



IRS Proposes Regulations limiting New Comparability Allocations

The IRS recently proposed regulations that, if finalized, may have drastic effects on plans with new comparability allocation formulas and individual allocation groups. The regulations would make it harder for affected plans to pass nondiscrimination testing and would increase costs for employers maintaining such plans.

Current Regulations

Using a new comparability allocation method, an employer can demonstrate that a profit sharing contribution is nondiscriminatory by using “rate group testing.” Contributions are projected to normal retirement age using an assumed interest rate and mortality table. To satisfy rate group testing, each rate group must pass either the ratio percentage test or the average benefit test.

To satisfy the ratio percentage test, at least 70 percent of the nonhighly compensated employees (NHCEs) must benefit when compared to the percentage of highly compensated employees (HCEs) who benefit under the plan.

A plan that fails the ratio percentage test can attempt to satisfy testing using the average benefits test. The average benefits test is a two-step test.

Step One: Nondiscriminatory Classification Test

A rate group satisfies the nondiscriminatory classification test (including the reasonable classification requirement) if the rate group’s ratio percentage equals or exceeds the midpoint between the safe harbor and the unsafe harbor percentages for the plan and the ratio percentage for the plan, whichever is less.

Step Two: Average Benefit Percentage Test

The average benefit provided to the NHCEs must be at least 70 percent of the average benefit provide to the HCEs.

Proposed Regulations

The testing under the IRS’ recently proposed regulations changes Step One of the average benefits test. Under the proposal, the current requirements described above will apply, but the formula used to determine the allocation for the HCE’s rate group must apply to a group of employees that satisfies the reasonable classification requirement.

A rate group is currently deemed to meet the reasonable classification requirement as long as the rate group satisfies a numerical test based upon the rate group’s ratio percentage and the NHCE concentration in the plan. To use the average benefits test, the proposed regulations would require each HCE within a rate group to have an allocation that satisfies a reasonable classification requirement. A reasonable classification, which currently applies only to coverage testing, would need to be determined “based on all the facts and circumstances” and be

“established under objective business criteria that identify the category of employees who benefit under the plan”. Examples of reasonable classifications generally include the nature of compensation (e.g., hourly or salaried), geographic location, and similar bona fide business criteria.

Effect

Many employers that use rate group testing place each employee into a separate allocation group. This allows an employer the most flexibility when allocating contributions and satisfying either the ratio percentage test or average benefits test for each rate group. Employers that use individual allocation groups would, if the proposed regulations become final, no longer be able to satisfy rate group testing using the average benefits test as the groups will not satisfy the reasonable classification requirement. Their plans would need to either be amended so that the allocation groups satisfy the reasonable classification requirement or have each rate group satisfy the ratio percentage test, which could require significantly higher employer contributions than are needed under the current regulations. In addition, the average benefits test, currently an entirely numerical test, would include a “facts and circumstances” component. Without being reviewed by the IRS, employers will not know if their classifications of employees are considered reasonable.

Conclusion

If the regulations are finalized, they may have a dramatic effect on employers whose plans currently use a new comparability allocation formula. The timing of the proposed regulations is curious considering the IRS recently relaxed rules that limited the number of allocation groups for NHCEs in prototype plans. More disconcerting is that this new proposal was completely unexpected. It immediately follows the restatement of pre-approved plans for the Pension Protection Act of 2006 and may require plans to be amended. The IRS is currently accepting comments until April 28, 2016, with a public hearing scheduled for May 19, 2016. The regulations are proposed to become effective the plan year beginning after the regulations are finalized.