

# I FOR YOUR INFORMATION

August 15, 2001

## IRS ISSUES FINAL REGULATIONS RESTRICTING THE USE OF CROSS-TESTING

### Executive Summary

*The IRS has issued final regulations that limit the ability of defined contribution plans to test for nondiscrimination on the basis of benefits (cross-testing). Importantly, one way for a "new comparability" plan to continue to use cross-testing would be to give each nonhighly-compensated employee an allocation of at least 5% of compensation. The regulations are effective for plan years beginning on or after January 1, 2002.*

### Background

New comparability plans are defined contribution (DC) plans that provide different allocation rates to different classes of employees. Typically, a new comparability plan provides much larger allocations to some highly-compensated employees (HCEs) than to most nonhighly-compensated employees (NHCEs). If only employer allocations are considered in testing for nondiscrimination, the typical new comparability plan would be found to discriminate under IRC Section 401(a)(4) in favor of HCEs.

IRS regulations have allowed nondiscrimination to be demonstrated by cross-testing – i.e., by comparing the benefits payable at normal retirement age instead of by comparing each year's allocations. Under this technique, allocations for all participants are projected with interest to normal retirement age and converted into annuity benefits. The projected annuity benefits of the younger employees, usually NHCEs, often compare favorably with the projected annuity benefits of the older employees, usually HCEs.

Nonetheless, new comparability and other similar plan designs, and their use of cross-testing, have attracted unfavorable scrutiny from the press and the Treasury. The IRS requested comments from plan sponsors and issued proposed regulations (see our December 26, 2000 *For Your Information*). The IRS has now issued final regulations. The final regulations reflect some of the changes to the proposed regulations suggested by Buck in comments to the IRS (see our January 25, 2001 *For Your Information*). At the same time, the IRS issued Revenue Ruling 2001-30 clarifying one aspect of the final regulations.

### IRS Final Regulations

In general, cross-testing is not available for certain types of DC plans including 401(k) plans, 401(m) plans and ESOPs. The final regulations impose new restrictions on the continued use of cross-testing for plans where it is allowable, but do not eliminate it altogether.

The regulations allow a DC plan to use cross-testing if it satisfies a gateway test. Alternatively, a plan can cross-test if it has broadly available allocation rates

or if it uses certain age-based allocation rates. The regulations also provide rules applicable to combinations of defined benefit (DB) and DC plans.

## Gateway to Cross-Testing

A DC plan can cross-test if each eligible NHCE is immediately eligible for an allocation rate equal to at least one-third of the allocation rate of the HCE with the highest allocation rate under the plan. For example, if the highest HCE allocation rate is 12%, the plan can cross-test if an allocation rate of at least 4% is provided to each NHCE. When calculating the allocation rate (i.e., allocation amount divided by compensation) under this test, any definition of compensation under IRC Section 414(s) can be used.

Alternatively, the regulations provide that a DC plan can cross-test if each eligible NHCE is immediately eligible for an allocation rate of at least 5% of compensation as defined in Section 415(c)(3).

Elective and matching contributions to 401(k) plans may not be used in performing the gateway test. However, if an employer sponsors a safe-harbor 401(k) plan that provides for at least 3% nonelective contributions, then those nonelective contributions can be taken into account in determining allocation rates for the NHCEs under the 5% rule.

***Buck Comment*** – *Sponsors of new comparability plans were concerned that regulations would prevent them from using cross-testing entirely. Instead, the gateway test will allow these plans to continue to cross-test, but at the cost of possibly higher required contributions for NHCEs.*

## Broadly Available Allocation Rates

Under the regulations, a DC plan may cross-test without satisfying the gateway test if each allocation rate is available to a group of employees that satisfies the coverage rules of Section 410(b) without regard

to the average benefit percentage test (i.e., the allocation rates are broadly available). For this purpose, two allocation rates can be aggregated if the higher allocation rate covers a nondiscriminatory classification of employees. Further, differences in allocation rates resulting from permitted disparity are disregarded.

For example, if a plan provides an allocation rate of 10% of pay to a nondiscriminatory group of employees at location X and an allocation rate of 5% of pay to a nondiscriminatory group of employees at location Y, then the plan would be deemed to provide broadly available allocation rates.

**Transition Allocations May be Disregarded** – In determining whether a plan has broadly available allocation rates, the final regulations permit an employee's allocation to be disregarded to the extent that it is a transition allocation. The regulations distinguish three types of transition allocations that may be disregarded. These are DB replacement allocations (the only type of transition allocation that can be disregarded in the future), pre-existing replacement allocations, and pre-existing merger and acquisition allocations. Each type of transition allocation must be provided to a closed group of employees, and once established, the transition allocations cannot be modified except to reduce allocations for HCEs or as a result of de minimis changes to the plan.

**DB Replacement Allocations** – To be DB replacement allocations, transition allocations must be –

- provided to a group of employees who formerly benefited under an established nondiscriminatory DB plan of the employer or of a prior employer
- reasonably calculated to replace the retirement benefits that each employee would have been provided had the employee continued to participate in the DB plan (Allocations that are a level percentage of pay or allocations that increase with age might be considered reasonable.)

- provided to a group of employees whose composition is nondiscriminatory.

In Revenue Ruling 2001-30, the IRS clarified the conditions for determining if allocations are DB replacement allocations. In particular, the revenue ruling requires that the DB plan have been in effect for at least 5 years (1 year in the case of a prior employer) before the date benefit accruals cease.

**Pre-Existing Replacement Allocations** – For transition allocations to be pre-existing replacement allocations, they must be –

- provided pursuant to a plan provision adopted before June 29, 2001
- provided to employees who formerly benefited under a DB plan
- reasonably designed to replace some or all of the retirement benefits that the employee would have received under the DB plan, and any other plan of the employer, if the employee had continued to benefit under the prior arrangement.

**Pre-Existing Merger and Acquisition Allocations** – For transition allocations to be pre-existing merger and acquisition allocations, they must –

- be established in connection with a merger, acquisition or similar transaction occurring before August 28, 2001
- apply to a group of employees who were employed by the acquiring organization prior to a specified date, and the group is closed no later than two years after the transaction, or January 1, 2002, if earlier
- be reasonably calculated to replace some or all of the retirement benefits that the employee would have received under the DB plan and any other plan of the employer, if the employee had continued to benefit under the prior arrangement.

## Age-Based Allocation Rates

Under the regulations, a DC plan does not have to satisfy the gateway test if the allocation rates increase as an employee ages or earns additional service, provided that the schedule of allocation rates is a “gradual age or service schedule.” The regulations define a gradual age or service schedule as one where allocation rates increase smoothly at regular intervals.

For a schedule of allocation rates to increase smoothly, the allocation rate for each age, service or age plus service band has to be greater than the allocation rate for the immediately preceding band, but by no more than 5 percentage points. Furthermore, the ratio of the allocation rate for any band to the allocation rate for the immediately preceding band cannot exceed 2.0 nor can it exceed the corresponding ratio of the allocation rates for the two immediately preceding bands. For example, if the allocation rates for the first two bands are 3% and 5%, then the allocation rate for the third band cannot be greater than  $5/3 \times 5 = 8-1/3\%$ .

For a schedule of allocation rates to have regular intervals, all the age or service bands, other than the band applicable to the highest age or last period of service, have to be of the same length. Also, if the schedule is based on age and the first band ends on or before age 25, the first band is deemed to be the same length as the other bands. If the first band ends after age 25, the starting age is deemed to be 25 or any younger age for the purpose of determining if the first band is a regular interval. For example, bands covering ages 0 to 30, 30 to 40, 40 to 50, and 50 and over are considered to be regular intervals.

In a change from the proposed regulations, it is now possible to have a minimum allocation rate at the lower ages and still be deemed to have a gradual age or service schedule provided one of the following conditions is met –

- The allocation rates that exceed the minimum could form part of a hypothetical gradual age or

service schedule in which the lowest allocation rate is at least 1% of compensation.

- No allocation rate above the minimum results in an equivalent accrual rate greater than the equivalent accrual rate of the oldest employee eligible for the minimum allocation rate.

**Buck Comment** – *The ability to use a minimum allocation rate is a change requested by Buck. It should prove helpful to sponsors of large nondiscriminatory plans.*

**Target Benefit Plans** – A target benefit plan is a DC plan in which the contribution is determined, under specified interest and mortality assumptions, as the amount needed to provide for a certain level of defined benefit. Some target benefit plans are safe harbor designs under the nondiscrimination regulations and are not affected by these final regulations.

In addition, a target benefit plan is deemed to have age-based allocation rates, and thus does not have to satisfy the gateway test, if it satisfies the definition of a safe harbor target benefit plan, except that it has one or more of the following provisions –

- The interest rate for determining present values is lower than a standard interest rate (i.e., 7-1/2% to 8-1/2%).
- The stated benefit is calculated assuming compensation increases.
- The current year contribution is calculated using the actual account balance instead of the theoretical reserve.

### **Combinations of Defined Benefit and Defined Contribution Plans (DB/DC Plans)**

Under the regulations, if one or more DB plans and one or more DC plans are aggregated for nondiscrimination testing, the resulting DB/DC plan can be tested on the basis of benefits (i.e., cross-tested) only if it meets one of three requirements. The DB/DC

plan would have to satisfy a gateway test, or be primarily DB in character, or consist of broadly available separate plans.

**Gateway for Benefits Testing of DB/DC Plans** – The regulations provide a numerical gateway to cross-testing a DB/DC plan that resembles the gateway test previously described for stand-alone DC plans. The gateway test is based on the calculation of an aggregate allocation rate for each employee. This rate is determined by adding the employee's allocation rate under the DC plan to the allocation rate that is the actuarial equivalent of the normal accrual rate under the DB plan.

Under the gateway test, if the aggregate allocation rate for the HCE with the highest aggregate allocation rate is less than 15%, then every eligible NHCE's aggregate allocation rate must be at least one-third of the highest HCE aggregate allocation rate. If the highest HCE aggregate allocation rate is between 15% and 25%, then every eligible NHCE's aggregate allocation rate must be at least 5%. If the highest HCE aggregate allocation rate exceeds 25%, then every eligible NHCE's aggregate allocation rate must be at least 5% plus 1% for each 5% increment (or portion thereof) by which the highest HCE aggregate allocation rate exceeds 25%.

Alternatively, the final regulations allow a plan to satisfy the minimum aggregate allocation gateway if the aggregate normal allocation rate for each NHCE is at least 7-1/2% of compensation as defined in Section 415(c)(3).

Instead of using each NHCE's equivalent allocation rate under a DB plan in calculating the aggregate allocation rate, it is permissible to use the average of the equivalent allocation rates of all NHCEs benefiting under the DB plan.

**Buck Comment** – *An arrangement, common to law firms, that provides a DB plan to the partners, a DC plan to the staff and cross-tests to pass the nondiscrimination rules, will continue to work under the*

*final regulations. However, the DC allocations may have to be increased.*

**Primarily DB in Character** – Under the final regulations, a DB/DC plan can use cross-testing if it is primarily DB in character – i.e., at least 50% of the NHCEs benefiting under the DB/DC plan have normal accrual rates in the DB plan that exceed their equivalent accrual rates attributable to allocations under the DC plan. For example, if the salaried employees of a company are only in the DC plan and the hourly employees are only in the DB plan, and at least 50% of all NHCEs are hourly employees, then the DB/DC plan would be considered primarily DB in character.

**Broadly Available Separate Plans** – Under the final regulations, a DB/DC plan can use cross-testing if it consists of broadly available separate plans – i.e., each plan would have to separately satisfy the non-discriminatory coverage and nondiscriminatory benefit or contribution requirements of the Internal Revenue Code, other than the average benefit percentage test. In conducting separate testing, all plans of the same type (DB or DC) within the DB/DC plan would be aggregated and tested without regard to plans of the other type.

**Buck Comment** – *Although the regulations suggest that the broadly available separate plans alternative might be useful to avoid the average benefit percentage test and/or separate lines of business testing, we believe it will be of limited use.*

*Also note that many floor-offset arrangements will be unable to use cross-testing and will have to be re-*

*designed. (In a floor-offset arrangement, benefits from a DB plan are reduced by benefits payable from a DC plan.)*

## **Component Plans and Permitted Disparity**

Under the regulations, cross-testing is not available for component plans under Section 401(a)(4).

Also, permitted disparity is not available in calculating allocation rates and equivalent allocation rates under the minimum allocation gateway, the minimum aggregate allocation gateway, or the DB in character alternative. With respect to a DB/DC plan, permitted disparity can be used either in the DB plan or in the DC plan, but not in both, to determine if the DB/DC plan consists of broadly available separate plans.

## **Effective Date**

The final regulations are effective for plan years beginning on or after January 1, 2002, regardless of when the plan became or becomes effective.

## **Conclusion**

For many sponsors of new comparability plans and similar arrangements, the final regulations may require additional allocations to NHCEs. Large plan sponsors that do not maintain new comparability plans but do use cross-testing will find the final regulations add an additional level of complexity and some risk of failing the nondiscrimination tests.

Buck's consultants would be pleased to discuss with you how these regulations might affect the design and administration of your retirement programs.

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