35, the sum of the total annual disparity fractions for an employee cannot exceed 35. The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 3. Plan O is a defined benefit excess plan that provides a normal retirement benefit of 0.75 percent of average annual compensation up to covered compensation, plus 1.25 percent of average annual compensation above covered compensation, for each year of service up to 45. The disparity provided under the plan for the plan year is 0.5 percent, the excess benefit percentage of 1.25 percent minus the base benefit percentage of 0.75 percent. The maximum excess allowance for the plan year is 0.75 percent. Thus, each employee's annual defined benefit excess plan disparity fraction under the plan for each plan year is 0.67 (0.5 percent divided by 0.75 percent). Because the plan limits the years of service taken into account under the plan to 45, the sum of the total annual disparity fractions for an employee cannot exceed 30 (0.67 x 45). The plan therefore satisfies the cumulative permitted disparity limit of this paragraph (c).

Example 4. (a) Plan P is a defined contribution excess plan. Plan P provides a base contribution percentage of 6 percent and an excess contribution percentage of 11.7 percent, thus providing disparity of 5.7 percent for the plan year. Because the maximum excess allowance for each plan year under Plan P is 5.7 percent, each employee's annual defined contribution excess plan disparity fraction under Plan P for each plan year is one. Plan Q is a defined benefit excess plan maintained by the same employer. Plan Q provides a base benefit percentage of 1 percent and an excess benefit percentage of 1.75 percent for each year of service up to 35, thus providing disparity of 0.75 percent for the plan year. Because the maximum excess allowance for each plan year under Plan Q is 0.75 percent, each employee's annual defined benefit excess plan disparity fraction under Plan Q for each plan year is one.

(b) Employee A benefits under Plan P for the 1980 through the 1994 plan years. The sum of Employee A's total annual disparity fractions under Plan P is 15. (Under paragraph (c)(3)(i) of this section, Employee A's annual disparity fraction for each year of service as of the end of the 1988 plan year is one.) As of the 1995 plan year, Employee A no longer benefits under Plan P and begins to benefit under Plan Q for the first time. In order to satisfy the cumulative permitted disparity limit of this paragraph (c), Plan Q must provide that no disparity will be provided if the sum of an employee's total annual disparity fractions reaches 35, taking into account the employee's annual defined contribution plan disparity fractions under Plan P as well as the employee's annual defined benefit excess plan disparity fractions under Plan Q. Thus, after Employee A has benefited under Plan Q for 20 years, Plan Q may not provide any disparity in additional benefits accrued for Employee A.

(d) *Additional rules.* The Commissioner may prescribe additional rules under this section as the Commissioner considers appropriate Additional rules may include (without being limited to) rules for computing the fractions described in this section with respect to terminated plans, rules for applying the overall permitted disparity limits to employees who benefit under plans maintained by railroad employers, and rules for determining which plans do not satisfy section 401(l) if the overall permitted disparity limits are not exceeded.

§ 1.401(l)–6 Effective dates and transition rules.

(a) *In general.* Section 401(a)(5)(C) is effective for plan years beginning after December 31, 1988, and section 401(l) is effective with respect to plan years, and benefits attributable to plan years, beginning after December 31, 1988. The preceding sentence is applicable to a plan without regard to whether the plan was in existence as of a particular date.

(b) *Defined contribution plans.* A defined contribution plan satisfies section 401(l) with respect to a plan year beginning after December 31, 1988, if it satisfies the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 for the plan year.

(c) *Defined benefit plans.* A defined benefit excess plan or offset plan satisfies section 401(l) with respect to all plan years, and benefits attributable to all plan years, beginning after December 31, 1988, by satisfying the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 and the requirements § 1.401(a)(4)–13(c), using as the fresh-start date the last day of the last plan year beginning before January 1, 1989. A defined benefit excess plan or offset plan that does not satisfy section 401(l) with respect to all plan years, and benefits attributable to all plan years, beginning after December 31, 1988, may, under the rules of § 1.401(a)(4)–13(c), satisfy section 401(l) for plan years beginning after a fresh-start date by satisfying the applicable requirements of §§ 1.401(l)–1 through 1.401(l)–5 after the fresh-start date. See § 1.401(a)(4)–13 (c)(5)(iii) and (d), which allow increases in each employee's benefit accrued as of the fresh-start date to reflect increases in the employee's compensation if the plan uses a fresh-start date before the effective date applicable to the plan under § 1.401(a)(4)–13 (a) or (b).

(d) *Collectively bargained plans.* (1) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986, sections 401(a)(5) and 401(l) are applicable for plan years beginning on or after the later of—

(i) January 1, 1989, or

(ii) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986). However, notwithstanding the preceding sentence, sections 401(a)(5) and 401(l) apply to plans described in this paragraph (d) no later than the first plan year beginning after January 1, 1991.

(2) For purposes of paragraph (d)(1)(ii) of this section, a change made after October 22, 1986, in the terms or conditions of a collectively bargained plan, pursuant to a collective bargaining agreement ratified before March 1, 1986, is not treated as a change in the terms and conditions of the plan.

(3) In the case of a collectively bargained plan described in paragraph (d)(1) of this section, if the date in paragraph (d)(1)(ii) of this section precedes November 15, 1988, then the date in this paragraph (d) is replaced with the date on which the last of any collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(l).

(4) Whether a plan is maintained pursuant to a collective bargaining agreement is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan is not treated as maintained under a collective bargaining agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See § 301.7701–17T of this chapter for other requirements for a plan to be considered to be collectively bargained. In the case of a collectively bargained plan described in paragraph (d)(1) of this section, if the date in paragraph (d)(1)(ii) of this section precedes November 15, 1988, then the date in this paragraph (d) shall be replaced with the date on which the last of any collective bargaining agreements in effect on November 15, 1988, terminates, provided that the plan complies during this period with a reasonable good faith interpretation of section 401(l).

Fred T. Goldberg, Jr.,

Commissioner of Internal Revenue.

Approved: August 30, 1991.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

[FR Doc. 91–21923 Filed 9–12–91; 10:53 am]

BILLING CODE 4830–01–M

26 CFR Part 1

[T.D. 8363]

RIN 1545-AK41

Minimum Coverage Requirements

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the minimum coverage requirements of section 410(b) of the Internal Revenue Code of 1986. They reflect changes made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance necessary to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans and certain other employee benefit plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning on or after January 1, 1989, and applied to those plan years except as set forth in § 1.410(b)-10.

FOR FURTHER INFORMATION CONTACT: Rebecca Wilson at 202-377-9372 (not a toll-free number).

SUPPLEMENTARY INFORMATION: Proposed regulations under section 410(b) of the Internal Revenue Code (Code) were published in the **Federal Register** May 18, 1989 (54 FR 21437). The proposed regulations were supplemented and modified by proposed regulations published in the **Federal Register** on May 14, 1990 (55 FR 19897, 19931, and 55 FR 19947, 19958), September 14, 1990 (55 FR 37888, 37901), December 3, 1990 (55 FR 49906, 49908), and February 1, 1991 (56 FR 3988).

Written comments were received from the public on the proposed regulations. In addition, a public hearing on the proposed section 410(b) regulations was held November 20, 1989; a public hearing on the May 14, 1990, and September 14, 1990, proposed regulations was held September 26, 27, and 28, 1990; and a public hearing on the February 1, 1991, proposed regulations was held on May 16, 1991. After consideration of all the written comments received and the statements made at the public hearings, the proposed regulations under section 410(b) are adopted as modified by this Treasury Decision.

Explanation of Provisions:

Section 410(c) Minimum Coverage Requirement

I. The minimum coverage requirement

The proposed regulations provided that a plan could meet the section 410(b) minimum coverage requirement by satisfying either of two tests, the section 410(b)(1)(A) and (B) ratio percentage test or the section 410(b)(2) average benefit test. These provisions are retained in the final regulations. To satisfy the ratio percentage test for a plan year, a plan must have a ratio percentage of at least 70 percent. A plan's ratio percentage is the percentage of the employer's nonhighly compensated employees who benefit under the plan divided by the percentage of the employer's highly compensated employees who benefit under the plan.

To satisfy the average benefit test, two requirements must be met—the nondiscriminatory classification test of section 410(b)(2)(A)(i) and the average benefit percentage test of section 410(b)(2)(A)(ii). The nondiscriminatory classification test requires a plan to benefit employees who qualify under a reasonable employer-determined classification that does not discriminate in favor of highly compensated employees. The average benefit percentage test requires that the average benefit percentage for nonhighly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees. Both of these requirements are discussed in greater detail below.

2. Plans automatically meeting the minimum coverage requirement

The final regulations retain provisions under which certain plans automatically satisfy the minimum coverage requirement. These include plans that benefit only nonhighly compensated employees, plans maintained by employers that have only highly compensated employees, and collectively bargained plans or portions of plans (including governmental plans described in section 414(d)). The proposed regulations also provided that a plan with no accruals for a plan year automatically satisfied section 410(b). This remains true but the provision has been deleted in the final regulations because any plan that automatically satisfies section 410(b) under this rule also satisfies section 410(b) automatically because it is a plan that benefits no highly compensated employees for a plan year.

3. Benefiting Under a Plan

As provided in the proposed regulations, the final regulations provide that an employee benefits under a plan for a plan year only if the employee receives an allocation or an accrual for that plan year. Thus, for example, an employee who has an accrued benefit under a defined benefit plan but does not receive an accrual for the plan year because the employee worked less than the 1,000 hour minimum service requirement under the plan in that year is not benefiting under the plan for the plan year. Or, for example, an employee who is a participant in a defined contribution plan but does not receive an allocation because the employee is not employed by the employer on the last day of the plan year is not benefiting under the plan for the plan year. To the extent that Rev. Rul. 76-250, 1976-2 C.B. 124, and Rev. Rul. 81-210, 1981-2 C.B. 89, conflict with this general rule, they are superseded.

The final regulations also retain the special rule for section 401(k) and section 401(m) plans. Thus, an employee benefits under these plans for purposes of section 410(b) if the employee is eligible to make elective contributions (in the case of the section 401(k) feature) or to make after-tax employee contributions or to receive matching contributions (in the case of the section 401(m) feature), regardless of whether the employee actually elects to participate.

The final regulations retain and clarify the general rule that a former employee benefits under a plan for a plan year only if the plan provides additional benefit accruals for the former employee for that plan year. Thus, for example, a former employee is benefiting under a plan for a plan year if the plan is amended to provide an ad hoc cost-of-living increase in the former employee's benefits, and the amendment is first effective in the plan year.

4. Nondiscriminatory Classification Test

The section 410(b)(2)(A)(i) nondiscriminatory classification test requires a plan to benefit a group of employees that constitutes an employer-determined classification that is both reasonable and nondiscriminatory. The final regulations, like the proposed regulations, require that, in order to be a reasonable classification, the classification must be based on objective business criteria that identify the category of employees who benefit under the plan.

The final regulations, like the proposed regulations, provide that the nondiscrimination requirement under the nondiscriminatory classification test may be met by satisfying either a safe harbor or a facts-and-circumstances test. While the safe harbor in the final regulations is unchanged, the presentation of the requirements has been revised to improve clarity. As revised, the first step in determining

whether the safe harbor is satisfied is to determine the plan's ratio percentage in the same manner as the ratio percentage calculation described above in the discussion of the ratio percentage test. Under an incremental scale set forth in a chart in the regulations, a plan satisfies the safe harbor if the ratio percentage of the plan is 50 percent (or, as the concentration of nonhighly compensated employees in the employer's workforce increases, a lesser percentage). For example, if 64 percent of an employer's employees are nonhighly compensated employees, the safe harbor ratio percentage for the employer's plans is 47 percent. If 96 percent of an employer's employees are nonhighly compensated employees, the safe harbor ratio percentage for the employer's plans is 23 percent.

The regulations also provide an incremental scale un-safe harbor beginning at a ratio percentage of 40 percent and decreasing to 20 percent as the concentration of nonhighly compensated employees in the employer's workforce increases. Thus, any plan with a ratio percentage below 20 percent necessarily falls within an unsafe harbor and does not satisfy the minimum coverage requirement of section 410(b).

As in the proposed regulations, the final regulations provide that a plan with a ratio percentage between the safe harbor and the unsafe harbor ratio percentages may satisfy the nondiscrimination requirement of the nondiscriminatory classification test on the basis of facts and circumstances. Relevant facts and circumstances include the underlying business reason for the classification, the percentage of employees benefiting under the plan, whether the number of employees benefiting under the plan in each salary range is representative of the total in that range, how close the plan's ratio percentage is to the employer's safe harbor percentage, and the extent to which the plan's average benefit percentage exceeds 70 percent. The list of relevant facts and circumstances was revised in the final regulations to add the average benefit percentage factor. The revised list continues to provide only examples and is not intended to be exhaustive of all potentially relevant facts and circumstances for purposes of this nondiscrimination determination.

5. Average Benefit Percentage Test

As in the proposed regulations, satisfaction of the average benefit percentage test requires that the employer determine an employee benefit percentage for each employee taken into account for testing purposes and then separately average the percentages of all employees in the highly compensated and nonhighly compensated groups. In general, the test is satisfied if the benefits provided to nonhighly compensated employees under all plans of the employer (expressed as a percentage of compensation) are at least 70 percent as great, on average, as the benefit provided to the employer's highly compensated employees (expressed as a percentage of compensation).

The proposed regulations permitted benefit percentages to be determined on either a contribution or a benefit basis, using the approach provided under the proposed section 401(a)(4) regulations to determine accrual and allocation rates under aggregated plans. The final regulations generally continue this approach, but revise it to reflect changes made in the testing methods provided in the final regulations under section 401(a)(4) that are being issued simultaneously with these final regulations. In addition, in response to comments, a new method is provided for determining employee benefit percentages that allows an employee's employee benefit percentage to be calculated as the sum of the employee's allocation and accrual rates (as determined for purposes of section 401(a)(4)) under all plans in which the employee participates, provided the rates are determined on a consistent basis. This optional simplified method will in many cases permit employers to use the rates they have already calculated for purposes of section 401(a)(4) for purposes of the average benefit percentage test as well.

While, in general, all plans of the employer must be aggregated into a single testing group for purposes of the average benefits percentage test, this rule does not apply to aggregate collectively bargained plans with noncollectively bargained plans; to aggregate plans of different lines of business where the employer is treated as operating separate lines of business under section 414(r); or to aggregate plans maintained by different employers. In response to comments, however, and in the limited context of the average benefit percentage test, a special rule has been added to the final regulations to permit benefits provided to collectively bargained employees and noncollectively bargained employees to be considered together where the benefits are provided under a single plan covering both collectively bargained and noncollectively bargained employees. The special rule is only available to such a plan if the plan as a whole satisfies the ratio percentage test, and both groups of employees are covered under the same benefit formula. Under this special rule, a plan meeting these requirements is deemed to satisfy the average benefit percentage test. The special rule is applicable only to the average benefit percentage test prong of the average benefit test in § 1.410(b)–2(b)(3). Therefore, both groups must still separately satisfy the nondiscriminatory classification test of § 1.410(b)–4.

6. Retroactive Correction Mechanism

In response to comments, these final regulations, like the final regulations under section 401(a)(4) being issued simultaneously with these regulations, permit retroactive correction within a period extending through the fifteenth day of the tenth month after the end of the plan year. This approach, which is similar to that contained in section 401(b) with respect to certain disqualifying provisions, provides the employer with a significant period within which to run any necessary tests and take corrective action.

In order to permit employers to make practical choices based on administrative concerns, use of the retroactive correction period is not conditioned on a demonstration that the plan actually failed to satisfy the nondiscrimination requirements, including the minimum coverage requirements. In addition, the correction is not limited to amendments correcting disqualifying defects. The final regulations do require, however, that any retroactive amendment be nondiscriminatory standing alone and be consistent with the anti-cutback rules of section 411(d)(6).

7. Excludable Employees

Generally, in applying the minimum coverage requirements, all employees of the employer are taken into account. However, the final regulations, like the proposed regulations, provide that the following employees are excluded from consideration: employees who do not meet the plan's minimum age and service conditions, employees covered by a collective bargaining agreement (when testing the noncollectively bargained portion of the plan), employees of other qualified separate lines of business (when testing a plan of a given qualified separate line of business), and terminated employees with not more than 500 hours of service.

The final regulations revise the employee exclusion rules in five additional respects. First, the exclusion for terminated employees with not more than 500 hours of services, which was

mandatory in the proposed regulations, is permissive in the final regulations and is further modified to make the rule available to plans using the elapsed time method of determining years of service.

Second, in response to comments, the final regulations provide special rules to accommodate situations in which employees move into and out of collectively bargained status within a limited period of time while continuing to receive benefits pursuant to a collective bargaining agreement. Under these rules, the employer may, in certain situations, temporarily continue to treat these individuals as collectively bargained employees for purposes of satisfying section 410(b).

Third, because section 401(k)(4)(B) generally precludes state and local governments and tax-exempt organizations from maintaining section 401(k) plans for their employees, commentators requested that employees of these entities be excludable where the other employees of the controlled group are eligible to participate in a section 401(k) plan. Thus, an exclusion was added to the final regulations for employees of governmental or tax-exempt entities if those employees are precluded statutorily from benefiting under a section 401(k) plan and if more than 95 percent of the employees who are not precluded statutorily from participating in the section 401(k) plan benefit under the section 401(k) plan for the plan year.

Fourth, in response to comments, the final regulations clarify that an employee is treated as meeting a plan's age and service requirements on the date any employee with the same age and service would be eligible to commence participation in the plan. This conforms to the provision of section 410(b)(4)(C).

Finally, employees who are nonresident aliens and who receive no U.S. source earned income are excluded even if they are benefiting under the plan. The exclusion of nonresident aliens who receive no U.S. source income is required by section 410(b)(3)(C) and was included in the proposed regulations. A rule has been added to the final regulations permitting an employer to exclude nonresident aliens who receive U.S. source income if that income is exempt from U.S. income tax under an applicable income tax convention and if the employer excludes all employees in this category.

8. Definition of Plan and Rules of Disaggregation and Aggregation

In general, under the proposed regulations, each single plan (determined under the rules of section 414(l)) is a separate plan for purposes of section 410(b). In addition, the proposed regulations required certain single plans under section 414(l) to be disaggregated into two or most separate plans, each of which must satisfy section 410(b). These rules apply, for example, to separate the collectively bargained portion of a plan from the non-bargained portion, the employee stock ownership plan (ESOP) portion from the non-ESOP portion, and the qualified cash or deferred arrangement under section 401(k) (CODA) from the non-CODA portion. Several commentators requested exceptions from mandatory disaggregation of collectively bargained and noncollectively bargained portions of plans. In general, the final regulations retain the mandatory disaggregation rules, as they are consistent with the mandatory testing exclusions applicable to collectively bargained and noncollectively bargained employees in section 410(b). A limited exception in the context of the average benefit percentage test is provided in the final regulations and discussed in the context of that test above. Some commentators also requested guidance on the treatment of the defined contribution portion of a defined benefit plan that provides benefits described in section 414(k) based on separate accounts. The final regulations clarify that the defined benefit and defined contribution portions of such a plan are treated as separate plans.

The final regulations continue to provide permissive aggregation rules under which two or more plans that are not mandatorily disaggregated may be treated as a single plan for purposes of the ratio percentage and nondiscriminatory classification tests. The final regulations also continue to provide rules for determining the testing group of plans taken into account in determining whether a plan satisfies the average benefit percentage test. The final regulations clarify, however, that, except in certain limited circumstances such as the determination of excludable employees, the plans in the testing group are not actually treated as a single plan.

9. Other Rules

a. *Former employees.* The final regulations, like the proposed regulations, require that a plan satisfy the minimum coverage requirements separately for employees and former employees for each plan year. If no former employee receives an additional benefit accrual for a plan year, the plan automatically satisfies section 410(b) with respect to former employees. The proposed regulations included a special rule under which a defined benefit plan satisfied section 410(b) with respect to former employees for a plan year if (i) it benefits at least five former employees and (ii) 60 percent of benefiting former employees are nonhighly compensated employees. The final regulations retain this special rule, but add an alternative under which the second prong of the test is satisfied if 95 percent of all former employees with accrued benefits under the benefit under the plan.

b. *Plans maintained by more than one employer.* Multiple employer plans must satisfy section 410(b) on an employer-by-employer basis rather than on the basis of participating employers in the aggregate. Any noncollectively bargained portion of a multiemployer plan is tested as a multiple employer plan. Failure to satisfy section 410(b) with respect to any component of this testing process may result in disqualification of the plan for all participating employers. The final regulations, like the proposed regulations, do not provide an exception to this rule. However, where a multiemployer plan or a multiple employer plan fails to satisfy section 410(b), in a proper case, the Commissioner could retain the plan's qualified status for innocent employers by requiring corrective and remedial action with respect to the plan, such as allowing the withdrawal of an offending employer, allowing a disqualifying defect to be cured within a reasonable period of time after the plan administrator has or should have knowledge of the disqualifying event or was otherwise notified by the Service of the disqualifying defects, or requiring plan amendments to prevent future disqualifying events.

c. *Special rules for governmental plans, church plans, and tax-sheltered annuities.* In general, except for certain plans that provide section 403(b) tax-sheltered annuities, governmental plans and church plans must satisfy section 401(a)(3), as in effect prior to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), in lieu of satisfying section 410(b). The final regulations clarify, however, that, for purposes of this requirement, a plan that satisfies section 410(b) will be treated as satisfying pre-ERISA section 401(a)(3).

Governmental plans and church plans that provide nonelective contributions under section 403(b) must, pursuant to section 403(b)(12), satisfy section 410(b). Because section 410(c) does not apply to such plans, satisfaction of pre-ERISA section 401(a)(3) will not satisfy section 403(b)(12). Of course, such plans may continue to rely on the safe harbors

published in Notice 89–23, 1989–1 C.B. 654, until further guidance is issued.

Under the proposed regulations, section 410(b) was considered to be satisfied in the case of governmental plans for plan years beginning before 1993. This provision is retained in the final regulations. In addition, the final regulations provide that, if the governing body with authority to amend the plan does not meet continuously, section 410(b) will be considered satisfied for plan years beginning before 90 days after the opening of the first legislative session beginning after December 31, 1992.

The Treasury and the Service recognize that governmental plans may have some unique features that arise because the sponsoring employer is a governmental entity. Comments are specifically requested from governmental employers regarding the appropriate modifications to the regulations to take into account the operation of governmental plans.

d. *Special rule for certain dispositions or acquisitions.* Section 410(b)(6)(C) and the proposed regulations provide a transition rule for certain dispositions or acquisitions, under which a plan is treated as satisfying section 410(b) for a limited period. In response to comments, the final regulations clarify that this rule applies to asset as well as stock transactions as long as the transaction involves a change in employer of the employees of a trade or business. See § 1.410(b)–2(f).

e. *Definition of employee.* In response to comments, a provision has been added to clarify that an individual is treated as an employee rather than a former employee if the plan credits the individual with imputed compensation or service during a period in which the individual is not performing services.

f. *Annual testing option.* Under the proposed regulations, a plan was generally required to satisfy section 410(b) on every day of the plan year. Under certain conditions, a plan could, however, be deemed to satisfy section 410(b) for a plan year if it satisfied section 410(b) on a selected day in each quarter. The final regulations retain and clarify these minimum coverage testing rules in the proposed regulations. In addition, the final regulations add an annual testing option. Under this new testing option, a plan will satisfy section 410(b) for a plan year if it satisfies § 1.410(b)–2 as of the last day of the plan year. If this option is used, the employer must take into account all employees (or former employees) who were employees (or former employees) on any day during the plan year. This new annual method is required to be used in testing plans subject to section 401(k) or section 401(m), and for purposes of the average benefit percentage test.

g. *Other modifications.* The final regulations have also been clarified in certain respects and modified in conjunction with the final section 401(a)(4) regulations. For example, the definitions of compensation used are generally the same as those applicable under section 401(a)(4). As another example, a rule has been added to the final regulations to provide that all percentages are calculated to the nearest hundredth of a percentage point and all other numbers are calculated to the nearest hundredth.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Rebecca Wilson and Nancy J. Marks, Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

List of Subjects in 26 CFR 1.401–0 through 1.419A–2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * §§ 1.410(b)–2 through 1.410(b)–10 also issued under 26 U.S.C. 410(b)(6). * * *

Par. 2. New § 1.410(b)–0 is added to read as follows:

§ 1.410(b)–0 Table of Contents.

This section contains a listing of the headings of §§ 1.410(b)–1 through 1.410(b)–10.

§ 1.410(b)–1 Minimum coverage requirements (before 1989).

(a) In general.
(b) Coverage tests.
(1) Percentage test.
(2) Classification test.
(c) Exclusion of certain employees.
(1) Bargaining unit.
(2) Air pilots.
(3) Nonresident aliens.
(d) Special rules.
(1) Highly compensated.
(2) Discrimination.
(3) Multiple plans.
(4) Profit-sharing plans.
(5) Certain classifications.
(6) Integration with Social Security Act.
(7) Different age and service requirements.
(i) Application.
(ii) General rule.
(8) Certain controlled groups.
(9) Transitional rule.
(e) Example.

§ 1.410(b)–2 Minimum coverage requirements (after 1988).

(a) In general.
(b) Requirements with respect to employees.
(1) In general.
(2) Ratio percentage test.
(i) In general.
(ii) Examples.
(3) Average benefit test.
(4) Certain tax credit employee stock ownership plans.
(5) Employers with no nonhighly compensated employees.
(6) Plans benefiting no highly compensated employees.
(7) Plans benefiting collectively bargained employees.
(c) Requirements with respect to former employees.
(1) Former employees tested separately.
(2) Testing former employees.
(i) In general.
(ii) Special rule.
(d) Nonelective contributions under section 403(b) plans.
(e) Certain governmental and church plans.
(f) Certain acquisitions or dispositions.
(g) Additional rules.

§ 1.410(b)–3 Employees and former employees who benefit under a plan.

(a) Employees benefiting under a plan.
(1) In general.
(2) Exceptions to allocation or accrual requirement.
(i) Section 401(k) and 401(m) plans.
(ii) Section 415 limits.

(iii) Certain plan limits.
(iv) Benefit offset arrangements.
(v) Post-normal retirement age adjustments.
(3) Examples.
(b) Former employees benefiting under a plan.
(1) In general.
(2) Examples.

§ 1.410(b)-4 Nondiscriminatory classification test.

(a) In general.
(b) Reasonable classification established by the employer.
(c) Nondiscriminatory classification.
(1) General rule.
(2) Safe harbor.
(3) Facts and circumstances.
(i) General rule.
(ii) Factual determination.
(4) Definitions.
(i) Safe harbor percentage.
(ii) Unsafe harbor percentage.
(iii) Nonhighly compensated employee concentration percentage.
(iv) Table.
(5) Examples.

§ 1.410(b)-5 Average benefit percentage test.

(a) General rule.
(b) Determination of average benefit percentage.
(c) Determination of actual benefit percentage.
(d) Determination of employee benefit percentages.
(1) Overview.
(2) Employee contributions and employee-provided benefits disregarded.
(3) Plans and plan years taken into account.
(i) Testing group.
(ii) Testing period.
(4) Contributions or benefits basis.
(5) Determination on a contributions basis.
(6) Determination on a benefits basis.
(7) Requirements for certain plans providing early retirement benefits.
(i) General rule.
(ii) Exception.
(8) Use of optional methods provided in section 401(a)(4) regulations.
(i) General rule.
(ii) Certain restrictions on options involving defined benefit plans.
(9) Determination of testing age.
(i) General rule.
(ii) Different ages permitted under certain conditions.
(e) Additional optional rules.
(1) Overview.
(2) Determination of employee benefit percentages as sum of separately determined rates.
(i) General rule.
(ii) Determination of rates.
(iii) Treatment of permitted disparity.
(iv) Determination of compensation.
(3) Determination of employee benefit percentages without regard to plans of a different type.
(i) General rule.
(ii) Effect of use of separate testing group determination method.
(iii) Treatment of permitted disparity.
(iv) Consistency rules.
(v) Example.
(4) Accrued-to-date method.
(i) General rule.
(ii) Application to separate rate method.
(iii) Treatment of permitted disparity.
(iv) Uniform testing service assumption.
(v) Fresh-start alternative.
(5) Optional computation methods provided under section 401(a)(4).
(6) Alternative annual method for determining employee benefit percentages for certain defined benefit plans.
(7) Alternative method for converting benefits to contributions.
(8) Imputation of permitted disparity.
(i) Use of excess benefit and gross benefit percentages.
(ii) Uniform compensation assumption.
(9) Three-year averaging period.
(i) General rule.
(ii) Consistency rule.
(10) Alternative methods of determining compensation.
(i) Use of average annual compensation.
(ii) Rules for determining whether alternative definitions are discriminatory.
(iii) Use of different definitions for different groups of employees.
(f) Special rule for certain collectively bargained plans.

§ 1.410(b)-6 Excludable employees.

(a) Employees.
(1) In general.
(2) Rules of application.
(b) Minimum age and service exclusions.
(1) In general.
(2) Multiple age and service conditions.
(3) Plans benefiting certain otherwise excludable employees.
(i) In general.
(ii) Testing portion of plan benefiting otherwise excludable employees.
(4) Examples.
(c) Certain nonresident aliens.
(1) General rule.
(2) Special treaty rule.
(d) Collectively bargained employees.
(1) General rule.
(2) Definition of collectively bargained employee.
(i) In general.
(ii) Special rule for certain employees who cease to be collectively bargained employees.
(iii) Covered by a collective bargaining agreement.
(iv) Examples.
(2) Employees of qualified separate lines of business.
(f) Certain terminating employees.
(1) In general.
(2) Hours of service.
(3) Examples.
(g) Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan.
(h) Former employees.
(1) In general.
(2) Employees terminated before a specified date.
(2) Previously excludable employees.

§ 1.410(b)-7 Definition of plan and rules governing plan disaggregation and aggregation.

(a) In general.
(b) Separate asset pools are separate plans.
(c) Mandatory disaggregation of certain plans.
(1) Section 401(k) and section 401(m) plans.
(2) ESOPs and non-ESOPs.
(3) Plans benefiting otherwise excludable employees.
(4) Plans benefiting employees of qualified separate line of business.
(5) Plans benefiting collectively bargained employees.
(6) Plans maintained by more than one employer.
(d) Permissive aggregation for ratio percentage and nondiscriminatory classification tests.
(1) In general.
(2) Rules of disaggregation.
(3) Duplicative aggregation.
(4) Special rule for plans benefiting employees of a qualified separate line of business.
(5) Same plan year requirement.
(e) Determination of plans in testing group for average benefit percentage test.
(1) In general.
(2) Example.
(f) Section 403(b) plans.

§ 1.410(b)-8 Additional rules.

(a) Testing methods.
(1) In general.
(2) Daily testing option.
(3) Quarterly testing option.
(4) Annual testing option.
(5) Example.
(b) Family member aggregation rule.

§ 1.410(b)-9 Definitions.

Collectively bargained employee.
Defined benefit excess plan.
Defined benefit plan.
Defined contribution plan.
Employee.
Employer.
ESOP.
Excess benefit percentage.
Former employee.
Gross benefit percentage.
Highly compensated employee.
Highly compensated former employee.
Multiemployer plan.
Noncollectively bargained employee.
Nonhighly compensated employee.
Nonhighly compensated former employee.
Offset plan.
Plan year.
Plan year compensation.
Professional employee.
Ratio percentage.
Section 401(k) plan.
Section 401(*l*) plan.
Section 401(m) plan.

§ 1.410(b)-10 Effective dates and transition rules.

(a) General rule.
(b) Transition rules.
(1) Nondiscriminatory classification test.
(2) Average benefit percentage test.
(c) Employees who benefit under a plan.
(d) Aggression of two or more plans.
(e) Special rules for certain collective bargaining agreements.
(1) In general.

(2) Example.

(3) Plan maintained pursuant to a collective bargaining agreement.

Par. 3. Section 1.410(b)–1 is amended by revising the heading and paragraph (a) to read as follows:

§ 1.410(b)–1 Minimum coverage requirements (before 1989).

(a) *In general.* A plan is not a qualified plan (and a trust forming a part of the plan is not a qualified trust) unless the plan satisfies section 410(b)(1). For plan years prior to the applicable effective date set forth in § 1.410(b)–10, a plan satisfies section 410(b)(1) if it satisfies the requirements of paragraph (b)(1) or (b)(2) of this section. See also § 1.410(b)–2 for plan years beginning on or after the applicable effective date set forth in § 1.410(b)–10.

* * * * *

Par. 4. New §§ 1.410(b)–2 through 1.410(b)–10 are added to read as follows:

§ 1.410(b)–2 Minimum coverage requirements (after 1988).

(a) *In general.* A plan is a qualified plan for a plan year only if the plan satisfies section 410(b) for the plan year. A plan satisfies section 410(b) for a plan year if and only if it satisfies paragraph (b) of this section with respect to employees for the plan year and paragraph (c) of this section with respect to former employees for the plan year. The rules in paragraphs (a), (b), and (c) of this section apply to all plans as a condition of qualification, including plans under which no employee is able to accrue any additional benefits (for example, frozen plans). Paragraphs (d), (e), and (f) of this section provide special rules for nonelective section 403(b) plans subject to section 403(b)(12)(A)(i), for governmental and church plans subject to section 410(c), and for certain acquisitions or dispositions, respectively. See § 1.410(b)–7 for rules for determining the "plan" subject to section 410(b).

(b) *Requirements with respect to employees*—(1) *In general.* A plan satisfies this paragraph (b) for a plan year if and only if it satisfies at least one of the tests in paragraphs (b)(2) through (b)(7) of this section for the plan year.

(2) *Ratio percentage test*—(i) *In general.* A plan satisfies this paragraph (b)(2) for a plan year if and only if the plan's ratio percentage for the plan year is at least 70 percent. This test incorporates both the percentage test of section 410(b)(1)(A) and the ratio test of section 410(b)(1)(B). See § 1.410(b)–9 for the definition of ratio percentage.

(ii) *Examples.* The following examples illustrate the ratio percentage test of this paragraph (b)(2).

Example 1. For a plan year, Plan A benefits 70 percent of the employer's nonhighly compensated employees and 100 percent of an employer's highly compensated employees. The plan's ratio percentage for the year is 70 percent (70 percent/100 percent), and thus the plan satisfies the ratio percentage test.

Example 2. For a plan year, Plan B benefits 40 percent of the employer's nonhighly compensated employees and 60 percent of the employer's highly compensated employees. Plan B fails to satisfy the ratio percentage test because the plan's ratio percentage is only 66.67 percent (40 percent/60 percent).

(3) *Average benefit test.* A plan satisfies this paragraph (b)(3) for a plan year if and only if the plan satisfies both the nondiscriminatory classification test of § 1.410(b)–4 and the average benefit percentage test of § 1.410(b)–5 for the plan year.

(4) *Certain tax credit employee stock ownership plans.* A plan satisfies this paragraph (b)(4) for a plan year if and only if the plan—

(i) Is a tax credit employee stock ownership plan (as defined in section 409(a)),

(ii) Is the only plan of the employer that is intended to qualify under section 401(a), and

(iii) Is a plan that satisfies the rule set forth in section 410(b)(6)(D).

This paragraph (b)(4) is available only for plan years for which the tax credit employee stock ownership plan receives contributions for which the employer is allowed a tax credit under section 41 (as in effect prior to its repeal by the Tax Reform Act of 1986) or section 48(n) (as in effect prior to its amendment by the Tax Reform Act of 1984). The requirement of this paragraph (b)(4) that the plan be the only plan of the employer that is intended to qualify under section 401(a) is not satisfied if the employer has only one plan, but that plan is treated as two or more separate plans under the mandatory disaggregation rules of § 1.410(b)–7(c).

(5) *Employers with no nonhighly compensated employees.* A plan satisfies this paragraph (b)(5) for a plan year if the plan is maintained by an employer that has no nonhighly compensated employees at any time during the plan year.

(6) *Plans benefiting no highly compensated employees.* A plan satisfies this paragraph (b)(6) for a plan year if the plan benefits no highly compensated employees for the plan year.

(7) *Plans benefiting collectively bargained employees.* A plan that benefits solely collectively bargained employees for a plan year satisfies this paragraph (b)(7) for the plan year. If a plan (within the meaning of § 1.410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, § 1.410(b)–7(c)(5) provides that the portion of the plan that benefits collectively bargained employees is treated as a separate plan from the portion of the plan that benefits noncollectively bargained employees. Thus, the mandatorily disaggregated portion of the plan that benefits the collectively bargained employees automatically satisfies this paragraph (b)(7) for the plan year and hence section 410(b). See § 1.410(b)–9 for the definitions of collectively bargained employee and noncollectively bargained employee, respectively.

(c) *Requirements with respect to former employees*—(1) *Former employees tested separately.* Former employees are tested separately from employees for purposes of section 410(b). Thus, former employees are disregarded in applying the ratio percentage test, the nondiscriminatory classification test, and the average benefit percentage test with respect to the coverage of employees under a plan, and employees are disregarded in applying this section with respect to the coverage of former employees under a plan.

(2) *Testing former employees*—(i) *In general.* A plan satisfies section 410(b) with respect to former employees if it satisfies one of the tests in paragraphs (b)(2) through (b)(7) of this section with respect to former employees. For this purpose, these tests are applied by substituting "former employee" for "employee," "nonhighly compensated former employee" for "nonhighly compensated employee," and "highly compensated former employee" for "highly compensated employee," whenever those terms are used.

(ii) *Special rule.* A defined benefit plan satisfies section 410(b) with respect to former employees for a plan year if the plan benefits at least five former employees, and if either—

(A) More than 95 percent of all former employees with accrued benefits under the plan benefit under the plan for the plan year, or

(B) At least 60 percent of the former employees who benefit under the plan for the plan year are nonhighly compensated former employees.

(d) *Nonelective contributions under section 403(b) plans.* For plan years beginning on or after January 1, 1993, a plan subject to section 403(b)(12)(A)(i) with respect to nonelective contributions (i.e., contributions not made pursuant to a salary reduction

agreement) is treated as a plan subject to the requirements of this section. For this purpose, a plan described in the preceding sentence must satisfy the requirements of this section without regard to section 410(c) and paragraph (e) of this section. For plan years beginning before January 1, 1993, any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies the requirements of this section.

(e) *Certain governmental and church plans.* The requirements of section 410(b) do not apply to a plan described in section 410(c)(1) (other than a plan subject to section 403(b)(12)(A)(i) or a plan with respect to which an election has been made under section 410(d)). Such a plan must satisfy section 401(a)(3) as in effect on September 1, 1974. For this purpose, a plan that satisfies section 410(b) (without regard to this paragraph (e)) is treated as satisfying section 401(a)(3) as in effect on September 1, 1974. For plan years beginning before January 1, 1993, any plan described in section 410(c)(1)(A) (regarding governmental plans) satisfies section 401(a)(3) as in effect on September 1, 1974.

(f) *Certain acquisitions or dispositions.* Section 410(b)(6)(C) (relating to certain acquisitions or dispositions) provides a special rule whereby a plan may be treated as satisfying section 410(b) for a limited period of time after an acquisition or disposition. Section 410(b)(6)(C) does not apply to acquisitions or dispositions that occurred prior to the first plan year to which section 410(b), as amended by the Tax Reform Act of 1986, applies. For purposes of section 410(b)(6)(C) and this paragraph (f), the terms "acquisition" and "disposition" refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business.

(g) *Additional rules.* The Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide any additional rules that may be necessary or appropriate in applying the minimum coverage requirements of section 410(b), including (without limitation) additional rules limiting or expanding the methods in § 1.410(b)–5(d) and (e) for determining employee benefit percentages.

§ 1.410(b)-3 Employees and former employees who benefit under a plan.

(a) *Employees benefiting under a plan*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an employee is treated as benefiting under a plan for a plan year if and only if for that plan year, in the case of a defined contribution plan, the employee receives an allocation taken into account under § 1.401(a)(4)–2(c)(2)(ii), or in the case of a defined benefit plan, the employee receives an increase in the dollar amount of a benefit accrued or treated as an accrued benefit under section 411(d)(6).

(2) *Exceptions to allocation or accrual requirement*—(i) *Section 401(k) and 401(m) plans.* Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee under the plan as defined in § 1.401(k)–1(g)(4) for the plan year. Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in § 1.401(m)–1(f)(4) for the plan year.

(ii) *Section 415 limits.* In determining whether an employee is treated as benefiting under a plan for a plan year, plan provisions that implement the limits of section 415 are disregarded. Any plan provision that provides for increases in an employee's accrued benefit (which would have been greater but for the application of section 415(b)) due solely to adjustments under section 415(d)(1) is also disregarded, but only if such provision applies uniformly to all employees in the plan.

(iii) *Certain plan limits.* An employee is treated as benefiting under a plan for a plan year if the employee satisfies all of the applicable conditions for accruing a benefit for the plan year but fails to accrue the benefit solely because of a benefit limit under the plan that is uniformly applicable to all employees in the plan. Thus, for example, if a defined benefit plan takes into account only the first 30 years of service for accrual purposes, a participant who has completed more than 30 years of service is still treated as benefiting under the plan.

(iv) *Benefit offset arrangements.* An employee is treated as benefiting under a plan for a plan year even if the employee's current benefit accrual under the plan is offset by the contributions or benefits provided on behalf of the employee under another qualified plan, if the employee has satisfied all other conditions for a current benefit accrual under the plan. If the other plan is maintained by another employer, the employee whose benefits are subject to the offset must have become an employee of the employer maintaining the plan pursuant to a transaction described in § 1.410(b)–2(f) (regarding certain acquisitions and dispositions) between the two employers.

(v) *Post-normal retirement age adjustments.* An employee is treated as benefiting under a defined benefit plan for a plan year if the employee has attained normal retirement age and fails to accrue a benefit solely because of the provisions of section 411(b)(1)(H)(iii) regarding adjustments for delayed retirement.

(3) *Examples.* The following examples illustrate the determination of whether an employee is benefiting under a plan for purposes of section 410(b).

Example 1. An employer has 35 employees who are eligible under a defined benefit plan. The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer maintains a section 401(k) plan. Only employees who are at least 21 and who complete one year of service are eligible employees under the plan within the meaning of § 1.401(k)–1(g)(4). Under the rule of paragraph (a)(2)(i) of this section, only employees who have satisfied these age and service conditions are treated as benefiting under the plan.

Example 3. The facts are the same as in *Example 2*, except that the employer also maintains a section 401(m) plan that provides matching contributions contingent on elective contributions under the section 401(k) plan. The matching contributions are contingent on employment on the last day of the plan year. Under § 1.401(m)–1(f)(4), because matching contributions are contingent on employment on the last day of the plan year, not all employees who are eligible employees under the section 401(k) plan are eligible employees under the section 401(m) plan. Thus, employees who have satisfied the age and service conditions but who do not receive a matching contribution because they are not employed on the last day of the plan year are treated as not benefiting under the section 401(m) portion of the plan.

(b) *Former employees benefiting under a plan*—(1) *In general.* A former employee is treated as benefiting for a plan year if and only if the plan provides an allocation or benefit increase described in paragraph (a)(1) of this section to the former employee for the plan year. Thus, for example, a former employee benefits under a defined benefit plan for a plan year if the plan is amended to provide an ad hoc cost-of-living adjustment in the former employee's benefits. In contrast, because an increase in benefits payable under a plan pursuant to an automatic cost-of-living provision adopted and effective before the beginning of the plan year is previously accrued, a

former employee is not treated as benefiting in a subsequent plan year merely because the former employee receives an increase pursuant to such an automatic cost-of-living provision. Any accrual or allocation for an individual during the plan year that arises from the individual's status as an employee is treated as an accrual or allocation of an employee. Similarly, any accrual or allocation for an individual during the plan year that arises from the individual's status as a former employee is treated as an accrual or allocation of a former employee. It is possible for an individual to accrue a benefit both as an employee and as a former employee in a given plan year. During the plan year in which an individual ceases performing services for the employer, the individual is treated as an employee in applying section 410(b) with respect to employees and is treated as a former employee in applying section 410(b) with respect to former employees.

(2) *Examples.* The following examples illustrate the determination of whether a former employee benefits under a plan for purposes of section 410(b).

Example 1. Employer A amends its defined benefit plan in the 1995 plan year to provide an ad hoc cost-of-living increase of 5 percent for all retirees. Former employees who receive this increase are treated as benefiting under the plan for the 1995 plan year.

Example 2. Employer B maintains a defined benefit plan with a calendar plan year. In the 1995 plan year, Employer B amends the plan to provide that an employee who has reached early retirement age under the plan and who retires before July 31 of the 1995 plan year will receive an unreduced benefit, even though the employee has not yet reached normal retirement age. This early retirement window benefit is provided to employees based on their status as employees. Thus, although individuals who take advantage of the benefit become former employees, the window benefit is treated as provided to employees and is not treated as a benefit for former employees.

Example 3. The facts are the same as *Example 2*, except that on September 1, 1995, Employer B also amends the defined benefit plan to provide an ad hoc cost-of-living increase effective for all former employees. An individual who ceases performing services for the employer before July 31, 1995, under the early retirement window, and then receives the ad hoc cost-of-living increase, is treated as benefiting for the 1995 plan year both as an employee with respect to the early retirement window, and as a former employee with respect to the ad hoc COLA.

§ 1.410(b)-4 Nondiscriminatory classification test.

(a) *In general.* A plan satisfies the nondiscriminatory classification test of this section for a plan year if and only if, for the plan year, the plan benefits the employees who qualify under a classification established by the employer in accordance with paragraph (b) of this section, and the classification of employees is nondiscriminatory under paragraph (c) of this section.

(b) *Reasonable classification established by the employer.* A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria substantially the same effect as an enumeration by name is not considered a reasonable classification.

(c) *Nondiscriminatory classification*—(1) *General rule.* A classification is nondiscriminatory under this paragraph (c) for a plan year if and only if the group of employees included in the classification benefiting under the plan satisfies the requirements of either paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Safe harbor.* A plan satisfies the requirement of this paragraph (c)(2) for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage, as defined in paragraph (c)(4)(i) of this section. See § 1.410(b)-9 for the definition of a plan's ratio percentage.

(3) *Facts and circumstances*—(i) *General rule.* A plan satisfies the requirements of this paragraph (c)(3) if and only if—

(A) The plan's ratio percentage is greater than or equal to the unsafe harbor percentage, as defined in paragraph (c)(4)(ii) of this section, and

(B) The classification satisfies the factual determination of paragraph (c)(3)(ii) of this section.

(ii) *Factual determination.* A classification satisfies this paragraph (c)(3)(ii) if and only if, based on all the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following—

(A) The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.

(B) The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory.

(C) Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is to be nondiscriminatory.

(D) The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

(E) The extent to which the plan's average benefit percentage (determined under § 1.410(b)-5) exceeds 70 percent.

(4) *Definitions*—(i) *Safe harbor percentage.* The safe harbor percentage of an employer is 50 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. See paragraph (c)(4)(iv) for a table that illustrates the safe harbor percentage and unsafe harbor percentage.

(ii) *Unsafe harbor percentage.* The unsafe harbor percentage of an employer is 40 percent, reduced by ¾ of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent.

(iii) *Nonhighly compensated employee concentration percentage.* The nonhighly compensated employee concentration percentage of an employer is the percentage of all the employees of the employer who are nonhighly compensated employees. Employees who are excludable employees for purposes of the average benefit are not taken into account.

(iv) *Table.* The following table sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage:

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
0–60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

(5) *Examples.* The following examples illustrate the rules in this paragraph (c).

Example 1. Employer A has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Employer A maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees. Thus, the plan's ratio percentage is 55.56 percent ([60/120]/[72/80]=50%/90%=0.5556), which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)–2(b)(2). The employer's nonhighly compensated employee concentration percentage is 60 percent (120/200); thus, Employer A's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 2. The facts are the same as in *Example 1*, except that the plan benefits only 40 nonhighly compensated employees. The plan's ratio percentage is thus 37.03 percent ([40/120]/[72/80]=33.33%/90%=0.3703). Under these facts, the plan's classification is below the unsafe harbor percentage and is thus considered discriminatory.

Example 3. The facts are the same as in *Example 1*, except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is thus 41.67 percent ([45/120]/[72/80]=37.50%/90%=0.4167), above the unsafe harbor percentage (40 percent) and below the safe harbor percentage (50 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

Example 4. Employer B has 10,000 nonexcludable employees, of whom 9,600 are nonhighly compensated employees and 400 are highly compensated employees. Employer B maintains a plan that benefits 600 nonhighly compensated employees and 100 highly compensated employees. Thus, the plan's ratio percentage is 25.00 percent ([600/9,600]/[100/400]=6.25%/25%=0.2500), which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)–2(b)(2). Employer B's nonhighly compensated employee concentration percentage is 96 percent (9,600/10,000); thus, Employer B's safe harbor percentage is 23 percent, and its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (25.00 percent) is greater than the safe harbor percentage (23.00 percent), the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

Example 5. The facts are the same as in *Example 4*, except that the plan benefits only 400 nonhighly compensated employees. The plan's ratio percentage is thus 16.67 percent ([400/9,600]/[100/400]=4.17%/25%=0.1667). The plan's ratio percentage is below the unsafe harbor percentage and thus the classification is considered discriminatory.

Example 6. The facts are the same as in *Example 4*, except that the plan benefits 500 nonhighly compensated employees. The plan's ratio percentage is thus 20.83 percent ([500/9,600]/[100/400]=5.21%/25%=0.2083), above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the facts and circumstances.

§ 1.410(b)–5 Average benefit percentage test.

(a) *General rule.* A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) *Determination of average benefit percentage.* The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) *Determination of actual benefit percentage.* The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) *Determination of employee benefit percentages*—(1) *Overview.* This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for additional optional rules for determining employee benefit percentages.

(2) *Employee contributions and employee-provided benefits disregarded.* Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages. For this purpose, the amount of benefits derived from employee contributions that are not allocated to separate accounts must be determined under the method in § 1.401(a)(4)–6(b)(1) (section 411(c) method), (b)(4) (grandfather rule for plans in existence on May 14, 1990), (b)(5) (government plan method), or (b)(6) (cessation-of-employee-contributions method). See paragraph (e)(5) of this section, however, for a rule allowing the safe harbor methods in § 1.401(a)(4)–6(b)(2) (composition-of-workforce method) and (b)(3) (minimum benefit method) to be used if certain conditions are satisfied.

(3) *Plans and plan years taken into account*—(i) *Testing group.* All plans included in the testing group under § 1.410(b)–7(e)(1), and only those plans, are taken into account in determining an employee's benefit percentage. See paragraph (e)(3) of this section, however, for an optional rule permitting employee benefit percentages to be determined separately with respect to defined benefit plans and defined contribution plans in the testing group.

(ii) *Testing period.* An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the "relevant plan years" or, in the aggregate, as the "testing period." See paragraph (e)(9) of this section, however, for an optional rule permitting employee benefit percentages

to be determined over a three-year averaging period.

(4) *Contributions or benefits basis.* Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group. See paragraph (e)(3) of this section, however, for an optional rule permitting employee benefit percentages to be determined separately with respect to defined benefit plans and defined contribution plans in the testing group.

(5) *Determination on a contributions basis.* If employee benefit percentages for a testing group are determined on a contributions basis for a testing period, each employee's employee benefit percentage is determined as follows—

(i) Determine the dollar amount of the allocations taken into account with respect to the employee under § 1.401(a)(4)–2(c)(2)(ii) for the relevant plan year for each defined contribution plan to which the permitted disparity rules of section 401(l) are available.

(ii) Determine the actuarial present value of the increase in the employee's normalized accrued benefit for the relevant plan year under each defined benefit plan to which the permitted disparity rules of section 401(l) are available, using the method prescribed in § 1.401(a)(4)–8(c)(2)(i)(A) through (C).

(iii) Add the allocations and equivalent allocations determined in paragraphs (d)(5)(i) and (ii) of this section, and divide the total by the employee's plan year compensation for any one of the relevant plan years in the testing period. A relevant plan year may not be used for this purpose unless the employee actually benefited under the plan for that plan year. In addition, a relevant plan year may not be used if it is a short plan year, unless it is the longest of any plan year in the testing period. Plan year compensation may not be limited to an employee's period of plan participation during a relevant plan year unless the period of participation taken into account includes the employee's longest period of participation in any plan in the testing group during that year. Plan year compensation for this purpose must be determined by applying the requirements of section 401(a)(17) as if all plans in the testing group were a single plan.

(iv) Adjust the amount determined in paragraph (d)(5)(iii) of this section by imputing permitted disparity to the extent allowed under the rules of § 1.401(a)(4)–7 using the method in § 1.401(a)(4)–7(b). This adjustment is permitted, but not required. If it is made with respect to any nonhighly compensated employee's employee benefit percentage under the testing group for a testing period, however, it must be made with respect to all highly compensated employees' employee benefit percentages under the testing group for the testing period. In determining an employee's adjusted allocation rate under § 1.401(a)(4)–7(b), the percentage amount determined under paragraph (d)(5)(iii) of this section is substituted for the employee's unadjusted allocation rate.

(v) Add the employee's allocations and equivalent allocations for the relevant plan year under any defined contribution or defined benefit plans to which the permitted disparity rules of section 401(l) are not available, using the rules in paragraphs (d)(5)(i) and (d)(5)(ii) of this section, and divide the total by the employee's plan year compensation used in paragraph (d)(5)(iii) of this section.

(vi) Add the rate determined in paragraph (d)(5)(v) of this section to the rate determined in paragraph (d)(5)(iv) of this section (or paragraph (d)(5)(iii) of this section, if permitted disparity is not taken into account). This is the employee's benefit percentage for the testing period with respect to the testing group.

(6) *Determination on a benefits basis.* If employee benefit percentages for a testing group are determined on a benefits basis for a testing period, each employee's employee benefit percentage is determined as follows—

(i) Determine the increase in the employee's normalized accrued benefit determined under § 1.401(a)(4)–3(d)(2)(i)(E) for the relevant plan year under each defined benefit plan to which the permitted disparity rules of section 401(l) are available.

(ii) Determine the dollar amount of the allocations taken into account with respect to the employee under § 1.401(a)(4)–2(c)(2)(ii) for the relevant plan year for each defined contribution plan to which the permitted disparity rules of section 401(l) are available, and convert these allocations into equivalent accruals using the method prescribed in § 1.401(a)(4)–8(b)(2)(i)(A) and (B).

(iii) Add the accruals and equivalent accruals determined in paragraphs (d)(6)(i) and (d)(6)(ii) of this section, and divide the total by the employee's plan year compensation for any one of the relevant plan years in the testing period. A relevant plan year may not be used for this purpose unless the employee actually benefited under the plan for that plan year. In addition, a relevant plan year may not be used if it is a short plan year, unless it is the longest of any plan year in the testing period. Plan year compensation may not be limited to an employee's period of plan participation during a relevant plan year unless the period of participation taken into account includes the employee's longest period of participation in any plan in the testing group during that year. Plan year compensation for this purpose must be determined by applying the requirements of section 401(a)(17) as if all plans in the testing group were a single plan.

(iv) Adjust the amount determined in paragraph (d)(6)(iii) of this section by imputing permitted disparity to the extent allowed under the rules of § 1.401(a)(4)–7 using the annual method in § 1.401(a)(4)–7(c)(4)(iv)(C). This adjustment is permitted, but not required. If it is made with respect to any nonhighly compensated employee's employee benefit percentage under the testing group for a testing period, however, it must be made with respect to all highly compensated employees' employee benefit percentages under the testing group for the testing period. In determining an employee's adjusted accrual rate under § 1.401(a)(4)–7(c), the percentage amount determined under paragraph (d)(6)(iii) of this section is substituted for the employee's unadjusted accrual rate.

(v) Add the employee's accruals and equivalent accruals for the relevant plan year under any defined benefit or defined contribution plans to which the permitted disparity rule of section 401(*l*) are not available, using the rules in paragraphs (d)(6)(i) and (d)(6)(ii) of the section, and divide the total by the employee's plan year compensation used in paragraph (d)(6)(iii) of this section.

(vi) Add the rate determined in paragraph (d)(6)(v) of this section to the rate determined in paragraph (d)(6)(iv) of this section (or paragraph (d)(6)(iii) of this section, if permitted disparity is not taken into account). This is the employee's employee benefit percentage for the testing period with respect to the testing group.

(7) *Requirements for certain plans providing early retirement benefits*—(i) *General rule.* If any defined benefit plan in the testing group provides for early retirement benefits in addition to normal retirement benefits to any highly compensated employee, and the average actuarial reduction for any one of these benefits commencing in the 5 years prior to the plan's normal retirement age is less than 4 percent per year, then the increase in the normalized accrued benefit used in paragraphs (d)(5)(ii),

(d)(5)(v), (d)(6)(i), and (d)(6)(v) of this section must be replaced by the largest amount determined under § 1.401(a)(4)–3(d)(2)(ii)(A) through (G).

(ii) *Exception.* Paragraph (d)(7)(i) of this section does not apply if early retirement benefits with average actuarial reductions described in that paragraph are currently available, within the meaning of § 1.401(a)(4)–4(b), under plans in the testing group to a percentage of nonexcludable nonhighly compensated employees that is at least 70 percent of the percentage of nonexcludable highly compensated employees to whom these benefits are currently available.

(8) *Use of optional methods provided in section 401(a)(4) regulations*—(i) *General rule.* Except as otherwise provided in this paragraph (d), and optional methods or rules for determining allocations, accruals, compensation, and other items that are used in determining employee benefit percentages under this section that would be available in determining whether a plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2) may be used in determining employee benefit percentages under this section, provided that the optional methods or rules selected are applied on a consistent basis to all employees in the testing group. Thus, for example, employee benefits percentages may generally be calculated using any of the alternative methods of determining plan year compensation under § 1.401(a)(4)–12, and using any underlying definition of compensation that satisfies section 414(s). On the other hand, employee benefit percentages may not be calculated using the projected method in § 1.401(a)(4)–3(d)(4), the grouping rules in § 1.401(a)(4)–3(d)(6)(iv), or the floor on most valuable accrual rates in § 1.401(a)(4)–3(d)(6)(v), for example, since those rules relate exclusively to the determination of accrual rates, and not to the determination of allocations, accruals, compensation, or other items actually used in determining employee benefit percentages under this section.

(ii) *Certain restrictions on options involving defined benefit plans.* Optional methods or rules described in paragraph (d)(8)(i) of this section that may not be used in determining whether a DB/DC plan (within the meaning of § 1.401(a)(4)–9(a)) satisfies the nondisciminatory amount requirement of § 1.401(a)(4)–1(b)(2) also may not be used in determining employee benefit percentages, regardless of whether such percentages are determined on a contributions or benefits basis. See § 1.401(a)(4)–9(b)(2)(v)(B). Thus, for example, alternative actuarial assumptions available under § 1.401(a)(4)–3(d)(5)(iv)(B) may not be used unless they are standard interest rates or mortality assumptions based on a standard mortality table (as defined in § 1.401(a)(4)–12) plan provisions providing for actuarial increases after normal retirement age under § 1.401(a)(4)–3(f)(3) may not be disregarded, and benefits may not be determined other than on a plan-year basis under § 1.401(a)(4)–3(f)(6). Further, as noted in paragraph (d)(2) of this section, the amount of benefits derived from employee contributions not allocated to a separate account must be determined under the method in § 1.401(a)(4)–6(b)(1) (section 411(c) method), (b)(4) (grandfather rule for plans in existence on May 14, 1990), (b)(5) (government plan method), or (b)(6) (cessation-of-employee-contributions method). See paragraph (e)(5) of this section, however, for an optional rule permitting certain of these optional methods and rules to be used when employee benefit percentages are determined separately with respect to defined benefit and defined contribution plans in the testing group.

(9) *Determination of testing age*—(i) *General rule.* For purposes of this section, an employee's testing age must be determined under this definition of testing age in § 1.401(a)(4)–12 as if all plans in the testing group were a single plan. Thus, for example, in determining the increase in an employee's normalized accrued benefit for a relevant plan year for purposes of paragraph (d)(6)(i) of this section, benefits must be normalized to the same testing age for all employees, and the same testing age must be used in determining the employee's equivalent accruals for purposes of paragraph (d)(6)(ii) of this section.

(ii) *Different ages permitted under certain conditions.* Notwithstanding paragraph (d)(9)(i) of this section, employee benefit percentages may be determined using the respective testing ages determined for each plan in the testing group, if it is reasonable to believe that use of the different testing ages for different plans does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using a single testing age for all plans in the testing group.

(e) *Additional optional rules*—(1) *Overview.* This paragraph (e) contains various optional rules that may be used, alone or in combination, by an employer in determining employee benefit percentages for a testing period. Except as specifically provided, each optional rule used for a testing period must be applied, to the extent possible, on a consistent basis in determining the employee benefit percentages of all employees under all plans in the testing group for that testing period. It is not necessary, however, that a rule be used consistently from testing period to testing period. The rules in this paragraph (e) supplement and do not replace the rules in paragraph (d) of this section. Thus, for example, unless otherwise provided, the rules of paragraph (d)(7) of this section (regarding plans providing subsidized early retirement benefits) and of paragraph (d)(8) of this section (restricting the use of optional methods provided in the section 401(a)(4) regulations) continue to apply.

(2) *Determination of employee benefit percentages as sum of separately determined rates*—(i) *General rule.* If employee benefit percentages are determined on a contributions basis, an employer may substitute the sum of an employee's separately-determined allocation or equivalent allocation rates for the testing period under all plans in the testing group for the percentage amount determined in paragraph (d)(5)(vi) of this section. Similarly, if employee benefit percentages are determined on a benefits basis, an employer may sustitute the sum of an employee's separately-determined accrual or equivalent accrual rates for the testing period under all plans in the testing group for the percentage amount determined in paragraph (d)(6)(vi) of this section.

(ii) *Determination of rates.* For purposes of this paragraph (e)(2), an employee's allocation and accrual rates are determined under the rules of §§ 1.401(a)(4)–2(c)(2) and 1.401(a)(4)–3(d)(2)(i), respectively, and an employee's equivalent accrual and allocation rates are determined under the rules of §§ 1.401(a)(4)–8(b)(2)(i) and (c)(2)(i), respectively. If paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, an employee's most valuable accrual and most valuable equivalent allocation rates, as determined under §§ 1.401(a)(4)–3(d)(2)(ii) and 1.401(a)(4)–8(c)(2)(ii), must be substituted for the employee's accrual and equivalent allocation rates.

(iii) *Treatment of permitted disparity.* Permitted disparity may be taken into account in determining an employee's actual or equivalent accrual or allocation rates to the extent allowed

under the rules of § 1.401(a)(4)–7. If permitted disparity is taken into account in determining an employee's actual or equivalent accrual or allocation rate under any one plan in the testing group, it may not be taken into account in determining the employee's actual or equivalent accrual or allocation rates under any other plan in the testing group.

(iv) *Determination of compensation*—(A) *Plan year compensation used as testing compensation.* If employee benefit percentages are determined on a benefits basis, an employee's plan year compensation must be used for purposes of § 1.401(a)(4)–3(e)(3)(i) as the employee's testing compensation in determining the employee's actual or equivalent accrual rates for purposes of this paragraph (e)(2).

(B) *Consistency requirement.* Under the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, the same period must generally be used to determine each employee's plan year compensation used in determining the employee's actual and equivalent allocation and accrual rates under paragraph (e)(2)(ii) of this section under all plans in the testing group. This consistency requirement is not treated as violated, however, merely because the periods for determining employees' plan year compensation differ for different plans in the testing group because the plans have different plan years. Furthermore, this consistency requirement is not treated as violated merely because different optional determination periods permitted under the definition of plan year compensation in § 1.401(a)(4)–12 (e.g., the plan year or a 12-month period ending in the plan year) are used in determining employees' actual or equivalent accrual or allocation rates under one or more plans in the testing group, provided that the period is actually used in determining whether the plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2) for the relevant plan year.

(3) *Determination of employee benefit percentages without regard to plans of a different type*—(i) *General rule.* An employer may determine employee benefit percentages under plans of one type (i.e., defined benefit or defined contribution plans) without regard to plans of a different type (i.e., defined contribution or defined benefit plans, respectively), using the method provided in this paragraph (e)(3). If this method is used to determine whether a defined benefit plan satisfies the average benefit percentage test, employee benefit percentages under all defined benefit plans in the testing group must be determined on a benefits basis, and all allocations under any defined contribution plans in the same testing group must be treated as zero. Thus, for example, if all of the defined contribution plans in a testing group satisfy the ratio percentage test of § 1.410(b)–2(b)(2), these plans are not required to satisfy the average benefit percentage test, and are also disregarded in determining whether any defined benefit plans in the testing group satisfy the average benefit percentage test. If this method is used to determine whether a defined contribution plan satisfies the average benefit percentage test, employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis, and all benefits under any defined benefit plans in the same testing group must be treated as zero. Employees may not be treated as excludable employees solely because they are deemed to receive no benefit accrual or allocation under a plan under this optional method. This optional method may not be used for a testing period if any of the plans in the testing group relies on any of the cross-testing methods provided in § 1.401(a)(4)–8 (b)(2) or (c)(2) to satisfy section 401(a)(4) for a relevant plan year.

(ii) *Effect of use of separate testing group determination method.* A plan does not satisfy the average benefit percentage test using the method provided in this paragraph (e)(3) unless each of the plans of the employer of a different type (i.e., defined benefit plan or defined contribution plan) than the plan being tested satisfies the average benefit test of § 1.410(b)–2(b)(3) using this method or satisfies the ratio percentage test of § 1.410(b)–2(b)(2).

(iii) *Treatment of permitted disparity*—(A) *Plans of both types using method.* If the method provided in this paragraph (e)(3) is used to determine whether one or more defined benefit plans and one or more defined contribution plans in a testing group satisfy the average benefit percentage test, permitted disparity may generally be taken into account, to the extent permitted under this section, in determining employee benefit percentages with respect to both the group of defined benefit plans in the testing group and the group of defined contribution plans in the testing group. If any employee benefits under both a defined benefit and a defined contribution plan in the testing group in the testing period, however, permitted disparity may be taken into account for any employee in any plan in the testing group only with respect to the group of defined benefit plans in the testing group, or with respect to the group of defined contribution plans in the testing group, but not both.

(B) *Plans of only one type using method.* If the method in this paragraph (e)(3) is used to determine whether one or more defined benefit plans or one or more defined contribution plans in a testing group, but not plans of both types, satisfy the average benefit percentage test (for example, where each plan in one group of plans satisfies the ratio percentage test of § 1.410(b)–2(b)(2)), permitted disparity may be taken into account in determining employee benefit percentages under the group of plans subject to the average benefit percentage test only for those employees with respect to whom permitted disparity is not taken into account (i.e., either under section 401(*l*) or § 1.401(a)(4)–7), in testing any plans in the other group for nondiscrimination under section 401(a)(4). For this purpose, permitted disparity is treated as taken into account with respect to all employees benefiting under a section 401(*l*) plan.

(iv) *Consistency rules.* If the method in this paragraph (e)(3) is used, the consistency requirement of paragraphs (d)(8) and (e)(1) of this section may be applied separately with respect to the group of defined benefit plans and the group of defined contribution plans in the testing group.

(v) *Example.* Employer A maintains two defined benefit plans, neither of which covers a group of employees that satisfies the ratio percentage test of § 1.410(b)–2(b)(2), and a profit-sharing plan and a section 401(k) plan, each of which benefits a group of employees that satisfies the ratio percentage test of § 1.410(b)–2(b)(2). The defined benefit plans will satisfy the average benefit percentage test if the ratio of the actual benefit percentages of all nonexcludable nonhighly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan, is at least 70 percent of the actual benefit percentage of all nonexcludable highly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan.

(4) *Accrued-to-date method*—(i) *General rule.* An employer may use the accrued-to-date method to determine an employee's employee benefit percentage on a benefits basis under paragraph (d)(6) of this section. If this method is used, the accrual used in paragraph (d)(6) (i) and (v) of this section is replaced with the amount determined for the employee under § 1.401(a)(4)–

3(d)(3)(i) (A) through (C) (or, if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, the largest amount determined for the employee under § 1.401(a)(4)–3(d)(3)(ii) (A) through (E)). Also, the allocations used in paragraphs (d)(6)(ii) and (d)(6)(v) of this section are replaced by the employee's adjusted account balance, as defined in § 1.401(a)(4)–8(b)(2)(ii)(C), divided by the employee's testing service, as defined in § 1.401(a)(4)–12. Finally, the employee's plan year compensation (modified as provided in § 1.401(a)(4)–3(e)(3)(ii)) is used in lieu of the employee's plan year compensation in paragraphs (d)(6)(iii) and (d)(6)(v) of this section.

(ii) *Application to separate rate method.* If the accrued-to-date method provided in this paragraph (e)(4) is used in combination with the optional rule for determining employee benefit percentages as the sum of separately determined rates provided in paragraph (e)(2) of this section, an employee's actual and equivalent accrual rates must be determined using the accrued-to-date method in §§ 1.401(a)(4)–3(d)(3)(i) (or, if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, § 1.401(a)(4)–3(d)(3)(ii)) and 1.401(a)(4)–8(b)(2)(ii), respectively.

(iii) *Treatment of permitted disparity.* If the accrued-to-date method provided in this paragraph (e)(4) is used, disparity must be imputed, if at all, using the accrued-to-date method in § 1.401(a)(4)–7(c)(4)(iv)(D). In imputing permitted disparity for this purpose, the employee's plan year compensation, modified as provided in § 1.401(a)(4)–3(e)(3)(ii), must be used, notwithstanding § 1.401(a)(4)–7(c)(4)(vi) (generally requiring the use of average annual compensation).

(iv) *Uniform testing service assumption.* If the average of the testing service as defined in § 1.401(a)(4)–12 for the nonhighly compensated employees in a plan in the testing group is no greater than the average of the testing service for the highly compensated employees in that plan, an employer may assume that all employees in that plan have the same number of years of testing service for purposes of dividing an employee's benefit or adjusted account balance under that plan by the employee's testing service in paragraph (e)(4)(i) of this section. The years of testing service selected must be a reasonable approximation of the average testing service of either the highly compensated employees or the nonhighly compensated employees, or an amount in between.

(v) *Fresh-start alternative.* The consistency requirements of paragraphs (d)(8) and (e)(1) of this section are not violated merely because the option to disregard allocations made or benefits accrued for plan years that begin before a fresh-start date described in § 1.401(a)(4)–3(d)(6)(vii) or 1.401(a)(4)–8(b)(2)(ii)(B) is used by some but not all plans in the testing group, or if different fresh-start dates are used by different plans in the testing group. In applying § 1.401(a)(4)–3(d)(6)(vii) to determine an employee's employee benefit percentage, any adjustments provided for under § 1.401(a)(4)–13(d) are not included in the frozen accrued benefit as of the fresh-start date under § 1.401(a)(4)–3(d)(6)(vii)(B)(*2*) (or § 1.401(a)(4)–3(d)(6)(vii)(C)(*2*) if paragraph (d)(7) of this section requires employee benefit percentages to be determined by taking into account early retirement benefits), unless the only plans included in the testing group are defined benefit plans, or the option provided in this paragraph (e)(4) is applied solely to defined benefit plans tested under the method in paragraph (e)(3) of this section.

(5) *Optional computation methods provided under section 401(a)(4).* If the only plans included in the testing group are defined benefit plans (or the option is applied solely to defined benefit plans tested under the method in paragraph (e)(3) of this section), and if employee benefit percentages under these defined benefit plans are determined on a benefits basis, then, notwithstanding the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, any of the optional methods for determining the accruals, compensation and other items that are used in determining employee benefit percentages under this section that would be available in determining whether a plan satisfies the nondiscriminatory amount requirement of § 1.401(a)(4)–1(b)(2) may also be used for purposes of this section. Thus, for example, if the conditions on use of the option in this paragraph (e)(5) are satisfied, employee benefit percentages may be determined using any of the alternative actuarial assumptions permitted under § 1.401(a)(4)–3(d)(5)(iv)(B); plan provisions providing for an actuarial increase in benefits after normal retirement age under § 1.401(a)(4)–3(f)(3) may be disregarded; and accruals may be determined other than on a plan year basis under § 1.401(a)(4)–3(f)(6). In addition, if the conditions on use of the option in this paragraph (e)(5) are satisfied, the safe harbor methods of § 1.401(a)(4)–6(b)(2) (composition-of-workforce method) or (b)(3) (minimum benefit method) may be used in determining employees' accrual rates for purposes of paragraph (e)(2)(ii) of this section. As noted in paragraph (d)(8)(i) of this section, except as otherwise provided in this section, optional methods for adjusting employees' actual or equivalent normal or most valuable accrual rates are not available in determining employee benefit percentages.

(6) *Alternative annual method for determining employee benefit percentages for certain defined benefit plans.* An employer may substitute for the increase in an employee's normalized accrued benefit under a plan for the relevant plan year in paragraphs (d)(6) (i) and (v) of this section an amount determined by: determining the ratio of the normalized accrued benefit in § 1.401(a)(4)–3(d)(2)(i)(D) to the employee's testing compensation as defined in § 1.401(a)(4)–3(e)(3) for the prior relevant plan year, and the ratio of the normalized accrued benefit in § 1.401(a)(4)–3(d)(2)(i)(C) to the employee's testing compensation for the current relevant plan year; determining the excess (if any) of the second ratio over the first ratios; and multiplying the difference by the employee's testing compensation for the current relevant plan year. If paragraph (d)(7)(i) of this section requires employee benefit percentages to be determined by taking early retirement benefits into account, the employer must substitute the largest of the sums of the normalized QJSAs and QSUPPs determined for each age in § 1.401(a)(4)–3(d)(2)(ii)(C) for the normalized accrued benefit for the current relevant plan year, and the largest of the sums of the normalized QJSAs and QSUPPs determined for each age in § 1.401(a)(4)–3(d)(2)(ii)(D) for the normalized accrued benefit for the prior relevant plan year in the previous sentence. If this method is used, the testing compensation used in determining the increase in an employee's normalized accrued benefit must also be used, subject to the requirements of paragraph (e)(10) of this section, for purposes of paragraph (d)(6)(iii) of this section. This method may not be used unless the only plans included in the testing group are defined benefit plans (or the method is applied to defined benefit plans tested under the method in paragraph (e)(3) of this section), and employee benefit percentages under these defined benefit plans are determined on a benefits basis.

(7) *Alternative method for converting benefits to contributions.* An employer may convert an employee's most valuable accruals under a defined benefit plan for a relevant plan year into equivalent most valuable allocations for purposes of paragraph (d)(5) (ii) and (v) of this section using the method used by the employer for determining any increase in current liability (as defined in section 412(*l*)(7)) that are attributable to the employee for the year. For this purpose, current liability may include amounts attributable to projected accruals for the relevant plan year for which the determination of current liability is being made, if the projections are made on a reasonable basis applied consistently from year to year. Thus, for example, an employer may treat any increase in current liability attributable to an employee under a plan from one relevant plan year to the next as the employee's equivalent most valuable allocation for the second year.

(8) *Imputation of permitted disparity*—(i) *Use of excess benefit and gross benefit percentages.* An employee's excess benefit percentage under a defined benefit excess plan, or gross benefit percentage under an offset plan, multiplied by the employee's average annual compensation used under the plan in determining benefit accruals, may be substituted for the amount determined under paragraph (d)(6)(i) of this section as provided in this paragraph (e)(8)(i). If the option in paragraph (e)(2) of this section is used, permitted disparity may be taken into account under paragraph (e)(2)(iii) of this section by substituting an employee's excess benefit percentage or gross benefit percentage for the rate that would otherwise be determined under paragraph (e)(2)(iii) of this section. Neither of these methods may be used unless—

(A) The only plans included in the testing group are defined benefit plans (or the method is applied to defined benefit plans tested under the method in paragraph (e)(3) of this section, and those plans are allowed to impute permitted disparity under that paragraph), and employee benefit percentages under these defined benefit plans are determined on a benefits basis.

(B) Employee benefit percentages under the plans in the testing group are not required to be determined by taking into account early retirement benefits under paragraph (d)(7) of this section.

(C) The defined benefit excess plan or offset plan either is a section 401(*l*) plan that satisfies the ratio percentage test of § 1.410(b)–2(b)(2), or consists exclusively of component plans (as defined in § 1.401(a)(4)–9(c)) each of which is a section 401(*l*) plan that separately satisfies the ratio percentage test of § 1.410(b)–2(b)(2).

(D) Permitted disparity is imputed, to the extent possible, under paragraph (d)(6)(iv) of this section (or paragraph (e)(2)(iii) of this section, if applicable) with respect to all other defined benefit plans in the testing group, but only for employees not benefiting under the defined benefit excess plan or offset plan.

(ii) *Uniform compensation assumption.* For purposes of imputing disparity under paragraphs (d)(5)(iv) and (d)(6)(iv) of this section, the compensation of an employee who is benefiting only under one or more plans in the testing group that do not determine benefit accruals or allocations by reference to individual employees' compensation for example, plans granting flat dollar accruals for each year of service) may be deemed to be equal to the average compensation of all nonexcludable employees benefiting under such plans. This average must be determined using the method actually used to determine the employee's compensation for purposes of this section, or, if none, any other uniform method permitted under this section. In addition, the covered compensation of the employee may be determined based on the average age of all such nonexcludable employees benefiting under such plans. Covered compensation is defined in § 401(*l*)–1(c)(7).

(9) *Three-year averaging period*—(i) *General rule.* An employer may determine an employee's employee benefit percentage for a testing period as the average of the employee's employee benefit percentages determined separately for the testing period and for the immediately preceding one or two testing periods (referred to in this section as an "averaging period").

(ii) *Consistency rule.* Employee benefit percentages of a particular employee that are averaged together within an averaging period must be determined on a consistent basis. Thus, for example, they must be determined as a percentage of the same definition of compensation.

(10) *Alternative methods of determining compensation*—(i) *Use of average annual compensation.* If employee benefit percentages are determined on a benefits basis (or the option provided in this paragraph (e)(10)(i) is applied exclusively to defined benefit plans tested on a benefits basis under the method in paragraph (e)(3) of this section), an employee's average annual compensation as defined in § 1.401(a)(4)–3(e)(2) may be used in lieu of plan year compensation for purposes of paragraph (d)(6)(iii), (e)(2), or (e)(4) of this section.

(ii) *Rules for determining whether alternative definitions are discriminatory.* As under section 401(a)(4), an underlying definition of compensation that is not a definition described in § 1.414(s)–1(c) may not be used in determining employee benefit percentages unless the definition satisfies the requirements of § 1.414(s)–1(d) applicable to alternative definitions of compensation, including the nondiscrimination requirement of § 1.414(s)–1(d)(3). All employees taken into account in determining whether the average benefit percentage test is satisfied who benefit under one or more plans in the testing group are taken into account in determining whether this nondiscrimination requirement is satisfied. See § 1.414(s)–1(d)(3)(iii). The nondiscrimination requirement of § 1.414(s)–1(d)(3) is deemed to be met for purposes of the average benefit percentage test, however, if it is reasonable to believe that the definition used does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using a definition that actually satisfies the nondiscrimination requirement in § 1.414(s)–1(d)(3) taking into account all employees in all plans in the testing group.

(iii) *Use of different definitions for different groups of employees.* Notwithstanding the consistency requirement of paragraphs (d)(8) and (e)(1) of this section, different periods for determining compensation otherwise permitted under this section, and different underlying definitions of compensation, may be used to determine employee benefit percentages for employees benefiting under different plans or groups of plans in the testing group, if both of the following requirements are satisfied—

(A) It is reasonable to believe that use of different methods of determining compensation, or different underlying definitions of compensation, for different groups of employees does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined using the same method of determining compensation, and the same underlying definition of compensation, to determine the employee benefit percentages for all employees in all plans in the testing group.

(B) If any of the underlying definitions of compensation used to measure the compensation of employees in a plan or group of plans is not described in § 1.414(s)–1(c), and thus must satisfy the nondiscrimination requirement of § 1.414(s)–1(d)(3), the definition would satisfy that nondiscrimination requirement if the only employees taken into account were the employees in the plan or group of plans to which the definition is applied. The special rule in paragraph (e)(10)(ii) of this section for determining whether those requirements are satisfied may not be used for this purpose.

(f) *Special rule for certain collectively bargained plans.* A plan (as determined without regard to the mandatory disaggregation rule of § 1.410(b)–7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefit percentage test of this section if—

(1) The provisions of the plan applicable to each employee in the plan are identical to the provisions of the plan applicable to every other employee in the plan, including the plan benefit of allocation formula, any optional forms of benefits, any ancillary benefit, and any other right or feature under the plan, and

(2) The plan would satisfy the ratio percentage test of § 1.410(b)–2(b)(2), if §§ 1.410(b)–6(d) and 1.410(b)–7(c)(5) (the excludable employee and mandatory disaggregation rules for collectively bargained and noncollectively bargained employees) did not apply.

§ 1.410(b)–6 Excludable employees.

(a) *Employees*—(1) *In general.* For purposes of applying section 410(b) with respect to employees, all employees of the employer, other than the excludable employees described in paragraphs (b) through (h) of this section, are taken into account. Excludable employees are not taken into account with respect to a plan even if they are benefiting under the plan, except as otherwise provided in paragraph (b) of this section.

(2) *Rules of application.* Except as specifically provided otherwise, excludable employees are determined separately with respect to each plan for purposes of testing that plan under section 410(b). Thus, in determining whether a particular plan satisfies the ratio percentage test of § 1.410(b)–2(b)(2), paragraphs (b) through (h) of this section are applied solely with reference to that plan. Similarly, in determining whether two or more plans that are permissively aggregated and treated as a single plan under § 1.410(b)–7(d) satisfy the ratio percentage test of § 1.410(b)–2(b)(2), paragraphs (b) through (h) of this section are applied solely with reference to the deemed single plan. In determining whether a plan satisfies the average benefit percentage test of § 1.410(b)–5, the rules of this section are applied by treating all plans in the testing group as a single plan.

(b) *Minimum age and service exclusions*—(1) *In general.* If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date any employee with the same age and service would be eligible to commence participation in the plan, as provided in section 410(b)(4)(C).

(2) *Multiple age and service conditions.* If a plan, including a plan for which an employer chooses the treatment under paragraph (b)(3) of this section, has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy all of the different sets of age and service conditions are excludable employees. Except as provided in paragraph (b)(3) of this section, an employee who satisfies any one of the different sets of conditions is not an excludable employee.

(3) *Plans benefiting certain otherwise excludable employees*—(i) *In general.* An employer may treat a plan benefiting otherwise excludable employees as two separate plans, one for the otherwise excludable employees and one for the other employees benefiting under the plan. See § 1.410(b)–7(c)(3) regarding permissive disaggregation of plans benefiting otherwise excludable employees. The effect of this rule is that employees who would be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be treated as excludable employees with respect to the plan. This treatment is available only if the plan satisfies section 410(b) and § 1.410(b)–2 with respect to these otherwise excludable employees in the manner described in paragraph (b)(3)(ii) of this section.

(ii) *Testing portion of plan benefiting otherwise excludable employees.* In determining whether the plan that benefits employees who would otherwise be excludable under paragraph (b)(1) of this section (applied without regard to section 410(a)(1)(B)) satisfies section 410(b) and § 1.410(b)–2, employees who have satisfied the greatest permissible minimum age and service conditions with respect to the plan are excludable employees. In addition, if the plan being tested applies minimum age and service conditions and those conditions are less than the maximum permissible minimum age and service conditions, employees who have not satisfied the lower minimum age and service conditions actually provided for in the plan are excludable employees. Thus, for example, if the plan requires attainment of age 18 and 3 months of service, employees who have not attained age 18 or 3 months of service with the employer are excludable employees.

(4) *Examples.* The following examples illustrate the minimum age and service condition rules of this paragraph (b). In each example, the employer is not treated as operating qualified separate lines of business under section 414(r).

Example 1. An employer maintains Plan A for hourly employees and Plan B for salaried employees. Plan A has no minimum age or service condition. Plan B has no minimum age condition and requires 1 year of service. The employer treats Plans A and B as a single plan for purposes of section 410(b). Because Plan A imposes no minimum age or service condition, all employees of the employer automatically satisfy the minimum age and service conditions of Plan A. Therefore, no employees are excludable under this paragraph (b) in testing Plans A and B for purposes of section 410(b).

Example 2. An employer maintains three plans. Plan C benefits employees in Division C who satisfy the plan's minimum age and service condition of age 21 and 1 year of service. Plan D benefits employees in Division D who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan E benefits employees in Division E who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. The employer treats Plans D and E as a single plan for purposes of section 410(b). In testing Plan C under the ratio percentage test or the nondiscriminatory classification test of section 410(b), employees who are not at least age 21 or who do not have at least 1 year of service are excludable employees under paragraph (b)(1) of this section. In testing Plans D and E, employees who do not satisfy the age and service requirements of either of the two plans are excludable employees under paragraph (b)(2) of this section. Thus, an employee is excludable with respect to Plans D and E only if the employee is not at least age 18 with at least 1 year of service or is not at least age 21 with at least 6 months of service. Thus, an employee who is 19 years old and has 11 months of service is excludable. Similarly, an employee who is 17

years old and has performed 2 years of service is also excludable.

Example 3. An employer maintains three plans. Plan F benefits all employees in Division F (the plan does not apply any minimum age or service condition). Plan G benefits employees in Division G who satisfy the plan's minimum age and service condition of age 18 and 1 year of service. Plan H benefits employees in Division H who satisfy the plan's minimum age and service condition of age 21 and 6 months of service. In testing the employer's plans under the average benefit percentage test provided in § 1.410(b)–5, Plans F, G, and H are treated as a single plan and, as such, use the lowest minimum age and service condition under the rule of paragraph (b)(2) of this section. Therefore, because Plan F does not apply any minimum age or service condition, no employee is excludable under this paragraph (b).

Example 4. An employer maintains Plan J, which does not apply any minimum age or service conditions. Plan J benefits all employees in Division 1 but does not benefit employees in Division 2. Although Plan J has no minimum age or service condition, the employer wants to exclude employees whose age and service is below the permissible minimums provided in section 410(b)(1)(A). The employer has 110 employees who either do not have 1 year of service or are not at least age 21. Of these 110 employees, 10 are highly compensated employees and 100 are nonhighly compensated employees. Five of these highly compensated employees, or 50 percent, work in Division 1 and thus benefit under Plan J. Thirty-five of these nonhighly compensated employees, or 35 percent, work in Division 1 and thus benefit under Plan J. Plan J satisfies the ratio percentage test of section 410(b) with respect to employees who do not satisfy the greatest permissible minimum age and service requirement because the ratio percentage of that group of employees is 70 percent. Thus, in determining whether or not Plan J satisfies section 410(b), the 110 employees may be treated as excludable employees in accordance with paragraph (b)(3)(i) of this section.

(c) *Certain nonresident aliens*—(1) *General rule.* An employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who receives no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is treated as an excludable employee.

(2) *Special treaty rule.* In addition, an employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who does receive earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is permitted to be excluded, if all of the employee's earned income from the employer from sources within the United States is exempt from United States income tax under an applicable income tax convention. This paragraph (c)(2) applies only if all employees described in the preceding sentence are so excluded.

(d) *Collectively bargained employees*—(1) *General rule.* A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. If a plan (within the meaning of § 410(b)–7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, § 1.410(b)–7(c)(5) provides that the portion of the plan that benefits the collectively bargained employees is treated as a separate plan from the portion of the plan that benefits the noncollectively bargained employees. Thus, a collectively bargained employee is always an excludable employee with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees.

(2) *Definition of collectively bargained employee*—(i) *In general.* A collectively bargained employee is an employee who is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers. An employee is a collectively bargained employee regardless of whether the employee benefits under any plan of the employer. See section 7701(a)(46) and § 301.7701–17T (Temporary) of this Chapter for additional requirements applicable to the collective bargaining agreement.

(ii) *Special rules for certain employees who cease to be collectively bargained employees*—(A) *Employees who were collectively bargained employees in prior plan year.* An employee who was a collectively bargained employee throughout the prior plan year, but who ceases to be a collectively bargained employee during the current plan year, may be treated as a collectively bargained employee until the end of the current plan year if the collective bargaining agreement that covers the unit of employees of which the employee was a member in the prior plan year requires the employee to benefit, in the current plan year, under a multiemployer plan maintained pursuant to the collective bargaining agreement. For plan years beginning before January 1, 1992, any employee may be treated as a collectively bargained employee for a plan year if a collective bargaining agreement required the employee to benefit, for that year, under a multiemployer plan maintained pursuant to the collective bargaining agreement.

(B) *Employees who were collectively bargained employees during a portion of the current plan year.* An employee who performs services for an employer that is a party to a collective bargaining agreement that requires the employee to benefit under a multiemployer plan both as a collectively bargained employee and as a noncollectively bargained employee during a plan year may be treated as a collectively bargained employee with respect to all of the employee's hours of service during the plan year provided that at least half of the employee's hours of service during the plan year are performed as a collectively bargained employee.

(C) *Consistency requirement.* The rules in paragraph (d)(2)(i) and (ii) of this section must be applied to all employees on a reasonable and consistent basis for the plan year.

(iii) *Covered by a collective bargaining agreement.*—(A) *General rule.* For purposes of paragraph (d)(2)(i) of this section, an employee is included in a unit of employees covered by a collective bargaining agreement if and only if the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement under which the plan is maintained. Thus, for example, an employee of either a plan or the employee representative that is a party to the collective bargaining agreement under which the plan is maintained is not included in a unit of employees covered by the collective bargaining agreement under which the plan is maintained merely because the employee is covered under the plan pursuant to an agreement entered into by the plan or employee representative on behalf of the employee (other than in the capacity of an employee representative with respect to the employee). This is the case even if all of such employees benefiting under the plan constitute only a de minimis percentage of the total employees benefiting under the plan.

(B) *Plans covering professional employees*—(1) *In general.* An employee is not considered included in a unit of employees covered by a collective bargaining agreement for a plan year for purposes of paragraph (d)(2)(iii)(A) of this section if, for the plan year, more than 2 percent of the employees who are covered pursuant to the agreement are professionals. This rule applies to all employees under the agreement,

nonprofessionals as well as professionals. Thus, no employees covered by such an agreement are excludable employees with respect to employees who are not covered by a collective bargaining agreement.

(2) *Multiple collective bargaining agreements.* This paragraph (d)(2)(iii)(B) is applied separately with respect to each collective bargaining agreement. Thus, for example, if a plan benefits two groups of employees, one included in a unit of employees covered by collective bargaining agreement X, more than 2 percent of whom are professionals, and another included in a unit of employees covered by collective bargaining agreement Y, none of whom are professionals, the group covered by agreement X is not considered covered by a collective bargaining agreement and the group covered by agreement Y is considered covered by a collective bargaining agreement.

(3) *Application of minimum coverage tests.* If a plan covers more than 2 percent professional employees, no employees in the plan are treated as covered by a collective bargaining agreement. A plan that covers more than 2 percent professional employees must satisfy section 410(b) without regard to section 413(b) and the special rule in § 1.410(b)–2(b)(7) of this section (regarding collectively bargained plans). In such cases, all nonexcludable employees must be taken into account. For this purpose, employees included in other collective bargaining units are excludable employees. However, the employees who are not covered by a collective bargaining agreement and the employees who are covered by an agreement that has more than 2 percent professionals are not excludable employees.

(iv) *Examples.* The following examples illustrate the collective bargaining unit rules of this section.

Example 1. An employer has 700 collectively bargained employees (none of whom is a professional employee) and 300 noncollectively bargained employees (200 of whom are highly compensated employees). For purposes of applying the ratio percentage test of § 1.410(b)–2(b)(2) to Plan X, which benefits only the 300 noncollectively bargained employees, the 700 collectively bargained employees are treated as excludable employees pursuant to paragraph (d) of this section.

Example 2. (i) An employer has 1,500 employees in the following categories:

	Noncollectively bargained employees	Collectively bargained employees	Total
Highly compensated employees	100	100	200
Nonhighly compensated employees	900	400	1,300
Total	1,000	500	1,500

The employer maintains Plan Y, which benefits 1,100 employees, including all of the noncollectively bargained employees (except for 100 nonhighly compensated employees who are noncollectively bargained employees), and 200 of the collectively bargained employees (including the 100 highly compensated employees who are collectively bargained employees). There are no professional employees covered by the collective bargaining agreement. In accordance with § 1.410(b)–7(c)(5), the employer must apply the ratio percentage test of § 1.410(b)–2(b)(2) to Plan Y as if the plan were two separate plans, one benefiting the noncollectively bargained employees and the other benefiting the collectively bargained employees.

(ii) In testing the portion of Plan Y that benefits the noncollectively bargained employees, the collectively bargained employees are excludable employees. That portion's ratio percentage is 88.89 percent ([800/900] /[100/100] = 88.89%/100% =0.8889), and thus it satisfies the ratio percentage test. The portion of Plan Y that benefits collectively bargained employees automatically satisfies section 410(b) under the special rule in § 1.410(b)–2(b)(7).

(e) *Employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), in testing a plan that benefits the employees of one qualified separate line of business, the employees of the other qualified separate lines of business of the employer are treated as excludable employees. The rule in this paragraph (e) does not apply for purposes of satisfying the nondiscriminatory classification requirement of section 410(b)(5)(B).

(f) *Certain terminating employees*—(1) *In general.* An employee may be treated as an excludable employee for a plan year with respect to a particular plan if—

(i) The employee does not benefit under the plan for the plan year,

(ii) The employee is eligible to participate in the plan,

(iii) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year (last-day requirement) in order for an employee to accrue a benefit or receive an allocation for the plan year,

(iv) The employee fails to accrue a benefit or receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last-day requirement,

(v) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year (for purposes of this paragraph (f)(1)(v), a plan that uses the elapsed time method of determining years of service may use either 91 consecutive calendar days or 3 consecutive calendar months instead of 500 hours of service, provided it uses the same convention for all employees during a plan year), and

(vi) If this paragraph (f) is applied with respect to any employee with respect to a plan for a plan year, it is applied with respect to all employees with respect to the plan for the plan year.

(2) *Hours of service.* For purposes of this paragraph (f), the term "hours of service" has the same meaning as provided for such term by 29 CFR 2530.200b–2 under the general method of crediting service for the employee. If one of the equivalencies set forth in 29 CFR 2530.200b–3 is used for crediting service under the plan, the 500-hour requirement must be adjusted accordingly.

(3) *Examples.* The following examples illustrate the provision of this paragraph (f).

Example 1. An employer has 35 employees who are eligible to participate under a defined contribution plan. The plan provides that an employee will not receive an allocation of contributions for a plan year unless the employee is employed by the employer on the last day of the plan year. Only 30 employees are employed by the employer on the last day of the plan year. Two of the five employees who terminated employment before the last day of the plan year had 500 or fewer hours of service during the plan year, and the remaining three had more than 500 hours of service during the year. Of the five employees who were no longer employed on the last day of the plan year, the two with 500 hours of service or less during the plan year are treated as excludable employees for purposes of section 410(b), and the remaining three who had over 500 hours of service during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 2. An employer has 30 employees who are eligible to participate under a defined contribution plan. The plan requires 1,000 hours of service to receive an allocation of contributions or forfeitures. Ten employees do not receive an allocation because of their failure to complete 1,000 hours of service. Three of the 10 employees who failed to satisfy the minimum service requirement completed 500 or fewer hours of service and terminated their employment. Two of the employees completed more than 500, but fewer than 1,000 hours of service and

terminated their employment. The remaining five employees did not terminate employment. Under the rule in paragraph (f) of this section, the three terminated employees who completed 500 or fewer hours of service are treated as excludable employees for the portion of the plan year they are employed. The other seven employees who do not receive an allocation are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

Example 3. An employer maintains two plans, Plan A for salaried employees and Plan B for hourly employees. Of the 100 salaried employees, two do not receive an allocation under Plan A for the plan year because they terminate employment before completing 500 hours of service. Of the 300 hourly employees, 50 do not receive an allocation under Plan B for the plan year because they terminate employment before completing 500 hours. In applying section 410(b) to Plan A, the two employees who did not receive an allocation under Plan A are excludable employees, but the 50 who did not receive an allocation under Plan B are not excludable employees, because they were not eligible to participate under Plan A.

(g) *Employees of certain governmental or tax-exempt entities precluded from maintaining a section 401(k) plan.* For purposes of testing a section 401(k) plan or a section 401(m) plan that consists solely of employer matching contributions that are tied to elective contributions under a section 401(k) plan, an employer may treat as excludable those employees of governmental or tax-exempt entities who are precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B), if more than 95 percent of the employees of the employer who are not precluded from being eligible employees by section 401(k)(4)(B) benefit under the plan for the plan year.

(h) *Former employees*—(1) *In general.* For purposes of applying section 410(b) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described in paragraph (h)(2) or (h)(3) of this section as an excludable former employee. If either (or both) of the former employee exclusion rules under paragraphs (h)(2) and (h)(3) of this section is applied, it must be applied to all former employees for the plan year on a consistent basis.

(2) *Employees terminated before a specified date.* The employer may treat a former employee as excludable if—

(i) The former employee became a former employee either prior to January 1, 1984, or prior to the tenth calendar year preceding the calendar year in which the current plan year begins, and

(ii) The former employee became a former employee in a calendar year that precedes the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee.

(3) *Previously excludable employees.* The employer may treat a former employee as excludable if the former employee was an excludable employee (or would have been an excludable employee if these regulations had been in effect) under the rules of paragraphs (b) through (g) of this section during the plan year in which the former employee became a former employee. If the employer treats a former employee as excludable pursuant to this paragraph (h)(3), the former employee is not taken into account with respect to a plan even if the former employee is benefiting under the plan.

§ 1.410(b)–7 Definition of plan and rules governing plan disaggregation and aggregation.

(a) *In general.* This section provides a definition of "plan." First, this section sets forth a definition of plan within the meaning of section 401(a) or 403(a). Then certain mandatory disaggregation and permissive aggregation rules are applied. The result is the definition of plan that applies for purposes of sections 410(b) and 401(a)(4). Thus, in general, the term "plan" as used in this section initially refers to a plan described in section 414(l) and to an annuity plan described in section 403(a), and the term "plan" as used in other sections under these regulations means the plan determined after application of this section. Paragraph (b) of this section provides that each single plan under section 414(l) is treated as a single plan for purposes of section 410(b). Paragraph (c) of this section describes the rules for certain plans that must be treated as comprising two or more separate plans, each of which is a single plan subject to section 410(b). Paragraph (d) of this section provides a rule permitting an employer to aggregate certain separate plans to form a single plan for purposes of section 410(b). Paragraph (e) of this section provides rules for determining the testing group of plans taken into account in determining whether a plan satisfies the average benefit percentage test of § 1.410(b)–5.

(b) *Separate asset pools are separate plans.* Each single plan within the meaning of section 414(l) is a separate plan for purposes of section 410(b). See § 414(l)–1(b). For example, if only a portion of the assets under a defined benefit plan is available, on an ongoing basis, to provide the benefits of certain employees, and the remaining assets are available only in certain limited cases to provide such benefits (but are available in all cases for the benefit of other employees), there are two separate plans. Similarly, the defined contribution portion of a plan described in section 414(k) is a separate plan from the defined benefit portion of that same plan. A single plan under section 414(l) is a single plan for purposes of section 410(b), even though the plan comprises separate written documents and separate trusts, each of which receives a separate determination letter from the Internal Revenue Service. A defined contribution plan does not comprise separate plans merely because it includes more than one trust, or merely because it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are separately invested in individual insurance or annuity contracts for employees.

(c) *Mandatory disaggregation of certain plans*—(1) *Section 401(k) and 401(m) plans.* The portion of a plan that is a section 401(k) plan and the portion that is not a section 401(k) plan are treated as separate plans for purposes of section 410(b). Similarly, the portion of a plan that is a section 401(m) plan and the portion that is not a section 401(m) plan are treated as separate plans for purposes of section 410(b). Thus, a plan that consists of elective contributions under a section 401(k) plan, employee and matching contributions under a section 401(m) plan, and contributions other than elective, employee, or matching contributions is treated as three separate plans for purposes of section 410(b). In addition, the portion of a plan that consists of contributions described in § 1.401(k)–1(b)(4)(iv) (i.e., contributions that fail to satisfy the allocation or compensation requirements applicable to elective contributions and are therefore required to be tested separately) and the portion of the plan that does not consist of such contributions are treated as separate plans for purposes of section 410(b).

(2) *ESOPs and non-ESOPs.* The portion of a plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of section 410(b), except as otherwise permitted under § 54.4975–11(e) of this Chapter.

(3) *Plans benefiting otherwise excludable employees.* If an employer applies section 410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower

than the greatest minimum age and service conditions permissible under section 410(a), the plan is treated as comprising separate plans, one benefiting the employees who have satisfied the lower minimum age and service conditions but not the greatest minimum age and service conditions permitted under section 410(a) and one benefiting employees who have satisfied the greatest minimum age and service conditions permitted under section 410(a). See § 410(b)–6(b)(3)(ii) for rules about testing otherwise excludable employees.

(4) *Plans benefiting employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the portions of the same plan that benefit employees of the other qualified separate lines of business of the employer. If a plan satisfies the reasonable classification requirement of § 1.410(b)–4(b) before the application of this paragraph (c)(4), then any portion of that plan that is treated as a separate plan as a result of the application of this paragraph (c)(4) is deemed to satisfy that requirement.

(5) *Plans benefiting collectively bargained employees.* The portion of a plan that benefits collectively bargained employees is treated as a separate plan from the portion of the same plan that benefits noncollectively bargained employees. In addition, the portion of a plan that benefits collectively bargained employees covered under one collective bargaining agreement is treated as a separate plan from the portion of the same plan that benefits collectively bargained employees covered another collective bargaining agreement.

(6) *Plans maintained by more than one employer.* If a plan benefits employees of more than one employer, the plan is treated as comprising separate plans each of which is maintained by a separate employer and must satisfy section 410(b) by reference only to such employer's employees.

(d) *Permissive aggregation for ratio percentage and nondiscriminatory classification tests*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the ratio percentage test of § 1.410(b)–2(b)(2) or the nondiscriminatory classification test of § 1.410(b)–4, an employer may designate two or more separate plans (determined after application of paragraph (b) of this section) as a single plan. If an employer treats two or more separate plans as a single plan under this paragraph, the plans must be treated as a single plan for all purposes under sections 401(a)(4) and 410(b).

(2) *Rules of disaggregation.* An employer may not aggregate portions of a plan that are disaggregated under the rules of paragraph (c) of this section. Similarly, an employer may not aggregate two or more separate plans that would be disaggregated under the rules of paragraph (c) of this section if they were portions of the same plan. In addition, an employer may not aggregate an ESOP with another ESOP, except as permitted under § 54.4975–11(e) of this Chapter.

(3) *Duplicative aggregation.* A plan may not be combined with two or more plans to form more than one single plan. Thus, for example, an employer that maintains plans A, B, and C may not aggregate plans A and B and plans A and C to form two single plans. However, the employer may apply the permissive aggregation rules of this paragraph (d) to form any one (and only one) of the following combinations: plan ABC, plans AB and C, plans AC and B, or plans A and BC.

(4) *Special rule for plans benefiting employees of a qualified separate line of business.* For purposes of paragraph (d)(1) of this section, an employer is permitted to aggregate the portions of two or more plans that benefit employees of the same qualified separate line of business, regardless of whether the employer aggregates the portion of the same plans that benefit employees of the other qualified separate lines of business of the employer. Thus, the employer is permitted to apply paragraph (d)(1) of this section with respect to two or more separate plans determined after the application of paragraphs (b) and (c)(5) of this section. In all other respects, the provisions of this paragraph (d) regarding permissive aggregation apply, including (but not limited to) the disaggregation rules under paragraph (d)(2) of this section (including the mandatory disaggregation rule of paragraph (c)(5) of this section) and the prohibition on duplicative aggregation under paragraph (d)(3) of this section. This paragraph (d)(4) applies only in the case of an employer that is treated as operating qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r).

(5) *Same plan year requirement.* Two or more plans may not be aggregated and treated as a single plan under this paragraph (d) unless they have the same plan year. See § 1.410(b)–10 for a special effective date.

(e) *Determination of plans in testing group for average benefit percentage test*—(1) *In general.* For purposes of applying the average benefits percentage test of § 1.410(b)–5 with respect to a plan, all plans in the testing group must be taken into account. For this purpose, the plans in the testing group are the plan being tested and all other plans of the employer that could be permissively aggregated with that plan under paragraph (d) of this section (determined without regard to paragraph (d)(5) of this section and by applying paragraph (d)(2) of this section without regard to paragraphs (c)(1) through (c)(3) of this section).

(2) *Example.* The following example illustrates the rules of this paragraph (e).

Example. Employer X is treated as operating two qualified separate lines of business for purposes of section 410(b) in accordance with section 414(r), QSLOB1 and QSLOB2. Employer X maintains the following plans:

(a) Plan A, the portion of Employer X's employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB1,

(b) Plan B, the portion of Employer X's employer-wide section 401(k) plan that benefits all noncollectively bargained employees of QSLOB2,

(c) Plan C, a defined benefit plan that benefits all hourly noncollectively bargained employees of QSLOB1,

(d) Plan D, a defined benefit plan that benefits all collectively bargained employees of QSLOB1,

(e) Plan E, an ESOP that benefits all noncollectively bargained employees of QSLOB1,

(f) Plan F, a profit-sharing plan that benefits all salaried noncollectively bargained employees of QSLOB1.

Assume that Plan F does not satisfy the ratio percentage test of § 1.410(b)–2(b)(2), but does satisfy the nondiscriminatory classification test of § 1.410(b)–4. Therefore, to satisfy section 410(b), Plan F must satisfy the average benefit percentage test of § 1410(b)–5. The plans in the testing group used to determine whether Plan F satisfies the average benefit percentage test of § 1.410(b)–5 are Plans A, C, E, and F.

(f) *Section 403(b) plans.* In determining whether a plan satisfies section 410(b), a plan subject to section 403(b)(12)(A)(i) is disregarded. However, in determining whether a plan subject to section 403(b)(12)(A)(i) satisfied section 410(b), plans that are not subject to section 403(b)(12)(A)(i) may be taken into account.

§ 1.410(b)–8 Additional rules.

(a) *Testing methods*—(1) *In general.* A plan must satisfy section 410(b) for a plan year using one of the testing options in paragraphs (a)(2) through (a)(4) of this section. Whichever testing

option is used for the plan year must also be used for purposes of applying section 401(a)(4) to the plan for the plan year. The annual testing option in paragraph (a)(4) of this section must be used in applying section 410(b) to a section 401(k) plan or a section 401(m) plan, and in applying the average benefit percentage test of § 1.410(b)–5. For purposes of this paragraph (a), the plan provisions and other relevant facts as of the last day of the plan year regarding which employees benefit under the plan for the plan year are applied to the employees taken into account under the testing option used for the plan year. For this purpose, amendments retroactively correcting a plan in accordance with § 1.401(a)(4)–11(g) are taken into account as plan provisions in effect as of the last day of the plan year.

(2) *Daily testing option.* A plan satisfies section 410(b) for a plan year if it satisfies § 1.410(b)–2 on each day of the plan year, taking into account only those employees (or former employees) who are employees (or former employees) on that day.

(3) *Quarterly testing option.* A plan is deemed to satisfy section 410(b) for a plan year if the plan satisfies § 1.410(b)–2 on at least one day in each quarter of the plan year, taking into account for each of those days only those employees (or former employees) who are employees (or former employees) on that day. The preceding sentence does not apply if the plan's eligibility rules or benefit formula operate to cause the four quarterly testing days selected by the employer not to be reasonably representative of the coverage of the plan over the entire plan year.

(4) *Annual testing option.* A plan satisfies section 410(b) for a plan year if it satisfies § 1.410(b)–2 as of the last day of the plan year, taking into account all employees (or former employees) who were employees (or former employees) on any day during the plan year.

(5) *Example.* The following example illustrates this paragraph (a).

Example. Plan A is a defined contribution plan that is not a section 401(k) plan or a section 401(m) plan, and that conditions allocations on an employee's employment on the last day of the plan year. Plan A is being tested for the 1995 calendar plan year using the daily testing option in paragraph (a)(2) of this section. In testing the plan for compliance with section 410(b) on March 11, 1995, Employee X is taken into account because he was an employee on that day and was not an excludable employee with respect to Plan A on that day. Employee X was a participant in Plan A on March 11, 1995, was employed on December 31, 1995, and received an allocation under Plan A for the 1995 plan year. Under these facts, Employee X is treated as benefiting under Plan A on March 11, 1995, even though Employee X had not satisfied all of the conditions for receiving an allocation on that day, because Employee X satisfied all of those conditions as of the last day of the plan year.

(b) *Family member aggregation rule.* For purposes of section 410(b), and in accordance with section 414(q)(6), a highly compensated employee who is a 5-percent owner or one of the ten most highly compensated employees and any family member (or members) of such a highly compensated employee who is also an employee of the employer are to be treated as a single highly compensated employee. If any member of that group is benefiting under a plan, the deemed single employee is treated as benefiting under the plan. If no member of that group is benefiting under a plan, the deemed single employee is treated as not benefiting under the plan.

§ 1.410(b)–9 Definitions.

In applying this section and §§ 1.410(b)–2 through 1.410(b)–10, the definitions in this section govern unless otherwise provided.

Collectively bargained employee. Collectively bargained employee means a collectively bargained employee within the meaning of § 1.410(b)–6(d)(2).

Defined benefit excess plan. Defined benefit excess plan means a defined benefit excess plan as defined in § 1.410(l)–1(c)(16)(i).

Defined benefit plan. Defined benefit plan means a defined benefit plan within the meaning of section 414(j). The portion of a plan described in section 414(k) that does not consist of separate accounts is treated as a defined benefit plan.

Defined contribution plan. Defined contribution plan means a defined contribution plan within the meaning of section 414(i). The portion of a plan described in section 414(k) that consists of separate accounts is treated as a defined contribution plan.

Employee. Employee means an individual who performs services for the employer who is either a common law employee of the employer, a self-employed individual who is treated as an employee pursuant to section 401(c)(1), or a leased employee (not excluded under section 414(n)(5)) who is treated as an employee of the employer-recipient under section 414(n)(2) or 414(o)(2). Individuals that an employer treats as employees under section 414(n) pursuant to the requirements of section 414(o) are considered to be leased employees for purposes of this rule.

Employer. Employer means the employer maintaining the plan and those employers required to be aggregated with the employer under sections 414(b), (c), (m), or (o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

ESOP. ESOP or *employee stock ownership plan* means an employee stock ownership plan within the meaning of section 4975(e)(7) or a tax credit employee stock ownership plan within the meaning of section 409(a).

Excess benefit percentage. Excess benefit percentage means excess benefit percentage as defined in § 1.401(l)–1(c)(14).

Former employee. Former employee means an individual who was an employee but has ceased performing services for the employer. An individual is treated as a former employee beginning on the day after the day on which the individual ceases performing services for the employer. Thus, an individual who ceases performing services for an employer during a plan year is both an employee and a former employee for the plan year. Notwithstanding the foregoing, an individual is an employee (and not a former employee) even if the individual is not performing services for the employer during a period for which the plan credits the individual with imputed compensation that satisfies § 1.414(s)–1(e)(3) or imputed service that satisfies § 1.401(a)(4)–11(d)(2).

Gross benefit percentage. Gross benefit percentage means gross benefit percentage as defined in § 1.401(l)–1(c)(18).

Highly compensated employee. Highly compensated employee means a highly compensated employee within the meaning of section 414(q).

Highly compensated former employee. Highly compensated former employee means a highly compensated former employee within the meaning of section 414(q)(9).

Multiemployer plan. Multiemployer plan means a multiemployer plan within the meaning of section 414(f).

Noncollectively bargained employee. Noncollectively bargained employee means an employee who is not a collectively bargained employee.

Nonhighly compensated employee. Nonhighly compensated employee an employee who is not a highly compensated employee.

Nonhighly compensated former employee. Nonhighly compensated former employee means a former employee who is not a highly compensated former employee.

Offset plan. Offset plan means an offset plan as defined in § 1.401(l)–1(c)(24).

Plan year. Plan year means the plan year of the plan as defined in the written plan document. In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year.

Plan year compensation. Plan year compensation means plan year compensation within the meaning of § 1.401(a)(4)–12.

Professional employee. Professional employee means any highly compensated employee who, on any day of the plan year, performs professional services for the employer as an actuary, architect, attorney, chiropodist, chiropractor, dentist, engineer, executive, investment banker, medical doctor, optometrist, osteopath, podiatrist, psychologist, certified or other public accountant, stockbroker, or veterinarian, or in any other professional capacity determined by the Commissioner in a notice or other document of general applicability to constitute the performance of services as a professional.

Ratio percentage. With respect to a plan for a plan year, a plan's *ratio percentage* means the percentage (rounded to the nearest hundredth of a percentage point) determined by dividing the percentage of the nonhighly compensated employees who benefit under the plan by the percentage of the highly compensated employees who benefit under the plan. The percentage of the nonhighly compensated employees who benefit under the plan is determined by dividing the number of nonhighly compensated employees benefiting under the plan by the total number of nonhighly compensated employees of the employer. The percentage of the highly compensated employees who benefit under the plan is determined by dividing the number of highly compensated employees benefiting under the plan by the total number of highly compensated employees of the employer.

Section 401(k) plan. Section 401(k) plan means a plan consisting of elective contributions described in § 1.40(k)–1(g)(3) under a qualified cash or deferred arrangement described in § 1.401(k)–(a)(4)(i). Thus, a section 401(k) plan does not include a plan (or portion of a plan) that consists of contributions under a nonqualified cash or deferred arrangement, or qualified nonelective or qualified matching contributions treated as elective contributions under § 1.401(k)–1(b)(5).

Section 401(l) plan. Section 401(l) plan means a plan that—

(1) Provides for a disparity in employer-provided benefits or contributions that satisfies section 401(l) in form, and

(2) Relies on one of the safe harbors of § 1.401(a)(4)–2(b)(3), 1.401(a)(4)–3(b), 1.401(a)(4)–8(b)(3), or 1.401(a)(4)–8(c)(3)(iii)(B) to satisfy section 401(a)(4).

Section 401(m) plan. Section 401(m) plan means a plan consisting of employee contributions described in § 1.401(m)–1(f)(6) or matching contributions described in § 1.40(m)–1(f)(12), or both. Thus, a section 401(m) plan does not include a plan (or portion of a plan) that consists of elective contributions or qualified nonelective contributions treated as matching contributions under § 1.401(m)–1(b)(5).

§ 1.410(b)–10 Effective dates and transition rules.

(a) *General rule.* The minimum coverage rules of section 410(b), as amended by section 1112 of the Tax Reform Act of 1986, and §§ 1.410(b)–2 through 1.410(b)–9, other than § 1.410(b)–5, apply to plan years beginning on or after January 1, 1989. See paragraph (b)(2) of this section for the effective date of § 1.410(b)–5. Notwithstanding the first sentence of this paragraph (a) and § 54.4975–11(a)(5) of this Chapter, an employer may treat the rule in § 1.410(b)–7(c)(2), regarding mandatory disaggregation of ESOPs and non-ESOPs, as not effective for plan years beginning before January 1, 1990, except for purposes of the rule in § 1.410(b)–7(d)(2) prohibiting aggregation of two or more separate plans that would be disaggregated under the rules of § 1.410(b)–7(c) if they were portions of the same plan.

(b) *Transition rules*—(1) *Nondiscriminatory classification test.* Notwithstanding paragraph (a) of this section, in applying the average benefit test for any plan year beginning after December 31, 1988, and before January 1, 1990 (the "1989 plan year"), whether or not a plan's classification is nondiscriminatory may be determined either by applying the rules in § 1.410(b)–4 or solely on the basis of facts and circumstances, at the employer's election. If a plan's classification has been determined by the Commissioner to be nondiscriminatory, and there have been no significant changes in, or omissions of, a material fact, the classification will be treated as nondiscriminatory for the 1989 plan year.

(2) *Average benefit percentage test.* Section 1.410(b)–5 applies to plan years beginning on or after January 1, 1992. For plan years beginning before that date and on or after the first day of the first plan year to which the amendments made to section 410(b) by section 1112(a) of the Tax Reform Act of 1986 apply, a plan must be operated in accordance with a reasonable, good faith interpretation of sections 410(b)(2)(A)(ii) and 410(b)(2)(B) through (E). Whether a plan is operated in accordance with a reasonable, good faith interpretation of sections 410(A)(ii) and 410(b)(2)(b)(2)(B) through (E) will generally be determined based on all relevant facts and circumstances, including the extent to which an employer has resolved unclear issues in its favor. A plan will be deemed to be operated in accordance with a reasonable, good faith interpretation of sections 410(b)(2)(A)(ii) and 410(b)(2)(B) through (E) if it is operated in accordance with the terms of § 1.410(b)–5.

(c) *Employees who benefit under a plan.* Notwithstanding paragraph (a) of this section, for the first plan year beginning after December 31, 1988, and before January 1, 1990, any employee who is eligible to participate under the plan and who fails to accrue a benefit solely because of the failure to satisfy either a minimum-period-of-service requirement of 1,000 hours of service or less or a last-day-of-the-plan-year requirement may be treated as benefiting under the plan, provided that all such employees are treated as benefiting under the plan.

(d) *Aggregation of two or more plans.* Notwithstanding paragraph (a) of this section, an employer may treat the rule of § 1.410(b)–7(d)(5) (requiring plans permissively aggregated under § 1.410(b)–7(d) to have the same plan years) as not effective for plan years beginning before January 1, 1990.

(e) *Special rule for collective bargaining agreements*—(1) *In general.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the minimum coverage rules of section 410(b), as amended by section 1112 of the Tax Reform Act of 1986, and §§ 1.410(b)–2 through 1.410(b)–9 do not apply to employees covered by any such agreement in plan years beginning before the earlier of—

(i) January 1, 1991, or

(ii) The later of January 1, 1989, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986). For purposes of this paragraph (e)(1)(ii), any extension or renegotiation of a collective bargaining agreement,

which extension or renegotiation is ratified after February 28, 1986, is to be disregarded in determining the date on which the agreement terminates.

(2) *Example.* The following example illustrates this paragraph (e).

Example. Employer A maintains Plan 1 pursuant to a collective bargaining agreement. Plan 1 covers 100 of Employer A's noncollectively bargained employees and 900 of Employer A's collectively bargained employees. Employer A also maintains Plan 2, which covers Employer A's other 400 noncollectively bargained employees. The collective bargaining agreement under which Plan 1 is maintained was entered into on January 1, 1986, and expires December 31, 1992. Because Plan 1 is a plan maintained pursuant to a collective bargaining agreement, section 410(b) applies to the first plan year beginning on or after January 1, 1991. In applying section 410(b) to Plan 2, the 100 noncollectively bargained employees in Plan 1 must be taken into account. The deferred effective date for plans maintained pursuant to a collective bargaining agreement is not applicable in determining how section 410(b) is applied to a plan that is not maintained pursuant to a collective bargaining agreement.

(3) *Plan maintained pursuant to a collective bargaining agreement.* For purposes of this paragraph (e), a plan is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, if one or more of the agreements were ratified before March 1, 1986. Only plans maintained pursuant to agreements that the Secretary of Labor finds to be collective bargaining agreements and that satisfy section 7701(a)(46) are eligible for the deferred effective date under this paragraph (e). A plan will not be treated as a plan maintained pursuant to one or more collective bargaining agreements eligible for the deferred effective date under this paragraph (e) unless the plan would be a plan maintained pursuant to one or more collective bargaining agreements under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93rd Cong. 2d Sess. 266 (1974).

Fred T. Goldberg, Jr.,

Commissioner of Internal Revenue.

Approved: August 30, 1991.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

[FR Doc. 91-21927 Filed 9-12-91; 10:53 am]

BILLING CODE 4830-01-M

26 CFR Part 1

[T.D. 8361]

RIN 1545-AO66

Definition of Compensation for Qualified Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the scope and meaning of the term "compensation" for tax-qualified retirement plans under section 414(s) of the Internal Revenue Code of 1986. These regulations reflect changes made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance necessary to comply with the law and affect sponsors of, and participants in, tax-qualified retirement plans.

EFFECTIVE DATE: These regulations are effective for plan years beginning on or after January 1, 1987, and are applied to those plan years except as set forth in § 1.414(s)-(1(i).

FOR FURTHER INFORMATION CONTACT: David Fuller at 202-377-9372 (not a toll-free number).

SUPPLEMENTARY INFORMATION: On May 14, 1990, the Internal Revenue Service published temporary regulations relating to the scope and meaning of the term "compensation" under sections 414(s) and 415(c)(3) of the Internal Revenue Code (Code) in the **Federal Register** (55 FR 19875). Those regulations provided guidance concerning the definition of compensation and conformed the regulations to section 1115 of the Tax Reform Act of 1986 and section 1011(j)(1) of the Technical and Miscellaneous Revenue Act of 1988. The text of those temporary regulations served as the comment document for a notice of proposed rulemaking also published in the **Federal Register** May 14, 1990 (55 FR 19945).

Written comments were received from the public on the proposed regulations. In addition, on September 26, 27, and 28, 1990, a public hearing was held concerning the regulations. After consideration of all of the written comments received and the statements made at the public hearing, the proposed and temporary regulations are adopted as modified by this Treasury Decision.

Background

Section 414(s) and these regulations provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s). For example, section 414(s) is explicitly referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). The amount of plan benefits or contributions, expressed as a percentage of compensation within the meaning of section 414(s), is generally one of the key factors in determining whether these nondiscrimination provisions are satisfied.

The temporary regulations implemented the section 414(s) definition of compensation by providing design-based safe harbor definitions of compensation under section 415(c)(3) and a design-based safe harbor alternative definition under section 414(s). In addition, the temporary regulations generally provided that any other reasonable definition of compensation would satisfy section 414(s) if the definition did not by design favor highly compensated employees and satisfied a nondiscrimination requirement. Finally, the temporary regulations provided rules that permitted compensation to include elective salary reduction contributions specified in section 414(s)(2), section 457 deferred compensation, and section 414(h) employer pick-up amounts.

Overview of Development of Final Regulations

The Department of the Treasury and the Internal Revenue Service have received a number of comments on the proposed and temporary regulations under section 414(s) and the regulations under the related Code sections with which the section 414(s) regulations were published (in particular, sections 401(a)(4), 401(l), and 410(b)). This Treasury Decision reflects consideration of all of the comments received. In general, the final regulations retain the approach taken in the temporary regulations. In response to comments, revisions have been made to increase the utility of the design-based safe harbors, to increase the flexibility of the rules permitting reasonable nondiscriminatory definitions, and to simplify and clarify certain aspects of the temporary regulations.

Compensation Safe Harbors Under Section 415(c)(3) Applicable For Purposes Of Section 414(s)

1. 415(c)(3) Safe Harbor Definitions

The temporary regulations under section 414(s) provided that definitions of compensation that satisfied section 415(c)(3) also would constitute safe harbor definitions of compensation for purposes of section 414(s). The

temporary regulations also clarified the regulations under section 415(c)(3) as to what amounts were included in compensation. In addition, the temporary regulations added two new section 415(c)(3) safe harbors generally based on wages as defined for FICA tax purposes and on wages as defined for income tax withholding purposes.

Commentators generally favored the addition of a safe harbor definition based on wages for purposes of income tax withholding. This safe harbor definition is retained without modification in the final regulations.

In contrast, many commentators found the new safe harbor definition based on FICA wages to be of limited utility from an administrative point of view. In addition, comments indicated that the use of FICA wages as an alternative compensation definition under section 415(c)(3) was being misinterpreted and misapplied. Moreover, commentators pointed out that often the data was not readily accessible because many employers do not keep a separate accounting of FICA wages after an employee's wages exceed the taxable wage base limitation.

A number of commentators requested a safe harbor definition based on wages reported in Box 10 on Form W–2, Wage and Tax Statement (Box 10 Compensation), indicating that it would be a useful safe harbor definition of compensation. Box 10 Compensation does not precisely match either FICA wages or wages for income tax withholding purposes since it includes items that are not "wages" under either definition. However, the commentators noted that for many employers this is the most accessible individual employee compensation amount retained in their data bases.

In response to these comments and to further administrability, the final regulations eliminate the section 415(c)(3) safe harbor definition of compensation based on FICA wages and replace it with a new safe harbor definition for compensation required to be reported under sections 6041 and 6051. The safe harbor definition is intended to be a safe harbor for Box 10 Compensation. Employers may assume that, as long as the instructions to the Form W–2 concerning the amount to report in Box 10 remain the same as they are for the 1990 or 1991 Form W–2, the amount reported in Box 10 for any employee satisfies this safe harbor. In addition, the final regulations permit employers to adjust the Box 10 compensation amount by excluding moving expense reimbursements if it is reasonable to believe that a corresponding deduction is allowable under section 217.

2. Residents of Certain U.S. Possessions

Sections 931 and 933 provide that the gross income of residents of American Samoa, Guam, the Northern Mariana Islands, or Puerto Rico does not include income derived from sources within these specified possessions or Puerto Rico, respectively. The temporary regulations under section 415(c)(3) provided that an item or amount is only compensation to the extent that it is includible in gross income. The final regulations clarify that the exclusions from gross income under sections 931 and 933 are disregarded for purposes of determining whether income from any of the specified possessions or Puerto Rico is compensation under section 415(c)(3). The final regulations also provide that similar principles are to be applied in determining compensation of self-employed individuals who are residents of specified possessions or Puerto Rico.

Compensation Under Section 414(s)

1. Definition of Compensation That Satisfy Section 414(s)

Under section 414(s)(3), the Secretary is granted authority to prescribe alternative definitions of compensation by regulation. Section 1.414(s)–1(c)(3) of the temporary regulations exercised that authority by prescribing a safe harbor alternative definition of compensation that automatically satisfies section 414(s). Under the safe harbor alternative definition, an employer may generally define compensation as including regular or base salary or wages, plus commissions, tips, overtime and other premium pay, and bonuses, and excluding all of the items specified in the regulation for this purpose (even if includible in gross income). These specified exclusions are reimbursements or other expense allowances, fringe benefits (whether cash or noncash), moving expenses, deferred compensation, and welfare benefits.

This safe harbor definition is retained in the final regulations. The final regulations also retain the rule permitting an employer to elect to modify a section 415(c)(3) definition or the safe harbor alternative definition to include the amount of certain elective contributions, section 457 deferred compensation, and section 414(h) employer pickup amounts, provided that all these amounts are included.

Commentators asked that the safe harbor alternative definition be expanded to allow additional items to be excluded from the compensation of highly compensated employees. The final regulations amplify the temporary regulations by permitting an employer to modify any of the safe harbor definitions to permit additional items or amounts of compensation to be excluded on a uniform and consistent basis from the compensation of highly compensated employees, but not from the compensation of any nonhighly compensated employees. This modification is permitted to be made after the inclusion of elective contributions and deferred compensation. Thus, for example, a definition of compensation under section 415(c)(3) could be first modified to include all elective contributions, section 457 deferred compensation, and employer pick-up amounts, but then be further modified to exclude section 457 deferred compensation on a uniform consistent basis from the compensation of highly compensated employees.

2. Reasonable Definition of Compensation

In addition to the safe harbor alternative definition, the temporary regulations provided that any other alternative definition of compensation would satisfy section 414(s) if the definition was reasonable, did not by design favor highly compensated employees, and satisfied a nondiscrimination requirement. This flexible approach was intended to accommodate employers' legitimate business needs while retaining the basic statutory requirement that the compensation definition must be nondiscriminatory. Comments on this approach were generally favorable, and, therefore, the final regulations retain this general rule. Commentators also asked for clarification on certain aspects of the rule. Thus, final regulations provide further guidance on circumstances under which a definition is not reasonable. For example, under the final regulations, a definition of compensation is not reasonable if the definition includes an item or amount not includible under a safe harbor definition (e.g., business expenses substantiated to the payor under an accountable plan). In addition, a definition is not reasonable if it provides that each employee's compensation is a specified portion of the employee's total compensation (such as 90 percent) measured for the otherwise applicable determination period.

3. Use of Rate-of-Pay Definition for Purposes of Section 414(s)

Commentators indicated that many plans use a rate-of-pay definition of compensation under the plan benefit

formula and requested that the regulations permit use of a rate-of-pay definition as an alternative definition under section 414(s). Often an employer uses rate of pay in the benefit formula because it reduces data collection, is predictable, and is easily administered. The proposed regulations under section 401(a)(4) and the temporary regulations under section 414(s) did not preclude employers from retaining a rate-of-pay definition of compensation for purposes of applying the plan formula. However, a plan using a rate-of-pay benefit formula would have been required to use a different definition of compensation in testing for compliance with the nondiscrimination rules and could not have satisfied the nondiscrimination rules on a safe harbor basis.

Rate of pay as an alternative section 414(s) definition of compensation was not included in the temporary regulations because rate of pay is a projected figure, rather than a reflection of actual compensation. Thus, it appeared to be inconsistent with the underlying purpose of the definition of compensation under section 414(s). Nevertheless, the Treasury and the Service recognize that use of a rate-of-pay formula by a plan facilitates plan administration and may, in fact, be reasonable and nondiscriminatory under specified conditions. Consequently, the final regulation permit rate of pay (referred to as rate of compensation in the regulations) as an alternative definition under section 414(s). However, to limit possible distortions, if rate-of-pay compensation is used for purposes of section 414(s), amounts based on the employee's rate of pay can only be credited under the formula for 30 days after an employee terminates employment (or is otherwise absent without pay). Of course, as with any section 414(s) definition of compensation other than one included in a safe harbor, the definition must be nondiscriminatory. By permitting rate of pay as an alternative section 414(s) definition of compensation, plans using a rate-of-pay benefit formula may be able to satisfy section 401(a)(4) on a safe harbor basis.

4. Crediting Compensation During Leaves of Absence

Commentators suggested that the permissible definitions of compensation under section 414(s) should allow crediting of compensation while an employee is on leave of absence in order to permit continued accruals under the plan. During the interim between the temporary regulations and the final regulations, attention was focused on this issue as a result of the Persian Gulf conflict. Specifically, employers asked whether compensation credited to reservists under employee benefit plans while on leave of absence due to active military duty would satisfy section 414(s) as a reasonable definition of compensation.

In responses to these comments, the final regulations provide that compensation credited for benefit accrual purposes during an unpaid absence from service for a reason other than termination from employment can satisfy section 414(s). Under the final regulations, compensation may be credited indefinitely for absence from service due to military duty or jury duty. In addition to absence from service for military duty and jury duty, the final regulations also permit compensation to be deemed to continue under this rule for other unpaid absence from service for a period not to exceed 6 months. No similar rule was necessary for absence from service due to long-term disability because any benefit based on deemed compensation credited during a disability period generally gives rise to a qualified disability benefit and thus is not included in nondiscrimination testing of benefit amounts. See section 411(a)(9)(B).

The regulations impose certain restrictions on the compensation that may be credited during absence from service for purposes of section 414(s) in order to ensure that the method used is nondiscriminatory. Specifically, the final regulations required that the compensation credited not exceed the compensation that would have been credited under the plan if services had continued (e.g., actual compensation at the time the leave of absence began or the rate of pay in effect while the employee is absent from service that is applicable to the employee's specific job grade). In addition, the final regulations require that any provisions in the plan for crediting compensation must be applied uniformly to all similarly situated employees and that the provisions for crediting compensation satisfy the effective availability requirements under section 401(a)(4). See § 1.401(a)(4)–4(c).

5. Nondiscrimination Requirement

The final regulations, like the temporary regulations, provide that an alternative definition of compensation is nondiscriminatory under section 414(s) if the average percentage of total compensation included under the alternative definition for an employer's highly compensated employees as a group does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group. The preamble to the temporary regulations stated that any reasonable method could be used for this purpose. Several commentators suggested that the final regulations should provide more guidance on appropriate methodologies for determining the average percentage for each group.

The final regulations continue to provide that any reasonable method may be used in determining the average percentages of total compensation included under the alternative definitions for the highly compensated employee group and the nonhighly compensated employee group, respectively. However, the final regulations also include a specific averaging calculation method that is treated as satisfying the reasonableness requirement. Under this method, an individual compensation percentage is calculated for each employee in the highly compensated employee group and in the nonhighly compensated employee group. An employee's compensation percentage is calculated by dividing the amount of the employee's compensation that is included in the alternative definition by the amount of the employee's total compensation. These individual compensation percentages are then averaged within the highly compensated and nonhighly compensated groups producing an average for each group. Any other reasonable method may be utilized to calculate the average-compensation percentages for either group provided the average percentage produced by the method is not reasonably expected to very significantly from the average percentage using the individual-percentage method. Recognizing the factors that create a significant variance in the calculation of the average percentage may not be the same for both groups, the final regulations do not require that the same method must be used to calculate the average percentage for each group.

In the case of a rate-of-pay definition of compensation or a definition of compensation that credits compensation during absence from service, the nondiscrimination requirement is modified to prevent distortions in the average percentage of total compensation included under the alternative definition for the highly compensated employee group and the nonhighly compensated employee group. A distortion may result if the imputed compensation credited to some

employees for a year under the alternative definition exceeds actual compensation for those employees for the year. Therefore, the final regulations provide that, in the case of these definitions of compensation, solely for purposes of calculating the average percentages used in applying the nondiscrimination test, the compensation included for an employee under the alternative definition may not exceed the employee's total compensation.

6. Employees Taken Into Account for Nondiscrimination Purposes

The final regulations, like the temporary regulations, provide that the employees taken into account in determining whether a compensation definition is nondiscriminatory are the same employees taken into account in satisfying the applicable statutory provision. However, the temporary regulations permitted the nondiscrimination requirement to be satisfied taking into account all the nonexcludable employees of an employer unless use of that method could reasonably be expected to result in a distortion of the percentage that was more than de minimis given the compensation characteristics of the employer's work force. Concerns were raised that employers were reluctant to use this rule because of uncertainty as to whether their facts met the applicable standard. Thus, the rule has been modified to permit employers to take into account all employees in all plans of the employer for which the alternative definition is being used to determine whether the plan satisfies section 401(a)(4) for the plan year.

7. Availability of Elective, Employee, and Matching Contributions

The temporary regulations contained a rule providing that, for the limited purposes of applying the nondiscriminatory availability requirements of the proposed regulations with respect to elective, employee, and matching contributions, any reasonable definition of compensation was treated as nondiscriminatory. This rule was deleted from the final regulations because the final section 401(k) and 401(m) regulations published in the **Federal Register** on August 15, 1991, and the final section 401(a)(4) regulations issued simultaneously with this regulation, clarify the application of the nondiscriminatory availability requirement under section 401(a)(4) to arrangements subject to sections 401(k) and 401(m), and make this rule unnecessary. See § 1.401(k)–1(a)(4)(iv) and § 1.401(m)–1(a)(2). Under these rules, employee, elective, and matching contributions are not required to be based on compensation determined under a definition that satisfies section 414(s). Rather, use of different definitions of compensation for purposes of the right to employee, elective, and matching contributions are treated as different benefits, rights, and features, each of which must separately satisfy the nondiscriminatory availability requirement of § 1.401(a)(4)–4. In addition, employee, elective, and matching contributions that use a definition of compensation that has the effect of restricting access by nonhighly compensated employees may not satisfy the nondiscriminatory availability requirement of the final section 401(a)(4) regulations, even where the same definition of compensation is used for all employees.

Effective Date

These regulations are effective for plan years beginning on or after January 1, 1987, except as set forth in § 1.414(s)–1(i).

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Marjorie Hoffman and David Fuller of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

List of Subjects in 26 CFR 1.401–0 through 1.419A–2T

Bonds, Employee benefit plans, Income taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the citation for § 1.414(s)–1T and adding the following citation to read as follows:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805. * * * § 1.414(s)–1 also issued under 26 U.S.C. 414(s). * * *

Par. 2. New § 1.414(s)–1 is added to read as follows:

§ 1.414(s)–1 Definition of compensation.

(a) *Introduction*—(1) *In general.* Section 414(s) and this section provide rules for defining compensation for purposes of applying any provision that specifically refers to section 414(s) or this section. For example, section 414(s) is referred to in many of the nondiscrimination provisions applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). In accordance with section 414(s)(1), this section defines compensation as compensation within the meaning of section 415(c)(3). It also implements the election provided in section 414(s)(2) to treat certain deferrals as compensation and exercises the authority granted to the Secretary in section 414(s)(3) to prescribe alternative nondiscriminatory definitions of compensation.

(2) *Limitations on scope of section 414(s).* Section 414(s) and this section do not apply unless a provision specifically refers to section 414(s) or this section. For example, even though a definition of compensation permitted under section 414(s) must be used in determining whether the contributions or benefits under a pension, profit sharing, or stock bonus plan satisfy a certain applicable provision (such as section 401(a)(4)), except as otherwise specified, the plan is not required to use a definition of compensation that satisfies section 414(s) in calculating the amount of contributions or benefits actually provided under the plan.

(3) *Overview.* Paragraph (b) of this section provides rules of general application that govern a definition of compensation that satisfies section 414(s). Paragraph (c) of this section contains specific definitions of compensation that satisfy section 414(s) without satisfying any additional nondiscrimination requirement under section 414(s). Paragraph (d) of this

section provides rules permitting the use of alternative definitions of compensation that satisfy section 414(s) as long as the nondiscrimination requirement and other requirements described in paragraph (d) of this section are satisfied. Paragraph (e) of this section provides special rules permitting, under certain limited circumstances, the use of imputed compensation rather than actual compensation under a definition of compensation that satisfies section 414(s). Paragraph (f) of this section provides other special rules, including a special rule for determining the compensation of a self-employed individual under an alternate definition of compensation. Paragraph (g) of this section provides definitions for certain terms used in this section.

(b) *Rules of general application*—(1) *Use of a definition.* Any definition of compensation that satisfies section 414(s) may be used when a provision explicitly refers to section 414(s) unless the reference or this section specifically indicates otherwise.

(2) *Consistency rule.* A definition of compensation selected by an employer for use in satisfying an applicable provision must be used consistently to define the compensation of all employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, although any definition of compensation that satisfies section 414(s) may be used for section 401(a)(4) purposes, the same definition of compensation generally must be used consistently to define the compensation of all employees taken into account in determining whether a plan satisfies section 401(a)(4). Furthermore, a different definition of compensation that satisfies section 414(s) is permitted to be used to determine whether another plan maintained by the same employer separately satisfies the requirements of section 401(a)(4). Although a definition of compensation must be used consistently, an employer may change its definition of compensation for a subsequent determination period with respect to the applicable provision. Rules provided under any applicable provision may modify the consistency requirements of this paragraph (b)(2).

(3) *Self-employed individuals.* Notwithstanding paragraph (b)(1) of this section, self-employed individuals' compensation can only be determined under paragraph (c)(2) of this section (with or without the modification permitted by paragraph (c)(4) of this section) or by using an equivalent alternative compensation amount determined in accordance with paragraph (f)(1) of this section. These limitations on self-employed individuals do not affect their common-law employees. Thus, the compensation of common-law employees of a partnership or sole proprietorship may be defined using an alternative definition, provided the definition otherwise satisfies paragraph (c)(3), (d), or (e) of this section. If an alternative definition of compensation under paragraph (c)(3), (d), or (e) of this section is used for other employees to satisfy an applicable provision, the consistency requirement is only met if paragraph (f) of this section is used for the self-employed individuals.

(c) *Specific definitions of compensation that satisfy section 414(s)*—(1) *General rules.* The definitions of compensation provided in paragraphs (c)(2) and (c)(3) of this section satisfy section 414(s) and need not satisfy any additional requirements under section 414(s). Paragraph (c)(2) of this section describes definitions of compensation within the meaning of section 415(c)(3). Paragraph (c)(3) of this section provides a safe harbor alternative definition that excludes certain additional items of compensation. Paragraph (c)(4) of this section permits any definition provided in paragraph (c)(2) or (c)(3) of this section to include certain types of elective contributions and deferred compensation. Paragraph (c)(5) of this section permits certain modifications to a definition otherwise provided under this paragraph (c).

(2) *Compensation within the meaning of section 415(c)(3).* A definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation satisfies section 414(s). Sections 1.415–2(d)(2) and (d)(3) provide rules for determining items of compensation included in and excluded from compensation within the meaning of section 415(c)(3). In addition, section 414(s) is satisfied by the safe harbor definitions provided in § 1.415–2(d)(10) and (d)(11) and any additional definitions of compensation prescribed by the Commissioner under the authority provided in § 1.415–2(d)(13) that are treated as satisfying section 415(c)(3).

(3) *Safe harbor alternative definition.* Under the safe harbor alternative definition in this paragraph (c)(3), compensation is compensation as defined in paragraph (c)(2) of this section, reduced by all of the following items (even if includible in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits.

(4) *Inclusion of certain deferrals in compensation.* Any definition of compensation provided in paragraph (c)(2) or (c)(3) of this section satisfies section 414(s) even though it is modified to include all of the following types of elective contributions and all of the following types of deferred compensation—

(i) Elective contributions that are made by the employer on behalf of its employees that are not includible in gross income under section 125, section 402(a)(8), section 402(h), and section 403(b);

(ii) Compensation deferred under an eligible deferred compensation plan within the meaning of section 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations); and

(iii) Employee contributions (under governmental plans) described in section 414(h)(2) that are picked up by the employing unit and thus are treated as employer contributions.

(5) *Exclusions applicable solely to highly compensated employees.* Any definition of compensation that satisfies paragraph (c)(2) or (c)(3) of this section, with or without the modification permitted by paragraph (c)(4) of this section, may be modified to provide for exclusion of additional items or amounts (including, for example, any one or more of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section) on a uniform basis from the compensation of the employer's highly compensated employees. This paragraph (c)(5) only permits modifications that apply to the compensation of highly compensated employees. See paragraph (d) of this section for requirements with respect to any modifications in defining the compensation of nonhighly compensated employees.

(d) *Alternative definitions of compensation that satisfy section 414(s)*—(1) *General rule.* In addition to the definitions provided in paragraph (c) of this section, any definition of compensation satisfies section 414(s) with respect to employees (other than self-employed individuals treated as employees under section 401(c)(1)) if the definition of compensation does not by design favor highly compensated employees, is reasonable within the meaning of paragraph (d)(2) of this section, and satisfies the

nondiscrimination requirement in paragraph (d)(3) of this section.

(2) *Reasonable definition of compensation*—(i) *General rule.* An alternative definition of compensation under this paragraph (d) is reasonable under section 414(s) if it is a definition of compensation provided in paragraph (c) of this section, modified to exclude any one or more of the types of compensation as permitted in paragraph (d)(2)(ii) of this section. See paragraph (e) of this section, however, for certain definitions of compensation that include amounts of imputed compensation that are not includible under any definition of compensation provided in paragraph (c) of this section.

(ii) *Items that may be excluded.* Subject to the applicable facts and circumstances, a reasonable definition of compensation is permitted, on a consistent basis, to exclude certain types of irregular or additional compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums); bonuses; or any one of the types of compensation excluded under the safe harbor alternative definition in paragraph (c)(3) of this section. A reasonable definition is also permitted to include, on a consistent basis, some, without being required to include all, of the types of elective contributions or deferred compensation described in paragraph (c)(4) of this section.

(iii) *Limits on the amount excluded from compensation.* A definition of compensation is not reasonable if it provides that each employee's compensation is a specified portion of the employee's compensation measured for the otherwise applicable determination period under another definition. For example, a definition of compensation that specifically limits each employee's compensation for a determination period to 95 percent of the employee's compensation using a definition provided in paragraph (c) of this section is not reasonable. Similarly, a definition of compensation that limits each employee's compensation used to satisfy an applicable provision with a 12-month determination period to compensation under a definition provided in paragraph (c) of this section for one month is not a reasonable definition of compensation. However, a definition of compensation is not unreasonable merely because it excludes all compensation in excess of a specified dollar amount.

(3) *Nondiscrimination requirement*—(i) *In general.* An alternative definition of compensation under this paragraph (d) is nondiscriminatory under section 414(s) for a determination period if the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees, as a group for the determination period does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group.

(ii) *Total compensation.* For purposes of this paragraph (d)(3), total compensation must be determined using a definition of compensation provided in paragraph (c)(2) of this section, with or without the modification permitted by paragraph (c)(4) of this section. Total compensation taken into account for each employee (including, if added, the elective contributions and deferred compensation described in paragraph (c)(4) of this section) may not exceed the annual compensation limit of section 401(a)(17).

(iii) *Employees taken into account*—(A) *General rule.* In applying the requirement of this paragraph (d)(3), the employees taken into account are the same employees taken into account in satisfying the requirements of the applicable provision for the determination period. For example, in determining whether an alternative definition used to determine whether a plan satisfies section 401(a)(4) satisfies this paragraph (d)(3), all employees in the plan for the plan year are generally taken into account. If an employer is using the same alternative definition of compensation to determine whether more than one separate plan satisfies section 401(a)(4), the employer is permitted to take into account all the employees in all the plans in determining whether the alternative definition of compensation being used satisfies this paragraph (d)(3).

(B) *Exclusion of self-employed individuals.* In applying the requirement of this paragraph (d)(3), self-employed individuals are disregarded.

(iv) *Calculation of average percentages*—(A) *General rule.* To determine the average percentages described in paragraph (d)(3)(i) of this section, an individual compensation percentage must be calculated for each employee in a group, and then the average of the separately calculated compensation percentages for each employee in the group must be determined. The individual compensation percentage for an employee is calculated by dividing the amount of the employee's compensation that is included under the alternative definition by the amount of the employee's total compensation.

(B) *Other reasonable methods.* Notwithstanding paragraph (d)(3)(iv)(A) of this section, any other reasonable method is permitted to be used to determine the average percentages described in paragraph (d)(3)(i) of this section for either or both of the groups (i.e., highly compensated employees and nonhighly compensated employees), provided that the method cannot reasonably be expected to create a significant variance from the average percentage for that group determined using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section. The same method is not required to be used for calculating the two average percentages. For example, to determine the average percentage for nonhighly compensated employees as a group, an employer may calculate an aggregate compensation percentage by dividing the aggregate amount of compensation of nonhighly compensated employees that are included under the alternative definition by the aggregate amount of total compensation of nonhighly compensated employees, provided the resulting percentage is not reasonably expected to vary significantly from the average percentage produced using the individual-percentage method provided in paragraph (d)(3)(iv)(A) of this section because of the extra weight given employees with higher compensation.

(v) *Facts and circumstances determination.* The determination of whether the average percentage of total compensation included for the employer's highly compensated employees as a group for a determination period exceeds by more than a de minimis amount the average percentage of total compensation included for the employer's nonhighly compensated employees as a group is based on the applicable facts and circumstances. The differences between the percentages for prior determination periods may be considered in determining whether the amount of the difference between the percentages is more than de minimis. In addition, an isolated instance of a more than de minimis difference between the compensation percentages that is due to an extraordinary unforeseeable event (such as overtime payments to employees of a public utility due to a major hurricane) will be disregarded if

the amount of the difference in prior determination periods was de minimis.

(e) *Imputed compensation*—(1) *In general*—(i) *Overview.* Notwithstanding paragraph (d)(2)(i) of this section, a definition of compensation satisfies section 414(s) as a reasonable alternative definition of compensation under section 414(s) even though it includes imputed compensation that is not includible in compensation under any definition described in paragraph (c) of this section, but only if the definition satisfies the requirements of paragraph (e)(2) or (e)(3) of this section, or both paragraphs if applicable. Paragraph (e)(2) of this section specifies the requirements for alternative definitions of compensation that include compensation based on an employee's basic or regular rate of compensation. Paragraph (e)(3) of this section specifies the requirements for alternative definitions of compensation that credit imputed compensation during certain periods of absence from service. As an alternative definition of compensation, a definition of compensation that includes imputed compensation must satisfy the nondiscrimination requirement of paragraph (d)(3) of this section. Paragraph (e)(4) of this section provides special rules for determining whether a definition of compensation that includes imputed compensation satisfies the nondiscrimination requirement under paragraph (d)(3) of this section.

(ii) *Not applicable to certain contributions.* This paragraph (e) does not apply to a definition of compensation used in determining whether elective deferrals (as defined in section 402(g)(3)), matching contributions (as defined in section 401(m)(4)), or employee contributions subject to section 401(m) satisfy any applicable provision. Thus, for example, a definition of compensation that includes imputed compensation may not be used to measure compensation for purposes of determining if a qualified cash or deferred arrangement satisfies the actual deferral percentage test in section 401(k)(3).

(2) *Rate of compensation*—(i) *General rule.* An alternative definition that defines compensation for a specified period (or series of specified periods) within a determination period based on the basic or regular rate of compensation of each employee as of a designated date in the specified period (or in each of the specified periods in the series) satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in paragraph (e)(2)(ii) of this section and otherwise satisfies the requirements of paragraph (d) of this section, including the nondiscrimination test in paragraph (d)(3) of this section as applied in paragraph (e)(4) of this section.

(ii) *Requirements for definitions of compensation based on rate of compensation*—(A) *Benefit determination.* The alternative definition of compensation must actually be used to calculate the benefits or contributions that are subject to the applicable provision. For example, the alternative definition may not be used to determine whether a plan satisfies section 401(a)(4) with respect to the amount of benefits or contributions, unless the benefits or contributions for each employee in the plan are determined using the alternative definition of compensation.

(B) *Rate of compensation.* The employee's rate of compensation must be based on an hourly pay scale, weekly salary, or similar unit of base or regular compensation applicable to the employee.

(C) *Specified period.* The specified period may be a week, month, year, or other period provided that the period does not exceed 12 months or the determination period, if shorter.

(D) *Date for determining rate of compensation.* Any date during the specified period may be designated as the date on which the rate of compensation is determined provided that the same date is used for all employees taken into account in satisfying the applicable provision. In addition, the date selected, by itself, must not cause the portion of total compensation included for any employee (or group of employees) to vary significantly from the portion of total compensation included for any other employee (or group of employees).

(E) *Periods without compensation or with reduced compensation.* An employee's compensation may generally only be determined using the employee's rate of compensation for employment periods during which the employer actually compensates the employee. However, if an employee terminates employment or is absent from service either without compensation or with reduced compensation (such as for a leave of absence, layoff, or similar event), the employer may continue to credit the employee with compensation based on the employee's rate of compensation for a period of up to 31 days after the event, provided the 31-day period does not extend into a subsequent determination period with respect to the applicable provision. Paragraph (e)(3) of this section contains special rules for crediting compensation during periods of absence from service extending beyond 31 days.

(3) *Absence from service*—(i) *General rule.* Solely for purposes of determining whether a defined benefit plan, as defined in § 1.410(b)–9, satisfies section 401(a)(4) or 410(b), an alternative definition that includes imputed compensation credited to employees during a period of absence from service that is not otherwise includable in compensation within the meaning of section 415(c)(3) satisfies section 414(s) as a reasonable alternative definition if the definition satisfies the requirements specified in paragraph (e)(3)(ii) of this section. In addition, the definition must otherwise be described in paragraph (c) of this section or must otherwise satisfy the requirements of paragraph (d) or (e)(2) of this section for alternative definitions of compensation, including the nondiscrimination test in paragraph (d)(3) of this section as applied by paragraph (e)(4) of this section.

(ii) *Requirements for definitions of compensation crediting compensation during absence from service*—(A) *Absent from service.* For the period during which compensation is credited to an employee, the employee must be absent from service for a reason other than termination from employment with the employer maintaining the plan. If an employee continues to perform any services for the employer during the period, the employee is not absent from service.

(B) *Benefit determination.* The alternative definition of compensation must actually be used to calculate the benefits under the plan. For example, the alternative definition may not be used to determine whether a plan satisfies section 401(a)(4) with respect to the amount of benefits or equivalent allocations unless the benefits for each employee in the plan are determined using the alternative definition of compensation.

(C) *Uniformity.* Any provisions in the plan for crediting imputed compensation while an employee is absent from service must be applied uniformly to all similarly situated employees in the plan.

(D) *Effective availability.* For purposes of applying the effective availability requirement of § 1.401(a)(4)–4(c) to the right to imputed compensation credited under the plan, the manner in which the employer grants absences from service that give rise to imputed compensation is taken into account.

(E) *Period of credited compensation.* In the case of compensation credited for a period during which an employee is

absent from service for any reason other than military duty or jury duty, the maximum period for which the compensation may be credited under the alternative definition is the shorter of 6 months or the duration of the absence. If an employee is absent from service for military duty or jury duty, compensation may be credited to the employee for the entire period of the military duty or jury duty, even if the period exceeds 6 months.

(iii) *Reasonable method.* Any reasonable method may be used to determine the amount of compensation to be credited during an absence from service, provided that the following requirements are satisfied—

(A) The terms of the alternative definition of compensation for imputing credited compensation during an absence from service (when applied to the compensation described in paragraph (e)(3)(iii)(B) of this section) are not more inclusive than the terms of the alternative definition as applied to compensation for actual service.

(B) The amount credited is based on compensation that is reasonably representative of the compensation the employee would have received during the period if the employee had continued to perform services. Except as otherwise required by law, the compensation that the employee was receiving immediately before the absence from service began, or the rate of compensation in effect while the employee is absent from service that is applicable to the employee's specific job grade immediately before the absence from service began, will be the most representative compensation. For example, if an employee's compensation is determined under paragraph (c)(2) of this section for periods of actual service, the compensation credited for the employee during a period of absence from service might reasonably be based on the employee's compensation determined under paragraph (c)(2) of this section immediately before the absence began.

(4) *Application of the nondiscrimination requirement to imputed compensation*—(i) *Safe harbor definitions.* If the definition of compensation is otherwise described in paragraph (c) of this section, and the imputed compensation credited for periods of absence from service satisfies paragraph (e)(3) of this section, then the definition is deemed to satisfy paragraph (d) of this section (i.e., it is deemed to be nondiscriminatory), and thus need not satisfy any other nondiscrimination test under section 414(s).

(ii) *Other definitions.* The amount of each employee's compensation for a determination period (determined under an alternative definition that includes imputed compensation) that is taken into account in determining the average percentages in the nondiscrimination requirement of paragraph (d)(3) of this section must be limited to 100 percent of the employee's total compensation for that period. This rule applies even if the amount of compensation actually credited to the employee for the determination period under the alternative definition and, thus, used as compensation within the meaning of section 414(s), exceeds the employee's total compensation for the period.

(f) *Special rules*—(1) *Self-employed individuals*—(i) *General rule.* If an alternative definition of compensation under paragraph (c)(3), (d), or (e) of this section is used to satisfy an applicable provision, an equivalent alternative compensation amount must be determined for any self-employed individual who is in the group of employees for whom paragraph (b) of this section requires a single definition of compensation to be used. This equivalent alternative compensation amount is determined by multiplying the self-employed individual's total earned income (as defined in section 401(c)(2)) for the determination period by the percentage of total compensation (as defined in paragraph (d)(3)(ii) of this section) included under the alternative definition for the employer's nonhighly compensated common-law employees as a group (determined in a manner consistent with the rules in paragraph (d)(3)(iii) of this section and, if applicable, paragraph (e)(4)(ii) of this section). Thus, for purposes of this determination, highly compensated common-law employees must be disregarded. This equivalent alternative compensation amount will be treated as the self-employed individual's compensation under the alternative definition of compensation for the determination period.

(ii) *Inclusion of elective contributions.* If the alternative definition of compensation includes any types of elective contributions described in paragraph (c)(4) of this section, the self-employed individual's earned income for this determination must be increased by the amount of elective contributions made by the employer on behalf of the self-employed individual, and the definition of total compensation for this determination must include all the types of elective contributions described in paragraph (c)(4) of this section made by the employer on behalf of common-law employees (other than highly compensated employees).

(2) *Leased employees.* [Reserved]

(g) *Definitions.* The following definitions apply for purposes of this section:

(1) *Applicable provision.* "Applicable provision" means a provision that specifically refers to section 414(s) or this section.

(2) *Determinaion period.* "Determination period" means a period during which the amount of compensation is measured for use in determining whether the requirements of an applicable provision are satisfied. If no period is provided under the applicable provision for measuring compensation, the determination period is the period for which the applicable provision must be satisfied. The applicable provision may provide additional rules concerning the determination period to be used for satisfying the nondiscrimination requirement in paragraph (d) of this section.

(3) *Highly compensated employee.* "Highly compensated employee" means an employee who is a highly compensated employee as defined in section 414(q).

(4) *Nonhighly compensated employee.* "Nonhighly compensated employees" means an employee who is not a highly compensated employee.

(5) *Self-employed individual.* "Self-employed individual" means self-employed individual as defined in section 401(c)(1).

(h) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional rules for defining compensation within the meaning of section 414(s), including additional definitions of compensation that satisfy section 414(s).

(i) *Effective date*—(1) *General effective date.* This § 1.414(s)–1 applies to years beginning on or after January 1, 1987.

(2) *Optional use of prior regulations.* For years beginning before September 19, 1991, employers may, in defining compensation for purposes of section 414(s), comply with the prior regulation provisions of § 1.414(s)–1T. See § 1.414(s)–1T as contained in the CFR edition revised as of April 1, 1991.

§ 1.414(s)–1T [Removed]

Par. 3. Section 1.414(s)–1T is removed.

Par 4. Section 1.415–2 is amended by revising paragraph (d) to read as follows:

§ 1.415–2 Definitions and special rules.

* * * * *

(d) *Compensation*—(1) *General definition.* Except as otherwise provided, compensation within the meaning of section 415(c)(3) includes all remuneration described in paragraph (d)(2) of this section and excludes all other forms of remuneration. Paragraph (d)(3) of this section provides examples of types of remuneration not includible in compensation within the meaning of section 415(c)(3). Paragraphs (d)(4) and (d)(5) of this section provide rules regarding the payment of compensation in the limitation year. Paragraph (d)(6) of this section provides a special rule for determining the compensation of employees of controlled groups or affiliated service groups. Paragraph (d)(7) of this section provides a special rule for applying the limitations of section 415(c) when a section 403(b) annuity is aggregated with a qualified plan of a controlled employer. Paragraphs (d)(8) and (d)(9) of this section are reserved for special rules for leased employees and for permanent and total disability, respectively. Paragraphs (d)(10) and (d)(11) of this section provide additional definitions of compensation that are treated as satisfying section 415(c)(3). Paragraph (d)(12) of this section permits optional use of prior regulations. Paragraph (d)(13) of this section provides authority to the Commissioner to provide further additional definitions of compensation that satisfy section 415(c)(3).

(2) *Items includible as compensation.* For purposes of applying the limitations of section 415, the term "compensation" includes all of the following—

(i) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in § 1.62–2(c)).

(ii) In the case of an employee who is an employee within the meaning of section 401(c)(1) and the regulations thereunder, the employee's earned income (as described in section 401(c)(2) and the regulations thereunder).

(iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

(iv) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under section 217.

(v) The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.

(vi) The amount includible in the gross income of an employee upon making the election described in section 83(b).

Paragraphs (d)(2)(i) and (d)(2)(ii) of this section include foreign earned income (as defined in section 911(b)), whether or not excludable from gross income under section 911. Compensation described in paragraph (d)(2)(i) of this section is to be determined without regard to the exclusions from gross income in sections 931 and 933. Similar principles are to be applied with respect to income subject to sections 931 and 933 in determining compensation described in paragraph (d)(2)(ii) of this section.

(3) *Items not includible as compensation.* The term "compensation" does not include items such as—

(i) Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed. In addition, employer contributions made on behalf of an employee to a simplified employee pension described in section 408(k) are not considered as compensation for the taxable year in which contributed. Additionally, any distributions from a plan of deferred compensation are not considered as compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. However, any amounts received by an employee pursuant to an unfunded nonqualified plan is permitted to be considered as compensation for section 415 purposes in the year the amounts are includible in the gross income of the employee.

(ii) Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see section 83 and the regulations thereunder).

(iii) Amounts realized from the sale, exchange or other dispositin of stock acquired under a qualified stock option.

(iv) Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee).

(4) *Compensation in limitation year.* The compensation (as defined in paragraph (d)(2) of this section) actually paid or made available to an employee within the limitation year is the compensation used for purposes of applying the limitations of section 415.

(5) *Election to use compensation accrued during limitation year*—(i) *Years beginning after December 31, 1991.* For limitation years beginning after December 31, 1991, an employer may not use accrued compensation. Any election previously made to use accrued compensation is not valid for limitation years beginning after December 31, 1991.

(ii) *De minimis accrued compensation.* Notwithstanding paragraph (d)(5)(i) of this section, an employer may include in compensation amounts earned but not paid in a year because of the timing of pay periods and pay days if these amounts are paid during the first few weeks of the next year, the amounts are included on a uniform and consistent basis with respect to all similarly situated employees, and no compensation is included in more than one limitation period. No formal election is required to include the accrued compensation permitted under this de minimis rule. The rule described in this paragraph (d)(5)(ii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)).

(iii) *Years beginning before January 1, 1992.* For limitation years beginning before January 1, 1992, instead of using the compensation actually paid or made available to an employee during the limitation year, an employer may elect to use the compensation accrued for an entire limitation year for purposes of applying the limitations of section 415. In the case of a group of employers that constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) that are under

common control (within the meaning of section 414(c) as modified by section 415(h)), the election to use accrued compensation must be made by all members of the group that maintain a qualified plan. Once an election is made, it remains in effect until it is revoked by the employer or group of employers. The rule described in this paragraph (d)(5)(iii) does not apply to a section 403(b) annuity contract or to an individual retirement plan (as defined in section 7701(a)(37)). If, in a particular limitation year beginning before January 1, 1992, a previously effective election to use accrued compensation is revoked or an election to use accrued compensation is made, any amounts taken into account for compensation purposes for any preceding limitation year may not be counted again in determining compensation for the particular limitation year.

(6) *Special rule for employees of controlled groups of corporations, etc.* In the case of an employee of two or more corporations which are members of a controlled group of corporations (as defined in section 414(b) as modified by section 415(h)), the term "compensation" for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan. This special rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c) as modified by section 415(h)), to an employee of two or more members of an affiliated service group as defined in section 414(m), and to an employee of two or more members of any group of employers who must be aggregated and treated as one employer pursuant to section 414(o).

(7) *Special rule when section 403(b) annuity is aggregated with qualified plan of controlled employer.* If a section 403(b) annuity contract is combined or aggregated with a qualified plan of a controlled employer in accordance with either § 1.415–7(h)(2)(i) or § 1.415–8(d)(2), the following rules apply:

(i) In applying separately the limitations of section 415 (b) or (c) to the qualified plan and the limitations of section 415(c) and the exclusion allowance of section 403(b)(2)(A) to the section 403(b) annuity, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity.

(ii) However, in applying the limitations of section 415(c) in connection with the combining of the section 403(b) annuity with a qualified defined contribution plan or section 415(e) in connection with the aggregating of the section 403(b) annuity with a qualified defined benefit plan, the total compensation from both employers may be taken into account.

(8) *Special rules for leased employees.* [Reserved]

(9) *Special rules for permanent and total disability.* [Reserved]

(10) *Safe harbor rule with respect to plan's definition of compensation.* If a plan defines compensation for purposes of applying the limitations of section 415 to include only those items specified in paragraph (d)(2)(i) of this section and to exclude all those items listed in paragraph (d)(3) of this paragraph, if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies section 415(c)(3).

(11) *Alternative definition of compensation.* In lieu of defining compensation in accordance with paragraphs (d)(2) and (d)(3) of this section, for purposes of applying the limitations of section 415 in the case of employees other than self-employed individuals treated as employees within the meaning of section 401(c)(1), a plan may define compensation using either of the following definitions used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy section 415(c)(3):

(i) *Information required to be reported under sections 6041 and 6051.* Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d) and 6051(a)(3). See §§ 1.6041–1(a), 1.6041–2(a)(1) and 31.6051–1(a)(1)(i)(c). This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under section 217. Compensation under this paragraph (d)(11)(i) must be determined without regard to any rules under section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(ii) *Section 3401(a) wages.* Compensation is defined as wages within the meaning of section 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

(12) *Optional use of prior regulations.* For years beginning before September 19, 1991, employers are permitted, in defining compensation for purposes of section 415(c)(3), to comply with either the provisions of this § 1.415–2(d) or the prior regulation provisions of § 1.415–2(d). See § 1.415–2(d) as contained in the CFR edition revised as of April 1, 1991.

(13) *Additional rules.* The Commissioner may in revenue rulings, notices, and other guidance of general applicability provide additional definitions of compensation that are treated as satisfying section 415(c)(3)

Fred. T. Goldberg, Jr.,

Commissioner of Internal Revenue.

Approved: August 30, 1991.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

[FR Doc. 91–21925 Filed 9–12–91; 10:53 am]

BILLING CODE 4830–01–M