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INFORMATION RELEASE

IRS Issues Proposed New Comparability Regulations

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The Internal Revenue Service has issued proposed regulations affecting new comparability plans. A new comparability plan is one that provides a higher contribution rate for one or more key executives than it does for other participants.

For example, the key executive(s) might receive contributions of 10% of pay while all other participants receive contributions of 5% of pay. These plans rely on a process called "cross testing" to prove that they do not discriminate in favor of highly compensated employees. This means that the discrimination test is based on the amount of retirement income that can be generated by the contributions rather than on the contributions themselves.

The proposed regulations are significant because, in many cases, they require an increase in the contribution rate for participants who are not highly compensated.

Proposed Requirements

Under the proposed rules, "cross testing" cannot be used unless all nonhighly compensated employees (generally, those earning less than \$85,000 per year) receive a rate of contribution at least equal to the lesser of:

- (a) 1/3 of the highest contribution rate for any highly compensated employee, or
- (b) 5.0%.

In effect, the proposed regulations are creating a "gateway" in the form of a minimum contribution that must be made in order to use new comparability/cross testing to prove nondiscrimination.

For example...

1. In many new comparability plans, key executives receive contributions of \$19,500 (so that, along with a 401(k) contribution of \$10,500, the \$30,000 maximum total contribution is achieved). Based on compensation of \$170,000, the key executives are receiving 11.5% of pay (\$19,500 divided by \$170,000). Under the proposed regulations, the nonhighly compensated employees must receive allocations of at least 1/3 of 11.5%, or 3.83% of pay. If the plan currently provides for contributions less than 3.83% of pay, the contribution rate will have to be increased.

2. In plans where the key executives receive contributions of \$30,000, this represents 17.7% of their \$170,000 compensation. Under the new rules, the nonhighly compensated employees must receive contributions at least equal to 5% of pay (since 1/3 of 17.7% is greater than 5.0%, the 5.0% minimum applies).

Discrimination Testing Still Required

This minimum contribution percentage does **not** replace the annual nondiscrimination test. If this test results in a contribution requirement that exceeds the new minimum, the larger contribution must be made.

Combination Defined Benefit & Defined Contribution Plans

If a new comparability plan is combined with a defined benefit plan, such as a cash balance plan, the minimum contribution requirement will likely exceed 5.0% of pay. The rules for combination plans are very complex and beyond the scope of this information release.

Effective Date

The proposed regulations are to be effective for plan years beginning on or after January 1, 2002. Until that time, both new and existing plans can be operated under the current, more favorable rules.

To Learn More

The new regulations will have an impact on many plans. You can learn more about the new rules at one of our Retirement Plan Seminars being held this month. For information on these seminars, visit our web site at www.lkravitz.com or call Diane Hill at (818) 379-6147.

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