## Notice of Proposed Rulemaking and Notice of Public Hearing

## Nondiscrimination Requirements for Certain Defined Contribution Retirement Plans

## REG–114697–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that would prescribe conditions under which certain defined contribution retirement plans (sometimes referred to as "new comparability" plans) are permitted to demonstrate compliance with applicable nondiscrimination requirements based on plan benefits rather than plan contributions. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments, requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for January 25, 2001, at 10 a.m., must be received by January 5, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–114697–00) room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–114697–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.gov/tax_regs/reglist.html. The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, John T. Ricotta, 202-622-6060 or Linda S. F. Marshall, 202-622-6090; concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke, 202-622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

This document contains proposed amendments to 26 CFR part 1 under section 401(a)(4) of the Internal Revenue Code of 1986 (Code).

Section 401(a)(4) provides that a plan or trust forming part of a stock bonus, pension or profit-sharing plan of an employer shall not constitute a qualified plan under section 401(a) of the Code unless the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (HCEs) (within the meaning of section 414(q)). Whether a plan satisfies this requirement depends on the form of the plan and its effect in operation.

Section 415(b)(6)(A) provides that the computation of benefits under a defined contribution plan, for purposes of section 401(a)(4), shall not be made on a basis inconsistent with regulations prescribed by the Secretary. The legislative history of this provision explains that, in the case of target benefit and other defined contribution plans, "regulations may establish reasonable earnings assumptions and other factors for these plans to prevent discrimination." Conf. Rep. No. 1280, 93d Cong., 2d Sess. 277 (1974).

Under the section 401(a)(4) regulations, a plan can demonstrate that either the contributions or the benefits provided under the plan are nondiscriminatory in amount. Defined contribution plans generally satisfy the regulations by demonstrating that contributions are nondiscriminatory in amount, through certain safe harbors provided for under the regulations or through general testing.

A defined contribution plan (other than an ESOP) may, however, satisfy the regulations on the basis of benefits by using "cross-testing" pursuant to rules provided in §1.401(a)(4)–8 of the regulations. Under this cross-testing method, contributions are converted to equivalent benefits payable at normal retirement age and tested on the basis of these equivalent benefits. The conversion is done by making an actuarial projection of the benefits payable at normal retirement age that are attributable to the contributions. Thus, this cross-testing method effectively permits nonelective employer contributions under a defined contribution plan to be tested on the basis of the benefits attributable to those contributions, in a manner similar to the testing of employer-provided benefits under a defined benefit plan.

In Notice 2000–14 (2000–10 I.R.B. 737), released February 24, 2000, the IRS and the Treasury Department initiated a review of issues related to use of the cross-testing method by so-called "new comparability plans" and requested public comments on this plan design from plan sponsors, plan participants and other interested parties. In general, new comparability plans are defined contribution plans that have built-in disparities between the allocation rates for classifications of participants consisting entirely or predominately of HCEs and the allocation rates for other employees.

In a typical new comparability plan, HCEs receive high allocation rates, while nonhighly compensated employees (NHCEs), regardless of their age or years of service, receive comparatively low allocation rates. For example, HCEs in such a plan might receive allocations of 18 or 20% of compensation, while NHCEs might receive allocations of 3% of compensation. A similar plan design, sometimes known as a "super-integrated" plan, provides for an additional allocation rate that applies only to compensation in excess of a specified threshold, but the specified threshold (e.g., $100,000) or the additional allocation rate (e.g., 10%) is higher than the maximum threshold and rate allowed under the permitted disparity rules of section 401(*l*).

These new comparability and similar plans rely on the cross-testing method to demonstrate compliance with the nondiscrimination rules by comparing the actuarially projected value of the employer contributions for the younger NHCEs with the actuarial projections of the larger contributions (as a percentage of compensation) for the older HCEs. As a result, these plans are able generally to provide

higher rates of employer contributions to HCEs, while NHCEs are not allowed to earn the higher allocation rates as they work additional years for the employer or grow older. Notwithstanding the analytical underpinnings of cross-testing, the IRS and the Treasury Department are concerned whether new comparability and similar plans are consistent with the basic purpose of the nondiscrimination rules under section 401(a)(4).

A variety of public comments were submitted in response to Notice 2000–14. Some comments expressed the view that changes in the application of the nondiscrimination rules to new comparability plans are unnecessary. These comments noted that in some cases such plans are adopted by employers that previously had no retirement plan for their employees. At the same time, many of these comments advanced suggestions as to the types of conditions that might be imposed on new comparability plans if changes in the rules are in fact proposed.

Other comments expressed the view that the rules need to be changed to increase the contributions made for NHCEs in new comparability plans and similar tax-qualified plan designs. These comments suggested various methods for ensuring that NHCEs receive larger allocations of employer contributions under new comparability plans, including imposing a maximum ratio of the allocation rates for HCEs to those for NHCEs or requiring a minimum allocation rate for the NHCEs.

Still other comments questioned the policy justification for permitting new comparability plans under the nondiscrimination rules governing tax-qualified plans because new comparability plan designs often provide such an overwhelming percentage of total plan allocations to HCEs, with only a modest percentage of the plan allocations going to the NHCEs. Some of these comments expressed concern that new comparability plans in some instances have been marketed as a technique for limiting most employees to lower allocation rates than they would receive under other defined contribution plan designs (such as salary ratio or age-weighted) and allocating the difference to one or more HCEs. They noted that, in some cases, the percentage of total plan allocations provided to the HCEs can exceed 90%.

After consideration of the comments received, the IRS and Treasury are issuing these proposed regulations, which would prescribe conditions that new comparability and similar plans must satisfy if they are to use the cross-testing method. The proposed regulations preserve the existing cross-testing rules of the section 401(a)(4) regulations, and would not affect cross-tested defined contribution plans that provide broadly available allocation rates, as defined in the proposed regulations. The definition of broadly available allocation rates includes plans that base allocations or allocation rates on age or service. In contrast to new comparability plans, these plans provide an opportunity for participants to "grow into" higher allocation rates as they age or accumulate additional service.

These proposed regulations would continue to permit new comparability plans. As suggested in various comments, the proposed regulations would set forth a minimum allocation "gateway" that would constrain the plan designs with the greatest disparity in favor of HCEs, while leaving many new comparability plan designs unchanged. A new comparability plan that satisfies the minimum allocation gateway could continue to use the existing cross-testing rules of the section 401(a)(4) regulations.

The proposed regulations also would prevent circumvention of the minimum allocation gateway by aggregating (for purposes of satisfying the nondiscrimination rules) a new comparability defined contribution plan with a defined benefit plan that provides only minimal benefits or covers only a relatively small number of the employees, or by aggregating a defined contribution plan with a defined benefit plan that benefits primarily HCEs. However, an aggregated defined contribution and defined benefit plan that is primarily defined benefit in character (as defined in the proposed regulations) could test for nondiscrimination on the basis of benefits in the same manner as under current law. Similarly, the ability to test for nondiscrimination on a benefits basis as under current law would be unrestricted if each of the defined contribution and defined benefit portions of the aggregated plan is a broadly available separate plan (as defined in the proposed regulations).

The proposed regulations would not affect defined benefit plans except where a defined contribution plan is aggregated with a defined benefit plan for nondiscrimination purposes and thus is a part of a DB/DC plan (as defined in §1.401(a)(4)–9). The proposed regulations would not apply merely because a plan sponsor maintains both a defined contribution plan and a defined benefit plan. The proposed regulations would not require aggregation of a defined contribution plan with a defined benefit plan or otherwise modify the existing rules regarding when plans are required or permitted to be aggregated.

**Explanation of Provisions**

A. *Overview*

The basic structure of the proposed regulations permits defined contribution plans with broadly available allocation rates to test on a benefits basis ("cross-test") in the same manner as under current law, and permits other defined contribution plans to cross-test once they pass a gateway that prescribes minimum allocation rates for NHCEs. Similarly, the proposed regulations permit a DB/DC plan to test on a benefits basis in the same manner as under current law if the DB/DC plan either is primarily defined benefit in character or consists of broadly available separate plans. Other DB/DC plans are permitted to test on a benefits basis once they pass a corresponding gateway prescribing minimum aggregate normal allocation rates for NHCEs.

B. *Gateway for Cross-Testing of New Comparability and Similar Plans*

The proposed regulations would require that a defined contribution plan that does not provide broadly available allocation rates (as defined in these proposed regulations) satisfy a gateway in order to be eligible to use the cross-testing rules to meet the nondiscrimination requirements of section 401(a)(4). A plan would satisfy this minimum allocation gateway if each NHCE in the plan has an allocation rate that is at least one third of the allocation rate of the HCE with the highest alloca-

tion rate[1]; however, a plan would be deemed to satisfy this minimum allocation gateway if each NHCE received an allocation of at least 5% of the NHCE's compensation (within the meaning of section 415(c)(3)).

The proposed regulations would not change the general rule prohibiting aggregation of a 401(k) plan or 401(m) plan with a plan providing nonelective contributions. Accordingly, elective contributions and matching contributions would not be taken into account for purposes of the gateway. If an employer also provides a 401(k) plan, however, then to the extent the HCEs are electing contributions under that plan, the highest HCE allocation rate may be lower than it otherwise would be, which, in turn would lower the minimum required allocation for the NHCEs under the gateway. Further, if the employer sponsors a safe harbor 401(k) plan that provides for 3% nonelective contributions, then, as noted in Notice 98–52 (1998–2 C.B. 632), those nonelective contributions may be taken into account in determining the allocation rates for the NHCEs under section 401(a)(4), including the minimum allocation gateway.

C. *Plans with Broadly Available Allocation Rates*

As suggested in Notice 2000–14, a plan that has broadly available allocation rates would not need to satisfy the minimum allocation gateway and may continue to be tested for nondiscrimination on the basis of benefits as under current law. In order to be broadly available, each allocation rate under the plan must be currently available to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test). Thus, for example, if within one plan an employer provides different allocation rates for nondiscriminatory groups of employees at different locations or different profit centers, the plan would not need to satisfy the minimum allocation gateway in order to use cross testing.

In addition, a plan that provides allocation rates that increase as an employee ages or accumulates additional service would be treated as having broadly available allocation rates, if the schedule of allocation rates satisfies certain conditions that permit participants to "grow into" higher allocation rates. The conditions are that the same schedule of allocation rates is available to all employees in the plan and that the schedule provides for smoothly increasing allocation rates at regular intervals of age or service.

The proposed regulation would provide that in order for a schedule of allocation rates to increase smoothly, the allocation rate for each age or service band cannot be more than 5 percentage points higher than the allocation rate for the immediately preceding band and cannot be more than twice that allocation rate. For example, if the allocation rate for an age or service band were 6%, the allocation rate for the next higher age or service band could not exceed 11% (i.e., the lesser of 11% (6% plus 5%) and 12% (2 times 6%)).

Further, in order for a schedule of allocation rates to be considered to be increasing smoothly, the ratio of the allocation rate for any age or service band to the allocation rate for the immediately preceding band cannot exceed the ratio of the allocation rates between the two immediately preceding bands. The proposed regulations would provide that the intervals for the age or service bands are regular if they are all of the same length (although this requirement generally would not apply to the first and last bands).

The definition of broadly available allocation rates is designed to be sufficiently flexible to accommodate a wide variety of age- and service-based plans (including age-weighted profit-sharing plans that provide for allocations that result in the same equivalent accrual rate for all employees).

The conditions described above relating to a plan's schedule of age-based or service-based allocation rates are intended to exempt from the minimum allocation gateway those plans in which NHCEs actually receive the benefit of higher rates as they attain higher ages or complete additional years of service. Without conditions such as these, plans can be designed to backload allocation rates excessively, providing for lengthy plateau periods in which rates increase little if at all, followed by sharp increases.

Comments are invited on whether there are plans using schedules of allocation rates (such as schedules of rates based on points or otherwise combining age and service) that would fall outside the definition of broadly available allocation rates but that do afford sufficient opportunity for NHCEs to "grow into" higher allocation rates.

D. *Application to Defined Contribution Plans That Are Combined with Defined Benefit Plans*

The proposed regulations would prescribe rules for testing defined contribution plans that are aggregated with defined benefit plans for purposes of sections 401(a)(4) and 410(b). These rules would apply in situations in which the employer aggregates the plans because one of the plans does not satisfy sections 401(a)(4) and 410(b) standing alone.

1. *Gateway for benefits testing of combined plans*

Under the proposed regulations, the combination of a defined contribution plan and a defined benefit plan may demonstrate nondiscrimination on the basis of benefits if the combined plan is primarily defined benefit in character, consists of broadly available separate plans (as these terms are defined in the proposed regulations), or satisfies a gateway requirement. This minimum aggregate allocation gateway is generally similar to the minimum allocation gateway for defined contribution plans that are not combined with a defined benefit plan. To apply this minimum aggregate allocation gateway, the employee's aggregate normal allocation rate is determined by adding the employee's allocation under the defined contribution plan to the employee's equivalent allocation under the defined benefit plan. The use of aggregation would allow an employer that provides both a defined contribution and a defined benefit plan to the NHCEs to take both plans into account in determining whether the minimum aggregate allocation gateway is met.

Under the gateway, if the aggregate normal allocation rate of the HCE with the highest aggregate normal allocation rate under the plan (HCE rate) is less than 15%, the aggregate normal allocation rate for all NHCEs must be at least 1/3 of the

[1]For example, if any HCE had an allocation of 12% of compensation, all NHCEs in the plan would be required to have an allocation of at least 4% of compensation.

HCE rate. If the HCE rate is between 15% and 25%, the aggregate normal allocation rate for all NHCEs must be at least 5%. If the HCE rate exceeds 25%, then the aggregate normal allocation rate for each NHCE must be at least 5% plus one percentage point for each 5-percentage-point increment (or portion thereof) by which the HCE rate exceeds 25% (e.g., the NHCE minimum is 6% for an HCE rate that exceeds 25% but not 30%, and 7% for an HCE rate that exceeds 30% but not 35%, etc.).

In addition, in determining the equivalent allocation rate for an NHCE under a defined benefit plan, a plan is permitted to treat each NHCE who benefits under the defined benefit plan as having an equivalent allocation rate equal to the average of the equivalent allocation rates under the defined benefit plan for all NHCEs benefitting under that plan. This averaging rule recognizes the "grow-in" feature inherent in traditional defined benefit plans (i.e., the defined benefit plan provides higher equivalent allocation rates at higher ages).

Comments are invited on possible special situations involving DB/DC plans, such as situations arising as a result of a merger or acquisition or a situation in which some HCEs in a DB/DC plan have unusually high equivalent normal allocation rates for reasons other than the design of the plan. Comments are invited as to whether the regulations should address such special circumstances and, if so, how (e.g., through a maximum required rate for NHCEs under a DB/DC plan or other approaches).

2. *Primarily defined benefit in character*

A combined plan that is primarily defined benefit in character would not be subject to the gateway requirement and may continue to be tested for nondiscrimination on the basis of benefits as under current law. A combined plan would be primarily defined benefit in character if, for more than 50% of the NHCEs benefitting under the plan, the normal accrual rate attributable to benefits provided under defined benefit plans for the NHCE exceeds the equivalent accrual rate attributable to contributions under defined contribution plans for the NHCE. For example, a DB/DC plan would be primarily defined benefit in character where the defined contribution plan covers only salaried employees, the defined benefit plan covers only hourly employees, and more than half of the NHCEs participating in the DB/DC plan are hourly employees participating only in the defined benefit plan.

3. *Broadly available separate plans*

A combined plan that consists of broadly available separate plans would not be subject to the gateway requirement and may continue to be tested for nondiscrimination on the basis of benefits as under current law. A DB/DC plan consists of broadly available separate plans if the defined contribution plan and the defined benefit plan each would satisfy the requirements of section 410(b) and the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) if each plan were tested separately, assuming satisfaction of the average benefit percentage test of §1.410(b)–5. Thus, the defined contribution plan must separately satisfy the nondiscrimination requirements (taking into account these proposed regulations as applicable), but for this purpose assuming satisfaction of the average benefit percentage test. Similarly, the defined benefit plan must separately satisfy the nondiscrimination requirements, assuming for this purpose satisfaction of the average benefit percentage test. In conducting the required separate testing, all plans of a single type (defined contribution or defined benefit) within the DB/DC plan are aggregated, but those plans are tested without regard to plans of the other type.

This alternative would be useful, for example, where an employer maintains a defined contribution plan that provides a uniform allocation rate for all covered employees at one business unit and a safe harbor defined benefit plan for all covered employees at another unit, where the group of employees covered by each plan is a group that satisfies the nondiscriminatory classification requirement of section 410(b). Because the employer provides broadly available separate plans, it may continue to aggregate the plans and test for nondiscrimination on the basis of benefits, as an alternative to using the qualified separate line of business rules or demonstrating satisfaction of the average benefit percentage test.

E. *Use of Component Plans and Permitted Disparity*

Component plans under the restructuring rules cannot be used for the determination of whether a defined contribution plan provides broadly available allocation rates or satisfies the minimum allocation gateway, or the determination of whether a DB/DC plan satisfies the minimum aggregate allocation gateway, is primarily defined benefit in character, or consists of broadly available separate plans. For purposes of the two gateways and determining whether a DB/DC plan is primarily defined benefit in character, allocation rates and equivalent allocation rates are determined without the use of permitted disparity. For purposes of determining whether a DB/DC plan consists of broadly available separate plans, permitted disparity may be used in the defined contribution plan or the defined benefit plan but not in both plans with respect to each employee who participates in both.

**Proposed Effective Date**

The regulations are proposed to be applicable for plan years beginning on or after January 1, 2002.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or

written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. In addition to the other requests for comments set forth in this document, the IRS and Treasury also request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 25, 2001, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 5, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal authors of these regulations are John T. Ricotta and Linda S. F. Marshall of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

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**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.401(a)(4)–8, paragraph (b)(1) is revised to read as follows:

*§1.401(a)(4)–8 Cross-testing.*

* * * * *

(b) *Nondiscrimination in amount of benefits provided under a defined contribution plan*—(1) *General rule and gateway*—(i) *General rule*. Equivalent benefits under a defined contribution plan (other than an ESOP) are nondiscriminatory in amount for a plan year if—

(A) The plan would satisfy §1.401(a)(4)–2(c)(1) for the plan year if an equivalent accrual rate, as determined under paragraph (b)(2) of this section, were substituted for each employee's allocation rate in the determination of rate groups; and

(B) For plan years beginning on or after January 1, 2002, if the plan does not have broadly available allocation rates (within the meaning of paragraph (b)(1)(iii) of this section) for the plan year, the plan satisfies the minimum allocation gateway of paragraph (b)(1)(iv) of this section for the plan year.

(ii) *Allocations after testing age*. A plan does not fail to satisfy paragraph (b)(1)(i)(A) of this section merely because allocations are made at the same rate for employees who are older than their testing age (determined without regard to the current-age rule in paragraph (4) of the definition of *testing age* in §1.401(a)(4)–12), as they are made for employees who are at that age.

(iii) *Broadly available allocation rates*—(A) *In general*. A plan has broadly available allocation rates for the plan year if each allocation rate under the plan is currently available during the plan year (within the meaning of §1.401(a)(4)–4(b)(2)), to a group of employees that satisfies section 410(b) (without regard to the average benefit percentage test of §1.410(b)–5). For this purpose, the disregard of age and service conditions described in §1.401(a)(4)–4(b)(2)(ii)(A) applies only if the plan provides an allocation formula under which the allocation rates for all employees benefitting under the plan are determined using a single schedule of rates that are based solely on either age or service, and only if the allocation rates under the schedule increase smoothly at regular intervals, within the meaning of paragraphs (b)(1)(iii)(B) and (C) of this section. A plan does not fail to provide broadly available allocation rates merely because it provides the minimum benefit described in section 416(c)(2).

(B) *Smoothly increasing schedule of allocation rates*. A plan uses a single schedule of allocation rates that are based solely on age or service if it uses a single schedule of allocation rates that consists of a series of either age or service bands under which the same allocation rate applies to all employees whose age is within each age band or whose years of service are within each service band. A schedule of allocation rates increases smoothly if the allocation rate for each age or service band within the schedule is greater than the allocation rate for the immediately preceding band (i.e., the age or service band with the next lower number of years of age or service) but by no more than 5 percentage points. However, a schedule of allocation rates will not be treated as increasing smoothly if the ratio of the allocation rate for any age or service band to the rate for the immediately preceding band is more than 2.0 or if it exceeds the ratio of allocation rates between the two immediately preceding bands.

(C) *Regular intervals*. A schedule of allocation rates has regular intervals of age or service if each age or service band, other than the band associated with the highest age or years of service, is the same length. For this purpose, if the schedule is based on age, the first age band will be deemed to be of the same length as the other bands if it ends at or before age 25. If the first age band ends after age 25, then, in determining whether the length of the first band is the same as the length of other bands, the starting age for the first age band is permitted to be treated as age 25 or any age earlier than 25.

(iv) *Minimum allocation gateway*. A plan satisfies the minimum allocation gateway of this paragraph (b)(1)(iv) if each NHCE has an allocation rate that is at least one third of the allocation rate of the HCE with the highest allocation rate. However, a plan is deemed to satisfy this minimum allocation gateway if each NHCE receives an allocation of at least 5% of the

NHCE's compensation within the meaning of section 415(c)(3).

(v) *Determination of allocation rates.* For purposes of this paragraph (b)(1), allocations and allocation rates are determined under §1.401(a)(4)–2(c)(2), but without taking into account the imputation of permitted disparity under §1.401(a)(4)–7 in applying the minimum allocation gateway of paragraph (b)(1)(iv) of this section.

(vi) *Examples.* The following examples illustrate the rules in this paragraph (b)(1):

*Example 1.* (i) Plan M is a defined contribution plan that provides an allocation formula under which allocations are provided to all employees according to the following schedule:

| Years of Service | Allocation Rate | Ratio of Allocation Rate for Band to Allocation Rate for Immediately Preceding Band |
|---|---|---|
| 0- 5 | 3.0% | not applicable |
| 6-10 | 4.5% | 1.50 |
| 11-15 | 6.5% | 1.44 |
| 16-20 | 8.5% | 1.31 |
| 21-25 | 10.0% | 1.18 |
| 26 or more | 11.5% | 1.15 |

(ii) Because Plan M provides that allocation rates for all employees are determined using a single schedule based solely on service, the plan is permitted to disregard the service requirement in determining whether the allocation rates are broadly available (within the meaning of paragraph (b)(1)(iii) of this section), if the allocation rates under the schedule increase smoothly at regular intervals.

(iii) The schedule of allocation rates under Plan M does not increase by more than 5 percentage points between adjacent bands and the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band is never more than 2.0 and does not increase. Therefore, the allocation rates increase smoothly. In addition, the bands (other than the highest band) are all 5 years long, so the increases occur at regular intervals. Accordingly, the service requirement is disregarded and each allocation rate is broadly available within the meaning of paragraph (b)(1)(iii) of this section, as each allocation rate is currently available to all employees in the Plan.

(iv) Under paragraph (b)(1)(i) of this section, Plan M satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section, regardless of whether it satisfies the minimum allocation gateway of paragraph (b)(1)(iv) of this section.

*Example 2.* (i) Plan N is a defined contribution plan that provides an allocation formula under which allocations are provided to all employees according to the following schedule:

| Age | Allocation rate | Ratio of Allocation Rate for Band to Allocation Rate for Immediately Preceding Band |
|---|---|---|
| under 25 | 3.0 % | not applicable |
| 25-34 | 6.0 % | 2.00 |
| 35-44 | 9.0 % | 1.50 |
| 45-54 | 12.0% | 1.33 |
| 55-64 | 16.0% | 1.33 |
| 65 or older | 21.0% | 1.31 |

(ii) Because Plan N provides that allocation rates for all employees are determined using a single schedule based solely on age, the plan is permitted to disregard the age requirement in determining whether the allocation rates are broadly available (within the meaning of paragraph (b)(1)(iii) of this section), if the allocation rates under the schedule increase smoothly at regular intervals.

(iii) The schedule of allocation rates under Plan N does not increase by more than 5 percentage points between adjacent bands and the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band is never more than 2.0 and does not increase. Therefore, the allocation rates increase smoothly. In addition, the bands are all 10 years long (other than the highest band and the first band, which is deemed to be the same length as the other bands because it ends prior to age 25), so the increases occur at regular intervals. Accordingly, the age requirement is disregarded and each allocation rate is broadly available within the meaning of paragraph (b)(1)(iii) of this section, as each allocation rate is currently available to all employees in the Plan.

(iv) Under paragraph (b)(1)(i) of this section, Plan N satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section, regardless of whether it satisfies the minimum allocation gateway of paragraph (b)(1)(iv) of this section.

*Example 3.* (i) Plan O is a profit-sharing plan maintained by Employer A that covers all of Em-

ployer A's employees, consisting of two HCEs, X and Y, and 7 NHCEs. Employee X's compensation is $170,000 and Employee Y's compensation is $150,000. The allocation for Employees X and Y is $30,000 each, resulting in an allocation rate of 17.6% for Employee X and 20% for Employee Y. Under Plan O, each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3).

(ii) Because the allocation rate for X is not currently available to any NHCE, Plan O does not have broadly available allocation rates and must satisfy the minimum allocation gateway of paragraph (b)(1)(iv) of this section.

(iii) The highest allocation rate for any HCE under Plan O is 20%. Accordingly, Plan O would satisfy the minimum allocation gateway of paragraph (b)(1)(iv) of this section if all NHCEs have an allocation rate of at least 6.67%, or if all NHCEs receive an allocation of at least 5% of compensation within the meaning of section 415(c)(3).

(iv) Under Plan O, each NHCE receives an allocation of 5% of compensation within the meaning of section 415(c)(3). Accordingly, Plan O satisfies the minimum allocation gateway of paragraph (b)(1)(iv) of this section.

(v) Under paragraph (b)(1)(i) of this section, Plan O satisfies the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits if it satisfies paragraph (b)(1)(i)(A) of this section.

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Par. 3. Section 1.401(a)(4)–9 is amended by adding paragraph (b)(2)(v) and revising paragraph (c)(3)(ii) to read as follows:

*§1.401(a)(4)–9 Plan aggregation and restructuring.*

* * * * *

(b) * * *

(2) * * *

(v) *Eligibility for testing on a benefits basis*—(A) *General rule*. For plan years beginning on or after January 1, 2002, unless, for the plan year, a DB/DC plan is primarily defined benefit in character (within the meaning of paragraph (b)(2)(v)(B) of this section) or consists of broadly available separate plans (within the meaning of paragraph (b)(2)(v)(C) of this section), the DB/DC plan must satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section for the plan year in order to be permitted to demonstrate satisfaction of the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits.

(B) *Primarily defined benefit in character*. A DB/DC plan is primarily defined benefit in character if, for more than 50% of the NHCEs benefitting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under defined benefit plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under defined contribution plans that are part of the DB/DC plan.

(C) *Broadly available separate plans*. A DB/DC plan consists of broadly available separate plans if the defined contribution plan and the defined benefit plan that are part of the DB/DC plan each would satisfy the requirements of section 410(b) and the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) if each plan were tested separately and assuming that the average benefit percentage test of §1.410(b)–5 were satisfied. For this purpose, all defined contribution plans that are part of the DB/DC plan are treated as a single defined contribution plan and all defined benefit plans that are part of the DB/DC plan are treated as a single defined benefit plan. In addition, if permitted disparity is used for an employee for purposes of satisfying the separate testing requirement of this paragraph (b)(2)(v)(C) for plans of one type, it may not be used in satisfying the separate testing requirement for plans of the other type for the employee.

(D) *Minimum aggregate allocation gateway*. A DB/DC plan satisfies the minimum aggregate allocation gateway of this paragraph (b)(2)(v)(D) if each NHCE has an aggregate normal allocation rate that is at least one third of the aggregate normal allocation rate of the HCE with the highest such rate (HCE rate), or, if less, 5% of the NHCE's compensation, provided that the HCE rate does not exceed 25% of compensation. If the HCE rate exceeds 25% of compensation, then the aggregate normal allocation rate for each NHCE must be 5% increased by one percentage point for each 5-percentage-point increment (or portion thereof) by which the HCE rate exceeds 25% (e.g., the NHCE minimum is 6% for an HCE rate that exceeds 25% but not 30%, and 7% for an HCE rate that exceeds 30% but not 35%). For purposes of this paragraph (b)(2)(v)(D), a plan is permitted to treat each NHCE who benefits under the defined benefit plan as having an equivalent normal allocation rate equal to the average of the equivalent normal allocation rates under the defined benefit plan for all NHCEs benefitting under that plan.

(E) *Determination of rates*. For purposes of this paragraph (b)(2)(v), the normal accrual rate and the equivalent normal allocation rate attributable to defined benefit plans, the equivalent accrual rate attributable to defined contribution plans and the aggregate normal allocation rate are determined under paragraph (b)(2)(ii) of this section, but without taking into account the imputation of permitted disparity under §1.401(a)(4)–7, except as otherwise permitted under paragraph (b)(2)(v)(C) of this section.

(F) *Examples*. The following examples illustrate the application of this paragraph (b)(2)(v):

*Example 1*. (i) Employer A maintains Plan M, a defined benefit plan, and Plan N, a defined contribution plan. All HCEs of Employer A are covered by Plan M (at a 1% accrual rate), but not covered by Plan N. All NHCEs of Employer A are covered by Plan N (at a 3% allocation rate), but not covered by Plan M. Because Plan M does not satisfy section 410(b) standing alone, Plans M and N are aggregated for purposes of satisfying sections 410(b) and 401(a)(4).

(ii) Because none of the NHCEs participate in the defined benefit plan, the aggregated DB/DC plan is not primarily defined benefit in character within the meaning of paragraph (b)(2)(v)(B) of this section nor does it consist of broadly available separate plans within the meaning of paragraph (b)(2)(v)(C) of this section. Accordingly, the aggregated Plan M and Plan N must satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section in order to satisfy the nondiscrimination in amount requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits.

*Example 2*. (i) Employer B maintains Plan O, a defined benefit plan, and Plan P, a defined contribution plan. All of the six employees of Employer B are covered under both Plan O and Plan P. Under Plan O, all employees have a uniform normal accrual rate of 1% of compensation. Under Plan P, Employees A and B, who are HCEs, receive an allocation rate of 15%, and participants C, D, E and F, who are NHCEs, receive an allocation rate of 3%. Employer B aggregates Plans O and P for purposes of satisfying sections 410(b) and 401(a)(4). The equivalent normal allocation and normal accrual rates under Plans O and P are as follows:

| Employee | Equivalent Normal Allocation Rates for the 1% Accrual under Plan O (defined benefit plan) | Equivalent Normal Accrual Rates for the 15%/3% Allocations under Plan P (defined contribution plan) |
|---|---|---|
| HCE A (age 55) | 3.93% | 3.82% |
| HCE B (age 50) | 2.61% | 5.74% |
| C (age 60) | 5.91% | .51% |
| D (age 45) | 1.73% | 1.73% |
| E (age 35) | .77% | 3.90% |
| F (age 25) | .34% | 8.82% |

(ii) Although all of the NHCEs benefit under the Plan O (the defined benefit plan), the aggregated DB/DC plan is not primarily defined benefit in character because the normal accrual rate attributable to defined benefit plans (which is 1% for all the NHCEs) is greater than the equivalent accrual rate under defined contribution plans only for Employee C. In addition, because the 15% allocation rate is only available to HCEs, the defined contribution plan cannot satisfy the requirements of §1.401(a)(4)–2 and does not have broadly available allocation rates within the meaning of §1.401(a)(4)–8(b)(1)(iii). Further, the defined contribution plan does not satisfy the minimum allocation gateway of §1.401(a)(4)–8(b)(1)(iv) (3% is less than 1/3 of the 15% HCE rate). Therefore, the defined contribution plan within the DB/DC plan cannot separately satisfy §1.401(a)(4)–1(b)(2) and does not constitute a broadly available separate plan within the meaning of paragraph (b)(2)(v)(C) of this section. Accordingly, the aggregated plans can satisfy the nondiscrimination in amounts requirement of §1.401(a)(4)–1(b)(2) on the basis of benefits only if the aggregated plans satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

(iii) Employee A has an aggregate normal allocation rate of 18.93% under the aggregated plans (3.93% from Plan O plus 15% from Plan P), which is the highest aggregate normal allocation rate for any HCE under the plans. Employee F has an aggregate normal allocation rate of 3.34% under the aggregated plans (.34% from Plan O plus 3% from Plan P) which is less than the 5% aggregate normal allocation rate that Employee F would be required to have to satisfy the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

(iv) However, for purposes of satisfying the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section, Employer B is permitted to treat each NHCE who benefits under the Plan O (the defined benefit plan) as having an equivalent allocation rate equal to the average of the equivalent allocation rates under Plan O for all NHCEs benefitting under that plan. The average of the equivalent allocation rates for all the NHCEs under Plan O is 2.19% (the sum of 5.91%, 1.73%, .77%, and .34%, divided by 4). Accordingly, Employer B is permitted to treat all the NHCEs as having an equivalent allocation rate attributable to Plan O equal to 2.19%. Thus, all NHCEs can be treated as having an aggregate normal allocation rate of 5.19% for this purpose (3% from the defined contribution plan and 2.19% from the defined benefit plan) and the aggregated DB/DC plan satisfies the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section.

* * * * *

(c) * * *

(3) * * *

(ii) *Restructuring not available for certain testing purposes.* The safe harbor in §1.401(a)(4)–2(b)(3) for plans with uniform points allocation formulas is not available in testing (and thus cannot be satisfied by) contributions under a component plan. Similarly, component plans cannot be used for purposes of determining whether a plan provides broadly available allocation rates (as defined in §1.401(a)(4)–8(b)(1)(iii)), or determining whether a plan is primarily defined benefit in character or consists of broadly available separate plans (as defined in paragraphs (b)(2)(v)(B) and (C) of this section). In addition, the minimum allocation gateway of §1.401(a)(4)–8(b)(1)(iv) and the minimum aggregate allocation gateway of paragraph (b)(2)(v)(D) of this section cannot be satisfied on the basis of component plans. See §§1.401(k)–1(b)(3)(iii) and 1.401(m)–1(b)(3)(iii) for rules regarding the inapplicability of restructuring to section 401(k) plans and section 401(m) plans.

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(Filed by the Office of the Federal Register on October 5, 2000, 8:45 a.m., and published in the issue of the Federal Register for October 6, 2000, 65 F.R. 59774)