

New Comparability Profit Sharing Plans

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Qualified plans should be periodically reviewed to ensure compliance with statutory and regulatory changes and to assess whether the plans are meeting the client's objective. Plan sponsors should consider, among other things, new comparability plans or age-weighted profit-sharing plans. However, those contemplating changing a defined contribution plan into a "new comparability plan," may have to amend the plan to remove "built-in" disparities in contribution rates based upon recently issued proposed regulations.

Plan Design

Profit-sharing plans traditionally allocate the employer's contributions to each eligible participant's account under a formula that considers the employee's compensation for the year. In many plans, the allocation is in a pro-rata proportion to each participant's compensation. Other profit-sharing plans may allocate somewhat larger contributions to higher-paid employees, as allowed by the permitted disparity (integration) rules. However, traditional profit-sharing plans allocate the company's contributions solely on the basis of compensation, not age or length of service.

Under final non-discrimination regulations, an employer may maintain a qualified profit-sharing plan in which the participant's age is considered when allocating the employer's contributions. The result is that significantly larger amounts are provided to older employees than to younger employees.

Whereas, an employer may sponsor a qualified profit sharing plan taking into account new comparability, to affect the allocation of significantly larger amounts to higher paid employees, management level employees and owners (without regard to age and service).

New comparability plans and age-weighted profit sharing plans combine the flexibility of a profit sharing plan with the ability of a pension plan to skew benefits in favor of higher paid employees or older employees. This flexibility creates new planning choices for plan sponsors.

New Comparability

The Internal Revenue Code requires¹ that, as a condition of tax qualification, contributions or benefits provided under a plan may not discriminate in favor of highly compensated employees.² With the issuance of regulatory guidance, the Internal Revenue Service (IRS) revised the rules³ under which defined contribution plans may be tested for compliance on the basis of projected benefits and not on the basis of annual contributions. New comparability plans are generally used by doctors, accounting offices, law firms, and small closely held businesses that want to provide the owner and management team a better benefit package than is available under a traditional defined contribution plan arrangement.

A plan must satisfy the general non-discrimination requirements in the form of its document and its effect in operation. A defined contribution generally satisfies the requirements by demonstrating that contributions are non-discriminating in amount, through certain safe harbors or through general testing. A defined contribution plan may however satisfy the requirements on the basis of benefits, rather than contributions, by using the "cross-testing" method.

Under the cross-testing method, contributions are converted to equivalent benefits payable at normal retirement age and tested on the basis of these equivalent benefits. New comparability defined contribution plans use the cross-testing method to build disparities between the allocation rates for classifications of participants who are highly compensated and the allocation rates for all other employees.

Cross-testing led to the establishment of two primary types of defined contribution formulas that test for discrimination on an equivalent benefit basis: a formula using an age-weighted allocation formula, and the other using a new comparability allocation approach.

Under the age-weighted design approach, contributions under the plan are generally allocated proportionate to each individual participant's combination of compensation and age factor. Whereas the new comparability approach groups participants by some factors, such as owners vs. non-owners, or physicians vs. staff, with employees in the same group receiving the same allocation without regard to their respective ages or service.

IRS Concern

The IRS has grown increasingly concerned with the new comparability formula approach. In reliance upon the regulatory requirement that a profit sharing plan, while not required to provide definitely determinable contributions, is required to provide, as a condition of qualification, definitely determinable allocations, the IRS issued a Field Directive that would have made it virtually impossible to maintain new comparability profit sharing plans.⁴

Specifically, the IRS took the position that if a plan provides multiple allocation formulas and provides that the employer has discretion to decide each year the contribution to be made to each group, the plan would fail to provide a definite allocation even though, within each group, the allocation would be definitely determinable. Although the IRS ultimately withdrew the Field Directive, it did so not because of the impact on new comparability plans, but rather, because of the impact on plans being maintained by multiple members of a controlled group as well as the impact on failsafe language in Section 401 (k) plans.⁵

Thereafter, the IRS issued another Field Directive stating that while a plan may generally allow employers the discretion to determine the amount of employer contributions for each group of participants, the plan must require that the employer give the trustee written notice as to the amount to be allocated among each group each year.⁶

The IRS issued further guidance as it appeared to be uncomfortable with the new comparability approach, and the compatibility thereof with the overall goal of providing meaningful benefits to a broad class of participants.⁷

The IRS and Department of Treasury announced that they had initiated a review of issues related to the use of cross-testing by new comparability plans and requested public comments. As a result of that review,

the IRS has issued proposed regulations dealing with cross-tested plans, effective for plan years beginning on or after January 1,2002.

Proposed Regulations

The proposed regulations would not change the basic rules of cross-testing. However, the regulations would require either that a cross-tested plan provide broadly available allocation rates or satisfy a minimum allocation gateway in order to use cross-testing. If a defined contribution plan were to be aggregated with a defined benefit plan to satisfy the minimum coverage and nondiscrimination rules, special rules would be applied including a special minimum aggregate allocation gateway.

A cross-tested plan that provides broadly available allocation rates would not be affected by the proposed regulations. The definition of "broadly available allocation rates" includes certain plans that base allocations or allocation rates on age or service. These plans need to provide an opportunity for participants to "grow into" higher allocation rates as they age or accumulate additional service.⁸

Although the proposed regulations technically apply to all cross-tested defined contribution plans, the regulations are intended to apply primarily to new comparability plans and so called "super-integrated" plans, under which, an additional allocation rate applies only with respect to compensation above a certain level {e.g., in excess of \$100,000}. By satisfying the existing cross-testing regulations, super-integrated plans need not comply with the permitted disparity rules; therefore, they may have disparities in excess of what would be allocated under the permitted disparity rules.

Broadly Available Allocation Rates

A plan that provides "broadly available allocation rates" would not need to satisfy the minimum allocation gateway and may continue to use cross-testing as the rules currently exist.

A plan is deemed to have broadly available allocation rates for a plan year if each allocation rate under the plan is currently available during the plan year to a group of employees that satisfies the general coverage requirements (without regard to the average benefit percentage test). Current availability is determined based upon current facts and circumstances with respect to the employee (i.e., current compensation, position).

Thus, if within one plan, an employer provides different allocation rates for non-discriminatory 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. Although the current availability regulations permit certain conditions to be ignored for this purpose, the omission of age and service conditions applies only if the plan provides an allocation formula under which the allocation rates for all employees benefiting 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.

Thus, 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 only if the plan effectively permits participants to "grow into" higher allocation rates. This requirement will only be deemed satisfied if the schedule of allocation rates satisfies the above two requirements (i.e., a single schedule of rates is available to all employees in the plan based solely on either age or service under which the allocation rates under the schedule increase "smoothly" at regular intervals). A plan does not fail to provide broadly available allocation rates merely because it provides the minimum top-heavy benefit.

Smooth Progression

A plan will be deemed to use a single schedule of allocation rates that is 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 progresses 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 no more than five percentage points.

"Gateway" Requirements

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. This means then, that the schedule will be deemed to have a smooth progression if:

- the allocation rate for each age or service band is greater than the allocation rate for the immediately preceding band, but not by more than five percentage points, and
- the ratio of the allocation rate for an age or service band to the allocation rate for the immediately preceding band is not more than twice such allocation rate or, if less, the ratio of the allocation rates of the two preceding bands.

A schedule of allocation rates is deemed to have 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 the other bands, the starting age for the first age band is permitted to be treated as age 25 or any age earlier than 25.

For example, Plan M is a defined contribution plan that provides an allocation formula under which allocations are provided to all employees according to Exhibit 1.

EXHIBIT 1 Plan M Allocations		
Years of Service	Allocation Rate	Preceding Band
0-5	3.0%	N/A
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

Because the plan provides that allocation rates for all employees are determined using a single schedule based solely on service, the plan is permitted to ignore the service requirement in determining whether the allocation rates are broadly available, if the allocation rates under the schedule increase smoothly at regular intervals.

The schedule of allocation rates does not increase by more than five 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 twice such allocation rate and does not increase. As such, the allocation rates increase smoothly. In addition, the bands (other than the highest band) are all five years long, so the increases occur at regular intervals. Accordingly, the service requirement is ignored and each allocation rate is broadly available as each allocation rate is currently available to all employees in the plan.

Plan M satisfies the nondiscrimination in amount requirement of the proposed regulations on the basis of benefits if it satisfies the basic cross-testing requirement without regard to whether it satisfies the minimum allocation gateway.

In another example, Plan N is a defined contribution plan that provides an allocation formula under which allocations are provided to all employees according to Exhibit 2.

EXHIBIT Plan N Allocations	2	
Age	Allocation Rate	Preceding Band
under	25 3.0%	N/A
25-34	4.5%	2.00
35-44	9.2%	1.50
45-54	12.0%	1.33
55-64	16.0%	1.33
65 or older	21.0%	1.31

Because the plan provides that allocation rates for all employees are determined using a single schedule based solely on age, the plan is permitted to ignore the age requirement in determining whether the allocation rates are broadly available, if the allocation rates under the schedule increase smoothly at regular intervals.

The schedule of allocation rates does not increase by more than five 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 twice such allocation rate and does not increase. As such, 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 as each allocation rate is currently available to all employees in the plan.

Plan N satisfies the nondiscrimination in amount requirement on the basis of benefits if it satisfies the basic cross-testing requirement without regard to whether it satisfies the minimum allocation gateway.

Plans Failing Broadly Available Requirement

Plans that do not provide broadly available allocation rates must satisfy a minimum allocation gateway as a condition to utilization of the cross-testing regulations. Under the gateway, a plan would have to provide each non-highly compensated employee (NHCE) with a minimum allocation rate equal to at least one third of the allocation rate of the highly compensated employee (HCE) with the highest allocation rate. However, a plan would be deemed to satisfy the minimum allocation gateway if each NHCE receives an allocation of at least 5 percent of his or her compensation. This effectively results in a minimum allocation for NHCEs equal to at least the lesser of (i) 5 percent or, (ii) one-third of the allocation rate of the HCE with the highest allocation rate.

Where the HCE with the highest allocation rate has an allocation rate of less than 15 percent, the one third rule would apply as the minimum. Where the HCE with the highest allocation rate has an allocation rate of 15 percent or greater, the 5 percent rule applies. Allocation rates are determined by dividing the employee's allocation for the plan derived from employer contributions but excluding matching contributions under a 401 (k) plan, by the employee's compensation. However, the plan cannot take into consideration imputed permitted disparity for this purpose.

For example, Plan O is a profit sharing plan that covers all employees of the plan sponsor consisting of two HCEs (X and Y) and seven NHCEs. HCE X has compensation of \$170,000 and Y has compensation of \$150,000. Each receives an allocation of \$30,000 resulting in an allocation rate of 17.6 percent and 20 percent, respectively. Each NHCE receives an allocation of 5 percent of compensation. 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.

The highest allocation rate for any HCE under the plan is 20 percent. Accordingly, Plan O would satisfy the minimum allocation gateway if all NHCEs have an allocation rate of at least 6.67 percent, or if all NHCEs receive an allocation of at least 5 percent of compensation. Under Plan O, each NHCE receives an allocation of 5 percent of compensation. Accordingly, Plan O satisfies the minimum allocation gateway.

Aggregation with Defined Benefit Plans DEFINED BENEFIT PLANS

Where an employer maintains both a defined benefit plan and a defined contribution plan that is or proposes to be cross-tested and the plans are permissively aggregated to satisfy the minimum coverage and nondiscrimination requirements, the plans would have to satisfy a special minimum aggregate allocation gateway in order to be permitted to demonstrate satisfaction of the nondiscrimination in amounts requirement on the basis of benefits unless: (i) for the plan year, the defined benefit/defined contribution plan is primarily defined benefit in character, or (ii) the plans consists of broadly available separate plans.

A defined benefit/ defined contribution plan is primarily defined benefit in character if for more than 50 percent of the NHCEs benefiting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under the defined benefit plan that is part of the aggregated group exceeds the equivalent accrual rate for the NHCE attributable to contributions under the defined contribution plan that is part of the defined benefit/ defined contribution plan.

The defined benefit/ defined contribution plan will be deemed to consist of broadly available separate plans if the defined contribution plan and the defined benefit plan each would separately satisfy the coverage and nondiscrimination in amount requirement, assuming that the average benefit percentage test were satisfied. For this purpose, all defined contribution plans that are part of the defined benefit/ defined contribution plan and all defined benefit plans that are part of the defined benefit plans of the purposes of satisfying the separate testing requirement 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.

Where the combined plan does not satisfy either the primarily defined benefit test or the broadly available separate plan requirement, the plan must satisfy a special minimum aggregate allocation gateway. The aggregated plan will satisfy the minimum aggregate allocation gateway 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, or, if less, five percent of the NHCE's compensation, provided that the HCE rate does not exceed 25 percent of compensation.

If the HCE rate exceeds 25 percent of compensation, then the aggregate normal allocation rate for each NHCE must be five percent increased by one percentage point for each five percentage point increment (or portion thereof) by which the HCE rate exceeds 25 percent (e.g., the NHCE minimum is 6 percent for an HCE rate that exceeds 25 percent but not 30 percent and 7 percent for an HCE rate that exceeds 30 percent but not 35 percent).

For this purpose, 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 benefiting under that plan.

NOTES

- 1. I.R.C. §401(a) (4).
- 2. I.R.C. §414(q).
- 3. Treas. Reg. §1.401(a)(4)8(b)(1).
- 4. IRS Field Directive (Sept. 8, 1994).
- 5. IRS Memorandum (July 30, 1996).
- 6. IRS Directive Concerning Cross-Tested Plans (Mar.13,1998).
- 7. IRS Notice 2000-14,2000-10 I.R.B. 737.
- 8. Preamble to Proposed Regulations, 65 Fed Reg.59774 (Oct. 6, 2000).
- 9. I.R.C. §401(1).
- 10. Treas. Reg. §.401(a)(4)-4(b)(2).
- 11. I.R.C. §410(b).
- 12. Treas. Reg. §1.410(b)-5.
- 13. Treas. Reg. §1.401(a)(4)-4(b)(2)(i).