees, 50 do not receive an allocation under Plan B for the plan year because they terminate employment before completing 500 hours. In applying section 410(b) to Plan A, the two employees who did not receive an allocation under Plan A are excludable employees, but the 50 who did not receive an allocation under Plan B are not excludable employees, because they were not eligible to participate under Plan A.



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(g) Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan. For purposes of testing a section 401(k) plan or a section 401(m) plan that consists solely of employer matching contributions that are tied to elective contributions under a section 401(k) plan, an employer may treat as excludable those employees of governmental or tax-exempt entities who are precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B), if more than 95 percent of the employees of the employer who are not precluded from being eligible employees by section 401(k)(4)(B) benefit under the plan for the plan year.

(h) Former employees--(1) In general. For purposes of applying section 410(b) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (h)(2) or (h)(3) of this section as an excludable former employee. If either (or both) of the former employee exclusion rules under paragraphs (h)(2) and (h)(3) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) Employees terminated before a specified date. The employer may treat a former employee as excludable if--

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.



(3) Previously excludable employees. The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (b) through (g) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (h)(3), the former employee is not taken into account with respect to a plan even if the former employee is benefiting under the plan.



§1.410(b)-7 Definition of plan and rules governing plan disaggregation and aggregation.

(a) In general. This section provides a definition of "plan." First, this section sets forth a definition of plan within the meaning of section 401(a) or 403(a). Then certain mandatory disaggregation and permissive aggregation rules are applied. The result is the definition of plan that applies for purposes of sections 410(b) and 401(a)(4). Thus, in general, the term "plan" as used in this section initially refers to a plan described in section 414(*l*) and to an annuity plan described in section 403(a), and the term "plan" as used in other sections under these regulations means the plan determined after application of this section. Paragraph (b) of this section provides that each single plan under section 414(*l*) is treated as a single plan for purposes of section 410(b). Paragraph (c) of this section describes the rules for certain plans that must be treated as comprising two or more separate plans, each of which is a single plan subject to section 410(b). Paragraph (d) of this section provides a rule permitting an employer to aggregate certain separate plans to form a single plan for purposes of section 410(b). Paragraph (e) of this section provides rules for determining the testing group of plans taken into account in determining whether a plan satisfies the average benefit percentage test of §1.410(b)-5.

(b) Separate asset pools are separate plans. Each single plan within the meaning of section 414(*l*) is a separate plan for purposes of section 410(b). See §1.414(*l*)-1(b). For example, if only a portion of the assets under a defined benefit plan is available, on an ongoing basis, to provide the benefits of certain employees, and the remaining assets are available only in certain limited cases to provide such benefits (but are available in all cases for the benefit of other employees), there are two separate plans. Similarly, the defined



contribution portion of a plan described in section 414(k) is a separate plan from the defined

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benefit portion of that same plan. A single plan under section 414(*l*) is a single plan for purposes of section 410(b), even though the plan comprises separate written documents and separate trusts, each of which receives a separate determination letter from the Internal Revenue Service. A defined contribution plan does not comprise separate plans merely because it includes more than one trust, or merely because it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are separately invested in individual insurance or annuity contracts for employees.

(c) Mandatory disaggregation of certain plans--(1) Section 401(k) and 401(m) plans. The portion of a plan that is a section 401(k) plan and the portion that is not a section 401(k) plan are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that is a section 401(m) plan and the portion that is not a section 401(m) plan are treated as separate plans for purposes of section 410(b). Thus, a plan that consists of elective contributions under a section 401(k) plan, employee and matching contributions under a section 401(m) plan, and contributions other than elective, employee, or matching contributions is treated as three separate plans for purposes of section 410(b). In addition, the portion of a plan that consists of contributions described in §1.401(k)-1(b)(4)(iv) (i.e., contributions that fail to satisfy the allocation or compensation requirements applicable to elective contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b).



(2) ESOPs and non-ESOPs. The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b), except as otherwise permitted under §54.4975-11(e) of this Chapter.

(3) Plans benefiting otherwise excludable employees. If an employer applies section 410(b) separately to the portion of a plan that benefits only 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), the plan is treated as comprising separate plans, one benefiting the employees who have satisfied the lower minimum age and service conditions but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See §1.410(b)-6(b)(3)(ii) for rules about testing otherwise excludable employees.

(4) Plans benefiting employees of qualified separate lines of business. If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the portions of the same plan that benefit employees of the other qualified separate lines of business of the employer. If a plan satisfies the reasonable classification requirement of §1.410(b)-4(b) before the application of this paragraph (c)(4), then any portion of that plan that is treated as a separate plan as a result of the application of this paragraph (c)(4) is deemed to satisfy that requirement.

(5) Plans benefiting collectively bargained employees. The portion of a plan that benefits collectively bargained employees is treated as a separate plan from the portion of the



same plan that benefits noncollectively bargained employees. In addition, the portion of a plan that benefits collectively bargained employees covered under one collective bargaining agreement is treated as a separate plan from the portion of the same plan that benefits collectively bargained employees covered another collective bargaining agreement.

(6) Plans maintained by more than one employer. If a plan benefits employees of more than one employer, the plan is treated as comprising separate plans each of which is maintained by a separate employer and must satisfy section 410(b) by reference only to such employer's employees.

(d) Permissive aggregation for ratio percentage and nondiscriminatory classification tests--(1) In general. Except as provided in paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the ratio percentage test of §1.410(b)-2(b)(2) or the nondiscriminatory





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classification test of §1.401(b)-4, an employer may designate two or more separate plans (determined after application of paragraph (b) of this section) as a single plan. If an employer treats two or more separate plans as a single plan under this paragraph, the plans must be treated as a single plan for all purposes under sections 401(a)(4) and 410(b).

(2) Rules of disaggregation. An employer may not aggregate portions of a plan that are disaggregated under the rules of paragraph (c) of this section. Similarly, an employer may not aggregate two or more separate plans that would be disaggregated under the rules of paragraph (c) of this section if they were portions of the same plan. In addition, an employer may not aggregate an ESOP with another ESOP, except as permitted under §54.4975-11(e) of this Chapter.

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(3) Duplicative aggregation. A plan may not be combined with two or more plans to form more than one single plan. Thus, for example, an employer that maintains plans A, B, and C may not aggregate plans A and B and plans A and C to form two single plans. However, the employer may apply the permissive aggregation rules of this paragraph (d) to form any one (and only one) of the following combinations: plan ABC, plans AB and C, plans AC and B, or plans A and BC.

(4) Special rule for plans benefiting employees of a qualified separate line of business. For purposes of paragraph (d)(1) of this section, an employer is permitted to aggregate the portions of two or more plans that benefit employees of the same qualified separate line of business, regardless of whether the employer aggregates the portions of the same plans that benefit employees of the other qualified separate lines of business of the employer. Thus, the employer is permitted to apply paragraph (d)(1) of this section with respect to two or more separate plans determined after the application of paragraphs (b) and (c)(5) of this section. In all other respects, the provisions of this paragraph (d) regarding permissive aggregation apply, including (but not limited to) the disaggregation rules under paragraph (d)(2) of this section (including the mandatory disaggregation rule of paragraph (c)(5) of this section) and the prohibition on duplicative aggregation under paragraph (d)(3) of this section. This paragraph (d)(4) applies only in the case of an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r).

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(5) Same plan year requirement. Two or more plans may not be aggregated and treated as a single plan under this paragraph (d) unless they have the same plan year. See §1.410(b)-10 for a special effective date.

(e) Determination of plans in testing group for average benefit percentage test--(1) In general. For purposes of applying the average benefit percentage test of §1.410(b)-5 with respect to a plan, all plans in the testing group must be taken into account. For this purpose, the plans in the testing group are the plan being tested and all other plans of the employer that could be permissively aggregated with that plan under paragraph (d) of this section (determined without regard to paragraph (d)(5) of this section and by applying paragraph (d)(2) of this section without regard to paragraphs (c)(1) through (c)(3) of this section).

(2) Example. The following example illustrates the rules of this paragraph (e).

Example. Employer X is treated as operating two qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), QSLOB1 and QSLOB2. Employer X maintains the following plans:

(a) Plan A, the portion of Employer X's employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB1,

(b) Plan B, the portion of Employer X's employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB2,

(c) Plan C, a defined benefit plan that benefits all hourly noncollectively bargained employees of QSLOB1,

(d) Plan D, a defined benefit plan that benefits all collectively bargained employees of QSLOB1,

(e) Plan E, an ESOP that benefits all noncollectively bargained employees of QSLOB1,

(f) Plan F, a profit-sharing plan that benefits all salaried noncollectively bargained employees of QSLOB1.

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Assume that Plan F does not satisfy the ratio percentage test of §1.410(b)-2(b)(2), but does satisfy the nondiscriminatory classification test of §1.410(b)-4. Therefore, to satisfy section



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410(b), Plan F must satisfy the average benefit percentage test of §1.410(b)-5. The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of §1.410(b)-5 are Plans A, C, E, and F.

(f) Section 403(b) plans. In determining whether a plan satisfies section 410(b), a plan subject to section 403(b)(12)(A)(i) is disregarded. However, in determining whether a plan subject to section 403(b)(12)(A)(i) satisfies section 410(b), plans that are not subject to section 403(b)(12)(A)(i) may be taken into account.



§1.410(b)-8 Additional rules.

(a) Testing methods--(1) In general. A plan must satisfy section 410(b) for a plan year using one of the testing options in paragraphs (a)(2) through (a)(4) of this section. Whichever testing option is used for the plan year must also be used for purposes of applying section 401(a)(4) to the plan for the plan year. The annual testing option in paragraph (a)(4) of this section must be used in applying section 410(b) to a section 401(k) plan or a section 401(m) plan, and in applying the average benefit percentage test of §1.410(b)-5. For purposes of this paragraph (a), the plan provisions and other relevant facts as of the last day of the plan year regarding which employees benefit under the plan for the plan year are applied to the employees taken into account under the testing option used for the plan year. For this purpose, amendments retroactively correcting a plan in accordance with §1.401(a)(4)-11(g) are taken into account as plan provisions in effect as of the last day of the plan year.

(2) Daily testing option. A plan satisfies section 410(b) for a plan year if it satisfies §1.410(b)-2 on each day of the plan year, taking into account only those employees (or former employees) who are employees (or former employees) on that day.

(3) Quarterly testing option. A plan is deemed to satisfy section 410(b) for a plan year if the plan satisfies §1.410(b)-2 on at least one day in each quarter of the plan year, taking into account for each of those days only those employees (or former employees) who are employees (or former employees) on that day. The preceding sentence does not apply if the plan's eligibility rules or benefit formula operate to cause the four quarterly testing days



selected by the employer not to be reasonably representative of the coverage of the plan over the entire plan year.

(4) Annual testing option. A plan satisfies section 410(b) for a plan year if it satisfies §1.410(b)-2 as of the last day of the plan year, taking into account all employees (or former employees) who were employees (or former employees) on any day during the plan year.

(5) Example. The following example illustrates this paragraph (a).

Example. Plan A is a defined contribution plan that is not a section 401(k) plan or a section 401(m) plan, and that conditions allocations on an employee's employment on the last day of the plan year. Plan A is being tested for the 1995 calendar plan year using the daily testing option in paragraph (a)(2) of this section. In testing the plan for compliance with section 410(b) on March 11, 1995, Employee X is taken into account because he was an employee on that day and was not an excludable employee with respect to Plan A on that day. Employee X was a participant in Plan A on March 11, 1995, was employed on December 31, 1995, and received an allocation under Plan A for the 1995 plan year. Under these facts, Employee X is treated as benefiting under Plan A on March 11, 1995, even though Employee X had not satisfied all of the conditions for receiving an allocation on that day, because Employee X satisfied all of those conditions as of the last day of the plan year.

(b) Family member aggregation rule. For purposes of section 410(b), and in accordance with section 414(q)(6), a highly compensated employee who is a 5-percent owner or one of the ten most highly compensated employees and any family member (or members) of such a highly compensated employee who is also an employee of the employer are to be treated as a single highly compensated employee. If any member of that group is benefiting under a plan, the deemed single employee is treated as benefiting under the plan. If no member of that group is benefiting under a plan, the deemed single employee is treated as not benefiting under the plan.



§1.410(b)-9 Definitions.

In applying this section and §§1.410(b)-2 through 1.410(b)-10, the definitions in this section govern unless otherwise provided.

Collectively bargained employee. "Collectively bargained employee" means a collectively bargained employee within the meaning of §1.410(b)-6(d)(2).

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Defined benefit excess plan. "Defined benefit excess plan" means a defined benefit excess plan as defined in §1.401(*l*)-1(c)(16)(i).

Defined benefit plan. "Defined benefit plan" means a defined benefit plan within the meaning of section 414(j). The portion of a plan described in section 414(k) that does not consist of separate accounts is treated as a defined benefit plan.

Defined contribution plan. "Defined contribution plan" means a defined contribution plan within the meaning of section 414(i). The portion of a plan described in section 414(k) that consists of separate accounts is treated as a defined contribution plan.

Employee. "Employee" means an individual who performs services for the employer who is either a common law employee of the employer, a self-employed individual who is treated as an employee pursuant to section 401(c)(1), or a leased employee (not excluded under section 414(n)(5)) who is treated as an employee of the employer-recipient under section 414(n)(2) or 414(o)(2). Individuals that an employer treats as employees under section 414(n) pursuant to the requirements of section 414(o) are considered to be leased employees for purposes of this rule.

Employer. "Employer" means the employer maintaining the plan and those employers required to be aggregated with the employer under sections 414(b), (c), (m), or



(o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

ESOP. "ESOP" or "employee stock ownership plan" means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Excess benefit percentage. "Excess benefit percentage" means excess benefit percentage as defined in §1.401(*l*)-1(c)(14).

Former employee. "Former employee" means an individual who was an employee but has ceased performing services for the employer. An individual is treated as a former employee beginning on the day after the day on which the individual ceases performing services for the employer. Thus, an individual who ceases performing services for an employer during a plan year is both an employee and a former employee for the plan year. Notwithstanding the foregoing, an individual is an employee (and not a former employee) even if the individual is not performing services for the employer during a period for which the plan credits the individual with imputed compensation that satisfies §1.414(s)-1(e)(3) or imputed service that satisfies §1.401(a)(4)-11(d)(2).

Gross benefit percentage. "Gross benefit percentage" means gross benefit percentage as defined in §1.401(*l*)-1(c)(18).

Highly compensated employee. "Highly compensated employee" means a highly compensated employee within the meaning of section 414(q).



Highly compensated former employee. "Highly compensated former employee" means a highly compensated former employee within the meaning of section 414(q)(9).

Multiemployer plan. "Multiemployer plan" means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. "Noncollectively bargained employee" means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. "Nonhighly compensated employee" an employee who is not a highly compensated employee.

Nonhighly compensated former employee. "Nonhighly compensated former employee" means a former employee who is not a highly compensated former employee.

Offset plan. "Offset plan" means an offset plan as defined in §1.401(*l*)-1(c)(24).

Plan year. "Plan year" means the plan year of the plan as defined in the written plan



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document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Plan year compensation. "Plan year compensation" means plan year compensation within the meaning of §1.401(a)(4)-12.

Professional employee. "Professional employee" means any highly compensated employee who, on any day of the plan year, performs professional services for the employer as an actuary, architect, attorney, chiropodist, chiropractor, dentist, engineer, executive, investment banker, medical doctor, optometrist, osteopath, podiatrist, psychologist, certified or other public accountant, stockbroker, or veterinarian, or in any other professional capacity

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determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

Ratio percentage. With respect to a plan for a plan year, a plan's "ratio percentage" means the percentage (rounded to the nearest hundredth of a percentage point) determined by dividing the percentage of the nonhighly compensated employees who benefit under the plan by the percentage of the highly compensated employees who benefit under the plan. The percentage of the nonhighly compensated employees who benefit under the plan is determined by dividing the number of nonhighly compensated employees benefiting under the plan by the total number of nonhighly compensated employees of the employer. The percentage of the highly compensated employees who benefit under the plan is determined by dividing the number of highly compensated employees benefiting under the plan by the total number of highly compensated employees of the employer.

Section 401(k) plan. "Section 401(k) plan" means a plan consisting of elective contributions described in §1.401(k)-1(g)(3) under a qualified cash or deferred arrangement described in §1.401(k)-1(a)(4)(i). Thus, a section 401(k) plan does not include a plan (or portion of a plan) that consists of contributions under a nonqualified cash or deferred arrangement, or qualified nonelective or qualified matching contributions treated as elective contributions under §1.401(k)-1(b)(5).

Section 401(*l*) plan. "Section 401(*l*) plan" means a plan that--

(1) Provides for a disparity in employer-provided benefits or contributions that satisfies section 401(*l*) in form, and

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(2) Relies on one of the safe harbors of §1.401(a)(4)-2(b)(3), 1.401(a)(4)-3(b), 1.401(a)(4)-8(b)(3), or 1.401(a)(4)-8(c)(3)(iii)(B) to satisfy section 401(a)(4).

Section 401(m) plan. "Section 401(m) plan" means a plan consisting of employee contributions described in §1.401(m)-1(f)(6) or matching contributions described in §1.401(m)-1(f)(12), or both. Thus, a section 401(m) plan does not include a plan (or portion of a plan) that consists of elective contributions or qualified nonelective contributions treated as matching contributions under §1.401(m)-1(b)(5).

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§1.410(b)-10 Effective dates and transition rules.

(a) General rule. The minimum coverage rules of section 410(b), as amended by section 1112 of the Tax Reform Act of 1986, and §§1.410(b)-2 through 1.410(b)-9, other than §1.410(b)-5, apply to plan years beginning on or after January 1, 1989. See paragraph (b)(2) of this section for the effective date of §1.410(b)-5. Notwithstanding the first sentence of this paragraph (a) and §54.4975-11(a)(5) of this Chapter, an employer may treat the rule in §1.410(b)-7(c)(2), regarding mandatory disaggregation of ESOPs and non-ESOPs, as not effective for plan years beginning before January 1, 1990, except for purposes of the rule in §1.410(b)-7(d)(2) prohibiting aggregation of two or more separate plans that would be disaggregated under the rules of §1.410(b)-7(c) if they were portions of the same plan.

(b) Transition rules--(1) Nondiscriminatory classification test. Notwithstanding paragraph (a) of this section, in applying the average benefit test for any plan year



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beginning after December 31, 1988, and before January 1, 1990 (the "1989 plan year"), whether or not a plan's classification is nondiscriminatory may be determined either by applying the rules in §1.410(b)-4 or solely on the basis of facts and circumstances, at the employer's election. If a plan's classification has been determined by the Commissioner to be nondiscriminatory, and there have been no significant changes in, or omissions of, a

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material fact, the classification will be treated as nondiscriminatory for the 1989 plan year.

(2) Average benefit percentage test. Section 1.410(b)-5 applies to plan years beginning on or after January 1, 1992. For plan years beginning before that date and on or after the first day of the first plan year to which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 apply, a plan must be operated in accordance with a reasonable, good faith interpretation of sections 410(b)(2)(A)(ii) and 410(b)(2)(B) through (E). Whether a plan is operated in accordance with a reasonable, good faith interpretation of sections 410(b)(2)(A)(ii) and 410(b)(2)(B) through (E) will generally be determined based on all relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of sections 410(b)(2)(A)(ii) and 410(b)(2)(B) through (E) if it is operated in accordance with the terms of §1.410(b)-5.

(c) Employees who benefit under a plan. Notwithstanding paragraph (a) of this section, for the first plan year beginning after December 31, 1988, and before January 1, 1990, any employee who is eligible to participate under the plan and who fails to accrue a benefit solely because of the failure to satisfy either a minimum-period-of-service requirement of 1,000 hours of service or less or a last-day-of-the-plan-year requirement

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may be treated as benefiting under the plan, provided that all such employees are treated as benefiting under the plan.

(d) Aggregation of two or more plans. Notwithstanding paragraph (a) of this section, an employer may treat the rule of §1.410(b)-7(d)(5) (requiring plans permissively aggregated under §1.410(b)-7(d) to have the same plan years) as not effective for plan years beginning before January 1, 1990.

(e) Special rule for collective bargaining agreements--(1) In general. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the minimum coverage rules of section 410(b), as amended by section 1112 of the Tax Reform Act of 1986, and §§1.410(b)-2 through 1.410(b)-9 do not apply to employees covered by any such agreement in plan years beginning before the earlier of--

(i) January 1, 1991, or

(ii) The later of January 1, 1989, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986). For purposes of this paragraph (e)(1)(ii), any extension or renegotiation of a collective bargaining agreement, which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

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(2) Example. The following example illustrates this paragraph (e).

Example. Employer A maintains Plan 1 pursuant to a collective bargaining agreement. Plan 1 covers 100 of Employer A's noncollectively bargained employees and 900 of Employer A's collectively bargained employees. Employer A also maintains Plan 2, which covers Employer A's other 400 noncollectively bargained employees. The collective bargaining agreement under which Plan 1 is maintained was entered into on January 1, 1986, and expires December 31, 1992. Because Plan 1 is a plan maintained pursuant to a collective bargaining agreement, section 410(b) applies to the first plan year beginning on or after January 1, 1991. In applying section 410(b) to Plan 2, the 100 noncollectively bargained employees in Plan 1 must be taken into account. The deferred effective date for plans maintained pursuant to a collective bargaining agreement is not applicable in determining how section 410(b) is applied to a plan that is not maintained pursuant to a collective bargaining agreement.

(3) Plan maintained pursuant to a collective bargaining agreement. For purposes of this paragraph (e), a plan is maintained pursuant to one or more collective

bargaining agreements between employee representatives and one or more employers, if one or more of the agreements were ratified before March 1, 1986. Only plans maintained pursuant to agreements that the Secretary of Labor finds to be collective bargaining agreements and that satisfy section 7701(a)(46) are eligible for the deferred effective date under this paragraph (e). A plan will not be treated as a plan maintained pursuant to one or more collective bargaining agreements eligible for the deferred effective date under this paragraph (e) unless the plan would be a plan maintained pursuant to one or more collective bargaining agreements under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93rd Cong. 2d Sess. 266 (1974).

Commissioner of Internal Revenue
Fred T. Goldberg, Jr.

Approved:

Kenneth W. Gideon August 30, 1991
Assistant Secretary of the Treasury





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