

Rev. Rul. 81-202; 1981-2 C.B. 93

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Rev. Rul. 81-202

SECTION 1. PURPOSE

This revenue ruling provides guidelines for determining whether several different retirement plans, considered as a unit, provide contributions or benefits that discriminate in favor of employees who are officers, shareholders, or highly compensated (the prohibited group). These guidelines do not constitute an exclusive list of the methods that may be used to demonstrate that two plans, taken as a unit, do not discriminate in favor of the prohibited group. This revenue ruling also supersedes Rev. Rul. 70-580, 1970-2 C.B. 90.

SEC. 2. BACKGROUND

.01 Section 410(b) of the Internal Revenue Code requires that, in order to satisfy the requirements of section 401(a) of the Code, a retirement plan must cover either a certain percentage of employees or a classification of employees that does not discriminate in favor of the prohibited group.

.02 Section 1.410(b)-1(d)(3)(i) of the Income Tax Regulations allows an employer to designate two or more plans as a single plan for purposes of satisfying the requirements of section 410(b) of the Code. (Section 1.410(b)-1(d)(3)(ii) of the regulations prohibits this designation in certain cases involving TRASOPs and plans subject to section 401(a)(17)). However, if several plans are so designated as a unit, the plans considered as a unit must also satisfy the nondiscrimination requirements of section 401(a)(4).

.03 Section 401(a)(4) of the Code requires that, in order to satisfy the requirements of section 401(a), either the contributions or the benefits under a retirement plan must not discriminate in favor of the prohibited group.

.04 Section 401(a)(5) of the Code provides that a retirement plan shall not be considered discriminatory, within the meaning of sections 401(a)(4) and 410(b), merely because the contributions or benefits of employees under the plan differ because of any retirement benefits created under State or Federal law. An example

of such retirement benefits is the old age, survivors, and disability insurance benefits under the Social Security Act (social security benefits). Section 1.401-3(e) of the regulations and Rev. Rul. 71-446, 1971-2 C.B. 187 provide rules for measuring the value of employer-provided social security benefits.

.05 Section 401(a)(5) of the Code also provides that several plans of an employer shall not be considered discriminatory, within the meaning of section 401(a)(4), merely because employees' rights to benefits under the separate plans do not become nonforfeitable at the same rate. Rev. Ruls. 74-165, 1974-1 C.B. 96 and 74-166, 1974-1 C.B. 97 provide rules for measuring the value of differing vesting schedules.

SEC. 3. GENERAL RULE

.01 General Rule--Several plans, considered as a unit, will satisfy the nondiscrimination test of section 401(a)(4) of the Code as to the amount of benefits or contributions, if either the Normalized Employer-Provided Benefits or both the Actual Employer Contributions and the Adjusted Employer Contributions do not constitute a greater percentage of non-deferred compensation for prohibited group employees than for rank and file employees. The choice of either testing Normalized Employer-Provided Benefits or both Actual and Adjusted Employer Contributions may be made by the taxpayer independent of whether the plans being considered are defined benefit plans or defined contribution plans. In testing for discrimination, the normalized employer-provided social security benefits or actual and adjusted employer contributions to social security may be taken into account. (See section 6.) In testing for discrimination, reasonable groupings of participants by compensation ranges may be made. However, pursuant to section 401(a)(10) of the Code, a plan providing benefits for an owner-employee may not provide contributions or benefits for employees that are less favorable than contributions or benefits for owner-employees.

.02 Normalized Employer-Provided Benefits defined--For purposes of this revenue ruling, Normalized Employer-Provided Benefits are the flat benefits or unit benefits computed under section 4, normalized in accordance with section 5 to reflect the value of an annuity for the life of the participant commencing at age 65 with no death benefits and no other ancillary benefits and to reflect a difference in vesting provisions among the plans being considered.

.03 Actual and Adjusted Employer Contributions defined--

(1) Defined contribution plans--In the case of a defined contribution plan, the Actual Employer Contributions are the employer contributions allocated to the account of a participant (not including forfeitures, even if used to reduce employer contributions) and the Adjusted Employer Contributions are the sum of the employer contributions and forfeitures allocated to the account of the participant.

(2) Defined benefit plans--In the case of a defined benefit plan the Actual and Adjusted Employer Contributions are identical. Such contributions are the annual level dollar contributions from the date of initial participation in the plan to the latest of 65, current age, or the normal retirement age to fund the normalized flat benefit described in section 3.02. These contributions must be determined using solely reasonable interest and mortality assumptions.

SEC. 4. LEVEL OF EMPLOYER BENEFITS

.01 Flat benefit basis--

(1) Defined benefit plans--In the case of a defined benefit plan the flat benefit used for testing discrimination is the employer-provided portion of the participant's most valuable projected benefit. The participant's most valuable projected benefit is determined by projecting the accrued benefit to which the participant would be entitled at each possible retirement age based on the assumption that he or she continued to earn annually until such age the same rate of compensation as in the current year. This computation is made without regard to any benefit attributable to voluntary employee contributions. See section 411(d)(5) of the Code. These projected benefits are expressed as the actuarial equivalent amount of plan benefit commencing at age 65, and the most valuable projected benefit is selected. The employer-provided portion of the participant's most valuable projected benefit is the total benefit reduced by the projected benefit at age 65 attributable to mandatory employee contributions that would be made to the date of the most valuable projected benefit.

(2) Defined contribution plans--In the case of a defined contribution plan that provides a pre-retirement death benefit not less than the account balance, the participant's normalized flat benefit is determined as the amount purchasable as a life annuity commencing at age 65, by the accumulation, using a reasonable mortality and interest rate, of both (a) the participant's account balance in the year that discrimination is being tested, and (b) all reasonably estimated future Adjusted Employer Contributions for the participant. In the case of a defined contribution plan that provides no pre-retirement death benefit at any time other than the

minimum required benefit under section 401(a)(11)(C) (relating to joint and survivor annuities), the participant's normalized flat benefit is determined as the amount purchasable as a life annuity commencing at age 65 by the accumulation, using a reasonable interest rate only, of both (a) the participant's account balance in the year that discrimination is being tested, and (b) all reasonably estimated future Adjusted Employer Contributions for the participant. In the case of a money purchase plan, future Adjusted Employer Contributions shall be determined as the amount specified in the plan. Thus, for example, in a plan that provides for contributions of X% of compensation reduced by forfeitures, future Adjusted Employer Contributions are X% per year.

.02 Unit benefit basis--For either a defined benefit or defined contribution plan, the unit benefit may be determined by dividing the flat benefit computed as described in subsection .01 by the years of service the participant would have at the age at which the flat benefit was determined. Service must be determined on a reasonable and consistent basis.

SEC. 5. NORMALIZING BENEFITS

.01 General Rule--In the case of a defined benefit plan providing ancillary benefits, the flat benefit described in section 4.01(1) must be normalized by multiplying such flat benefit by the factors described in subsections .02, .03, .04, and .05 in succession.

.02 Form of annuity--If the plan provides benefits in a form other than as a single life annuity, the adjustment factor is the ratio of the present value of benefits under such form to the present value of benefits under a life annuity. The reciprocals of the factors found in section 9 of Rev. Rul. 71-446 may be used for this purpose.

.03 Pre-retirement death benefit--If the plan provides for pre-retirement death benefits, the adjustment factor is the ratio of the present value of death benefits and retirement benefits to the present value of retirement benefits. The reciprocals of the factors used in section 8 of Rev. Rul. 71-446 may be used for this purpose.

.04 Disability benefit--

(1) If the plan provides a qualified disability benefit (as defined in section 411(a)(9) of the Code), commencing at disability and payable for life, or until recovery from disability before normal retirement age, and such benefit is payable only for the period of time when the participant is eligible for and receives disability benefits under the Social Security Act, the disability adjustment factor is 1.11.

(2) If the plan provides any other form of disability benefit, such benefit shall be considered under section 4.01 as a retirement benefit.

.05 Vesting--If the plans being compared provide for different rates of vesting, the level of benefits may require adjustment by a vesting adjustment factor. Section 401(a)(5) of the Code provides for adjustments in such a situation. However, until regulations are adopted under this section, see Rev. Rul. 74-166.

SEC. 6. IMPUTING SOCIAL SECURITY BENEFITS OR CONTRIBUTIONS

.01 In general--Except as provided in subsections .04 and .05, if the plans of an employer, when considered as a unit, discriminate in favor of the prohibited group, this discrimination may be eliminated by considering employer-provided social security benefits as Normalized Employer-Provided Benefits or as both Actual and Adjusted Employer Contributions. This section provides rules for measuring the value of the employer-provided social security benefits or contributions. Subsections .02 and .03 provide rules for measuring the value of social security in testing whether plans discriminate in favor of a participant who is not an owner-employee. Subsection .04 provides rules for measuring the value of social security in testing whether plans discriminate in favor of an owner-employee. If social security benefits or contributions are imputed, they must be imputed for all individuals in the same manner.

.02 Imputing social security benefits--

(1) Flat benefits--In the case of a plan testing for discrimination on a flat benefit basis, employer-provided social security benefits may be determined under either (A) or (B) below.

(A) The imputed social security benefits equal $37\frac{1}{2}$ percent of a participant's highest five-year average compensation, to the extent such compensation does not exceed the participant's covered compensation. For a participant with less than 15 years of service at expected retirement age, this amount should be reduced to $21\frac{1}{2}$ percent per year of service. Covered compensation in any plan year will be determined in accordance with the rules set forth in section 3.02 of Rev. Rul. 71-446, as clarified by Rev. Rul. 78-92, 1978-1 C.B. 118.

(B) The imputed social security benefits equal $83\frac{1}{3}$ percent of the participant's primary insurance amount, determined using the same assumptions that are used to compute the flat benefit under section 4.01.

(2) Unit benefits--In the case of a plan testing for discrimination on a unit benefit basis, employer-provided social security benefits may be determined under either (A) or (B) below.

(A) The imputed social security benefits equal 1.4 percent of compensation in any year to the extent such compensation does not exceed the taxable wage base for the calendar year within which the plan year ends.

(B) The imputed social security benefits equal the amount determined under paragraph (1) divided by the participant's projected years of service as used in section 4.02.

.03 Imputing social security contributions--Both actual and adjusted employer contributions to social security for a plan year are deemed to be 7% of the participant's compensation in that year to the extent that such compensation does not exceed the taxable wage base for the calendar year within which the plan year ends.

.04 Discrimination in favor of an owner-employee--

For purposes of testing whether several plans discriminate in favor of an owner-employee, (1) if such owner-employee participates in a defined benefit plan, social security benefits may not be taken into account, and

(2) if such owner-employee participates in a defined contribution plan, social security benefits may only be taken into account if the requirements of section 401(d)(6) are satisfied.

.05 Multiple integration--This subsection only applies in the case where there is some participant covered in one or more of the combination of plans being tested for discrimination who is covered under another plan (not in the combination) maintained by the employer in which social security must be imputed for that plan to be nondiscriminatory (i.e., an integrated plan). In this case, the amount of social security benefits or contributions imputed under subsections .02 and .03 is multiplied for each participant by the multiple integration factor that is lowest for any participant. The multiple integration factor is equal to the excess, if any, of the number 1 over the sum of the integration utilization factors for all other plans in which this individual participates. The integration utilization factor is the ratio of (a) the lowest amount of social security benefits or contributions needed to be

imputed for that plan to be nondiscriminatory, to (b) the maximum amount that may be imputed under this section.

SEC. 7. REASONABLE INTEREST RATES

.01 For purposes of this revenue ruling, all computations must be based on reasonable actuarial assumptions. Although the assumptions used for every purpose need not be identical, they must not be applied in an inconsistent manner so as to distort the results.

.02 The reasonableness of the interest rate is determined under the facts and circumstances. For purposes of this revenue ruling, an interest rate not less than 5 percent nor more than 6 percent will automatically be considered reasonable.

SEC. 8. SCOPE OF REVENUE RULING

This revenue ruling considers only whether the amount of benefits or contributions are discriminatory in ongoing plans. However, other aspects of discrimination could nonetheless exist. For example, in the case of two plans each providing full vesting after 10 years service, more rapid vesting may be needed to satisfy the requirements of section 411(d)(1) of the Code. See Rev. Proc. 76-11, 1976-1 C.B. 550. The adjustment described in section 5.05 adjusts for a difference in vesting schedules but does not consider the minimum vesting necessary to preclude discrimination.

SEC. 9. EXAMPLE

.01 Facts--Employer M maintains a defined benefit and a defined contribution pension plan in 1981. Neither plan permits employee contributions. (1) The defined benefit plan covers all the rank and file employees of M and provides for a benefit accrual each year of 2 percent of that year's compensation. This benefit is provided in the form of a life annuity paid monthly starting at age 65. The plan also provides an insured death benefit prior to retirement of 100 times the anticipated monthly annuity. The plan provides full and immediate vesting but does not provide an early retirement benefit.

(2) The defined contribution plan covers the two shareholders of M and provides for contributions each year of 20 percent of that year's compensation. The plan provides for full and immediate vesting and a preretirement death benefit of the participant's account balance. Considered alone, the defined contribution plan does

not satisfy the coverage requirements of section 410(b) of the Code and must be considered in combination with the defined benefit plan to satisfy the coverage and nondiscriminatory requirements.

(3) The participants in the plans and other information is shown below:

Defined Contribution Plan

	Current	Prior	Current	Account Balance
Participant	Age	Service	Compensation	Beginning of Year
A	55	10	\$100,000	\$280,000
B	50	6	90,000	120,000

Defined Benefit Plan

	Current	Prior	Current	Accrued Benefit
Participant	Age	Service	Compensation	Beginning of Year
C	45	10	\$12,000	\$2,300
D	35	0	10,000	0

.02 Analysis of comparability--In accordance with section 3.01, the plans may be tested for discrimination by comparing either the Normalized Employer-Provided Benefits or both the Actual and Adjusted Employer Contributions. The analysis below first considers whether the Normalized Employer-Provided Benefits are nondiscriminatory. In accordance with section 3.02, the Normalized Employer-Provided Benefits may be compared as either flats benefits or unit benefits.

.03 Flat benefit basis--

(1) Defined contribution plan--In order to compare the Normalized Employer-Provided Benefits on a flat benefit basis, one must determine the normalized benefit for the two employees in the defined contribution plan. Because the defined contribution plan provides a pre-retirement death benefit of not less than the account balance, in accordance with section 4.01(2) the normalized benefit is determined by projecting both the account balance and future assumed Adjusted Employer Contributions to age 65 and determining the single life annuity which is actuarially equivalent to this projected account balance. In this example, the UP 1984 Mortality Table and 5 percent interest are used for this purpose.

The Normalized Employer-Provided Benefit on a flat benefit basis is computed as follows:

Table 1

	A	B
(1) 1981 Age (x)	55	50
(2) Account Balance Beginning of 1981	\$280,000	\$120,000
(3) Account Projection Factor/*/	.1869	.2470
(4) (2) x (3)	52,332	29,640
(5) 1981 Compensation	100,000	90,000
(6) Assumed Adjusted Employer Contributions		
[20% of (5)]	20,000	18,000
(7) Contribution Projection Factor/**/	1.4461	2.5559
(8) (6) x (7)	28,922	46,006
(9) Normalized Employer-Provided Benefit		
[(4) + (8)]	81,254	75,646

* Actuarial factor to determine amount of life annuity

payments each year commencing at age 65 for each \$1 of account balance at age x. Expressed in standard actuarial notation, this factor is computed as:

$$D_x / N_{65}(12)$$

** Actuarial factor to determine amount of life annuity

payments to be paid each year commencing at age 65 for each \$1 of annual contribution from age x to age 65. Expressed in standard actuarial notation, this factor is computed as:

$$(N_x - N_{65}) / N_{65}(12)$$

(2) Defined benefit plan--Because the defined benefit plan provides for no early retirement benefits, the flat benefit determined under section 4.01(1) is the sum of 2% of current compensation times the number of years from the attained age to age 65 plus the current accrued benefit. This benefit must then be normalized in accordance with section 5. The plan provides for a pre-retirement death benefit requiring normalization. Although any reasonable actuarial factors may be used for this adjustment, section 5.03 states that the reciprocal (9 / 8) of the factor shown in section 8 of Rev. Rul. 71-446 (8/9) may be used. For this example, this 9/8 factor is used. The Normalized Employer-Provided Flat Benefit may be computed as follows:

Table 2

	C	D
(1) 1981 Age	45	35
(2) 1981 Compensation	\$12,000	\$10,000
(3) 1981 Accrued Benefit	2,300	0
(4) No. of Years Until age 65 (65 - (1))	20	30
(5) Future Accruals [2% X (2) X (4)]	4,800	6,000
(6) Most Valuable Projected Benefit [(3) + (5)]	7,100	6,000
(7) Normalization Factor		
(8) Normalized Flat Benefit [(6) X (7)]	7,988	6,750

(3) Comparison--The flat benefits are compared by expressing the normalized flat benefits as a percentage of 1981 compensation.

Table 3

	A	B	C	D
(1) 1981 Compensation	\$100,000	\$90,000	\$12,000	\$10,000
(2) Adjusted Normalized Flat				

Benefit from Tables 1 & 2 81,254 75,646 7,988 6,750

(3) (2) / (1) 81.25% 84.05% 66.57% 67.50%

The percentages are higher for the prohibited group. Therefore, in order to demonstrate that the plan is nondiscriminatory on a flat benefit basis, social security benefits must be imputed using the rules of section 6. Although there are several ways to impute social security benefits, in this example the method described in section 6.02(1)(A) is used. Covered compensation was computed pursuant to section 3 of Rev. Rul. 71-446.

(4) Covered Compensation \$16,260 \$18,828 \$22,392 \$28,260

(5) Lesser of (1) or (4) 16,260 18,828 12,000 10,000

(6) Social Security (371/2%

of (5)) 6,098 7,061 4,500 3,750

(7) Total Benefit [(2) + (6)] 87,352 82,707 12,488 10,500

(8) (7) / (1) 87.35% 91.90% 104.07% 105.00%

Line (8) shows the Normalized Employer-Provided Benefits are nondiscriminatory, and no further computation need be made.

However, for illustrative purposes, comparability is also tested on a unit benefit basis and on a contributions basis.

.04 Unit benefit basis--In accordance with section 4.02 the unit benefit amount is obtained by dividing the flat benefit amount (on Line (2) of Table 3) by the years of service the participant would have at age 65.

Table 4

	A	B	C	D	
(1) Flat Benefit Amount		\$81,254	\$75,646	\$7,988	\$6,750
(2) Service at age 65		20	21	30	30
(3) (2) / (1)		4,063	3,602	266	225
(4) Compensation		100,000	90,000	12,000	10,000
(5) (3) / (4)		4.06%	4.00%	2.21%	2.25%

The percentages are higher for the prohibited group. Therefore, in order to demonstrate that the plan is nondiscriminatory on a unit benefit basis, social security benefits may be imputed, as allowed by section 6. Although there are several ways of imputing social security benefits, in this example social security benefits are imputed using the rule described in section 6.02(2)(A). The taxable wage base for 1981 is \$29,700.

(6) Lesser of (4) or \$29,700 29,700 29,700 12,000 10,000

(7) Social Security (1.4% of

(6)) 416 416 168 140

(8) Total Unit Benefits ((3)

+ (7)) 4479 4018 434 365

(9) (8) / (4) 4.48% 4.46% 3.62% 3.65%

Even after imputing social security benefits, the benefits under the plans are discriminatory on a unit benefit basis. Nevertheless, because the plan is not discriminatory on the flat benefit basis, the Normalized Employer-Provided Benefits are nondiscriminatory.

.05 Contributions--

(1) Defined contribution plan--Section 3.01 provides that contributions will be nondiscriminatory if both the Actual Employer Contributions and the Adjusted Employer Contributions do not constitute a greater percentage of non-deferred compensation for the prohibited group than for the rank and file employees.

Section 3.03(1) defines Actual and Adjusted Employer Contributions. Because there are no forfeitures in the defined contribution plan, the Actual and Adjusted Employer Contributions both equal 20% of compensation, or \$20,000 for A and \$18,000 for B.

(2) Defined benefit plan--Section 3.03(2) defines the Actual and Adjusted Employer Contributions in the case of a defined benefit plan as the level dollar contribution, required from the date of initial participation to the later of 65, or the normal retirement age, to fund the amount described in section 3.02. The amount described in section 3.02 is the amount contained on line (8) of Table 2. Although

any reasonable actuarial assumptions may be used for this computation, the UP 1984 Mortality Table and 5 percent interest are used in this example.

The contributions may be computed as follows:

Table 5

	C	D
(1) Flat Benefit (Line (8) of Table 2)	\$7,988	\$6,750
(2) Age at initial participation (y)	35	35
(3) Level Cost Factor/*/	.1202	.1202
(4) Adjusted Employer Contribution [(1) X (3)]	960	811
(5) 1981 Compensation	12,000	10,000
(6) (5) / (4)	8%	8%

*Annual contribution necessary to provide life annuity of \$1 per year at age 65 by level dollar contributions from age in (2) to 65. Expressed in standard actuarial notation, this factor is computed as:

$$N_{65}(12) / (N_y - N_{65})$$

(3) Comparison--Expressed as a percentage of 1981 compensation, the contributions are discriminatory. However, as allowed by section 6, social security

contributions may be imputed to eliminate this discrimination. Section 6.03 states that social security contributions are deemed to be 7% of compensation up to the taxable wage base. The taxable wage base in 1981 is \$29,700.

Table 6

	A	B	C	D	
(1) 1981 Compensation		\$100,000	\$90,000	\$12,000	\$10,000
(2) Actual and Adjusted					
Contributions		20,000	18,000	960	811
(3) Lesser of (1) or \$29,700		29,700	29,700	12,000	10,000
(4) Social Security					
Contributions (7% of (3))		2,079	2,079	840	700
(5) Total Contributions					
[(2) + (4)]		22,079	20,079	1,800	1,511
(6) (5) / (1)		22.08%	22.31%	15.00%	15.11%

Thus, the total contributions are discriminatory. Nevertheless, because the plan is not discriminatory on the basis of benefits, the requirements of section 401(a)(4) of the Code are satisfied.

SEC. 10. EFFECT ON OTHER DOCUMENTS

This revenue ruling supersedes Rev. Rul. 70-580 because the positions stated therein are restated in this ruling.