

Employee Benefit Plans

Explanation No. 5 Safe Harbor Nondiscrimination Requirements Defined Contribution Plans

Note:

Plans submitted during the 2020 Required Amendment List submission period must satisfy the applicable changes in plan qualification requirements listed in Section IV of Notice 2020-83, 2020-50 I.R.B. 1597 (the 2020 RA List).

The Service's review of a determination letter application for a plan will not consider, and a determination letter may not be relied on with respect to, whether the plan satisfies the requirements of Code sections 401(a)(4) (except as provided below), 401(a)(26), or 410(b).

However, for an individually-designed plan the Service will determine whether a plan's benefit or contribution formula satisfies the requirements of a nondiscriminatory design-based safe harbor under Regulation section 1.401(a)(4)-2(b) and will also continue to determine whether a plan's terms satisfy Code sections 401(k) and 401(m).

This publication is to be used in conjunction with:
Form 5627, Worksheet 5
Form 6045, Deficiency Checksheet 5

These forms are included as examples only and should not be completed and returned to the Internal Revenue Service.

The purpose of Form 5627, Worksheet Number 5 and this explanation is to determine whether a defined contribution plan satisfies the nondiscrimination safe harbor requirements of section 1.401(a)(4)-2(b) of the Regulations and associated requirements such as the nondiscriminatory compensation requirements of section 414(s). (Certain related requirements, such as the limitation on compensation under section 401(a)(17) of the Code, are addressed in other worksheets.)

If the plan is intended to satisfy safe harbor requirements of section 1.401(a)(4)-2(b) of the Regulations and the plan provides for permitted disparity, Worksheet Number 5B may be used to determine whether the disparity satisfies the requirements of section 401(l) of the Code

Generally, a "Yes" answer to a question on the worksheet indicates a favorable conclusion while a "No" answer signals a problem concerning plan qualification. This rule may be altered by specific instructions for a given question. Please explain any "No" answer in the space provided on the worksheet.

References at the end of each paragraph in the explanation are to the Internal Revenue Code and the Income Tax Regulations unless otherwise noted.



The technical principles in this publication may be changed by future regulations or guidelines.

I. Nondiscriminatory Allocations

This part of the worksheet deals with the safe harbor requirements of section 1.401(a)(4)-2(b) of the Regulations. Satisfaction of the safe harbor requirements under section 1.401(a)(4)-2(b) does not mean that the plan complies with all of the requirements of IRC 401(a)(4).

Line a. When an employer submits a determination letter application, the employer must indicate whether the plan is intended to satisfy one of the design-based safe harbors under the section 401(a)(4) regulations, and whether the employer elects to have the plan reviewed to determine if it so meets. A design-based safe harbor allows for a determination that the plan, by design, satisfies the nondiscrimination in amount requirement of 1.401(a)(4)-1(b)(2) but is not a determination whether the plan satisfies the requirements of 1.401(a)(4)-1(b)(3) and (4).

II. Design-Based Safe Harbors

This part of the worksheet deals with the design-based safe harbors. A design-based safe harbor allows for a determination that the plan, by design, satisfies the nondiscrimination in amount requirement without the need to test the actual allocations or benefits under the plan. The employer is asked to specify the particular safe harbor that the plan is intended to satisfy. Those lines of the worksheet that do not pertain to the specified safe harbor should not be completed. The remaining part of the worksheet (Part III) should be completed only in the case of design-based safe harbor plans.

Line a. The safe harbor for defined contribution plans with uniform allocation formulas is satisfied if the plan (including an ESOP) allocates contributions and forfeitures under a formula that allocates the same percentage of compensation, the same dollar amount, or the same amount per unit of service (not to exceed one week) to every participant under the plan. For this purpose, the contributions taken into account are all employer contributions other than elective and matching contributions that are subject to the actual deferral percentage (ADP) and actual contribution percentage (ACP) requirements of sections 401(k) and 401(m), respectively.

A plan will not fail to satisfy these requirements merely because:

- 1) Allocations are limited in accordance with section 415 or section 409(n).
- 2) Allocations are limited to a maximum dollar amount or a maximum percentage of compensation, or the plan limits the compensation taken into account, provided these limits apply either to all employees under the plan or only to some or all highly compensated employees under the plan.
- 3) Allocations for all employees are conditioned on a last day of the plan year or minimum hours of service (not over 1,000) requirement. (An exception can be made for all employees who terminate or just for those who terminate because of retirement, disability, death, or military service.)
- 4) The plan provides for permitted disparity in a manner that satisfies section 401(l).
- 5) The plan provides one or more entry dates during the plan year.
- 6) One or more HCEs receive lower allocations than would otherwise be provided if the plan satisfied the safe harbor disregarding this rule.
- 7) The plan provides that an employee's allocation is the greater of, or the sum of, two or more formulas each of which satisfies the safe harbor. Formulas that are available solely to some or all nonhighly compensated employees (but not to any highly compensated employees) fall within this exception, as do the following types of top-heavy formulas: formulas available solely to all non-key employees on the same terms as other formulas; formulas conditioned on the plan being top-heavy and formulas available only to all non-key employees who have not separated from service before the end of the plan year, provided the plan would meet coverage when employees receiving a top-heavy minimum allocation only are not counted as benefiting.

A plan will not satisfy this safe harbor if it weights allocations on the basis of age or service.
1.401(a)(4)-2(b)(2) and (4)

Line b. A target benefit plan is a defined contribution money purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated benefit under the plan. The benefit formula under a target benefit plan is similar to that under a defined benefit plan. However, the actual benefit that the participant will receive will be the account balance which will vary from the stated benefit based on investment performance. Thus, the stated benefit is a "target benefit."

An employer may not elect to have an individually designed plan reviewed to determine whether it meets the target benefit safe harbor. However, pre-approved specimen plans are so reviewed. A target benefit plan satisfies the target benefit plan safe harbor if it meets the following requirements:

- 1) Each employee's stated benefit is expressed as a straight life annuity under a formula that would satisfy the fractional rule unit credit or flat benefit safe harbor and the defined benefit uniformity requirements if the plan were in fact a defined benefit plan (see lines XI.a. through XI.a.(iii) of Worksheet 5A). Thus, for example, in order to satisfy the flat benefit safe harbor, a target benefit plan with a flat benefit formula must provide that the maximum benefit under the plan is reduced pro rata for years of credited service less than 25. Likewise, in order for the target benefit formula to satisfy one of the defined benefit design-based safe harbors, the plan's definition of compensation for purposes of the benefit formula must satisfy the compensation formula requirements described in lines a. and b. of Part XI of Worksheet 5A.

- 2) The stated benefit may not credit service for years before the employee first benefited under the plan nor service in years in which the target benefit safe harbor was not satisfied. However, these rules generally do not apply to a plan that was adopted and in effect on September 19, 1991, and that was qualified under prior law.
- 3) Employer contributions are based on the employee's stated benefit using the funding method set forth in the regulations and discussed below.
- 4) Forfeitures reduce employer contributions.
- 5) Employee contributions are not used to fund the stated benefit.
- 6) Disparity must satisfy the permitted disparity rules that apply to defined benefit plans (see Worksheet 5B for special rules).

The requirements of section 411(b)(1)(H) that prohibit a defined benefit plan from ceasing or reducing accruals on account of the participant's attainment of any age generally also apply to a target benefit plan. (See Alert Guidelines 2A for a discussion of these rules). Thus, the uniform post-normal retirement benefits rule discussed in line XI.a. of Worksheet 5A may apply. Such benefits must be provided under the stated benefit formula, subject to any uniformly applicable service cap under the formula. Actuarial increases in the stated benefit for delayed retirement are impermissible.

The regulations contain a detailed formula for calculating the required employer contribution that must be followed by a target benefit safe harbor plan. Specialists should refer to the regulations when reviewing a target benefit plan for the actual step-by-step calculations, but the main steps and some important points to keep in mind are described below.

First, a theoretical reserve is calculated based on the stated benefit as of the date the employer's required contribution for the current plan year is determined. The initial reserve for the participant's first year of participation (or the first plan year taken into account under the stated benefit formula, if that is the current year) is zero.

(The theoretical reserve for the first plan year following any plan year in which the plan failed to satisfy this safe harbor is also zero. However, if the plan was adopted and in effect on September 19, 1991 and met the qualification requirements for target benefit plans under prior law, it may be allowed to take into account years of service for years in which this safe harbor was not met. In this case, the theoretical reserve as of the determination date for the last year before the plan satisfies this safe harbor is the excess, if any, of the actuarial present value of the stated benefit the employee is projected to have at NRA over the actuarial present value of future employee contributions required through NRA.)

The subsequent years' reserves are the sum of the theoretical reserve for the prior year plus the required contribution for the prior year, increased, using a standard interest rate, for interest between the prior year determination date and the current year determination date.

Next, the actuarial present value of the participant's fractional rule benefit under the stated formula is determined as of the current plan year's determination date, using a standard interest rate and mortality table set forth in the plan and uniformly applied.

The required contribution for the current year is determined by amortizing the difference between the theoretical reserve and the fractional rule benefit on a level basis from the determination date for the current year and the determination date for the year in which the participant is projected to reach NRA.

Where the participant is at or past NRA, the required contribution is the difference between the actuarial present value of the stated benefit for the current year, using a straight life annuity factor based on the employee's NRA (rather than attained age), and the theoretical reserve as of the determination date.

Required contributions must be limited or increased, if necessary, to comply with sections 415 and 416, respectively. For purposes of these calculations, interest rates between 7.5% and 8.5% are standard interest rates. The UP-84 mortality table is an example of a standard mortality table.

1.401(a)(4)-8(b)(3)

III. Nondiscriminatory Compensation

Line a. If a design-based safe harbor plan bases allocations on compensation, it must use a definition of compensation that is nondiscriminatory under section 1.414(s)-1 of the regulations. (The requirement to use a nondiscriminatory definition of compensation would also apply in the case of the definition of compensation that a section 401(k) or 401(m) plan must use in its actual deferral percentage (ADP) or actual contribution percentage (ACP) test.) The regulations contain certain definitions that are automatically nondiscriminatory under section 414(s). A plan may use an alternative definition, provided the definition is reasonable, not designed to favor highly compensated employees, and that the average percentage of total compensation included for highly compensated employees as a group does not exceed the average percentage for nonhighly compensated employees by more than a de minimis amount. In addition, under certain circumstances a plan may use rate of compensation, imputed compensation, or prior-employer compensation under a definition of compensation that satisfies section 414(s). Section 414(s) and the accompanying regulations provide specific definitions of compensation that satisfy section 414(s). One of the definitions is compensation within the meaning of section 415(c)(3). See Explanation #6 for the full definition of compensation for section 415 purposes, (including other changes that are not reflected in the following summary).

The following definitions of compensation automatically satisfy section 414(s):

- 1) Compensation within the meaning of section 415(c)(3). This definition of compensation includes elective deferrals defined in section 402(g)(3) and amounts deferred under a section 125 cafeteria plan, section 132(f)(4), or under a section 457 plan. Under this definition, a self-employed person's compensation is earned income as defined in section 401(c)(2).
- 2) Wages as defined in section 3401(a) plus all other compensation required to be reported by the employer under sections 6041, 6051 and 6052, or wages as defined in 3401(a), both determined without regard to any rules that limit wages based on the nature or location of employment.
- 3) A safe-harbor definition that starts with 1 or 2, but excludes all of the following: reimbursements or other expense allowances, fringe benefits, moving expenses, deferred compensation, and welfare benefits. This safe harbor generally permits the following definition to fall within the scope of section 414(s): Regular or base salary or wages, plus commissions, tips, overtime and other premium pay, bonuses, and any other item of compensation includible in gross income not listed in the safe-harbor exclusions. If this definition is used, any self-employed individual's compensation is to be limited to earned income multiplied by the percentage of nonhighly compensated employees' total compensation (determined on a group basis) that is included under the plan definition.
- 4) Under any of these definitions, the employer can elect to include or exclude elective contributions not includible in income, section 457(b) deferred compensation, and section 414(h)(2) pick-up contributions. If any of these are included (excluded), they must all be included (excluded).

1.414(s)-1

Line b. If the plan is using a definition of compensation permissible under section 415(c)(3), then it must define compensation for any self-employed individual as earned income within the meaning of section 401(c)(2).

If the plan is using the alternative safe harbor definition that excludes certain expenses and other items or an alternative definition that requires a demonstration, then the terms of the plan must provide for an equivalent alternative definition for self-employed individuals, determined as follows.

The self-employed individual's earned income (increased by elective contributions, if any of these are included in the plan's alternative definition) is multiplied by the percentage of total compensation (including elective contributions, if any of these are included in the plan's alternative definition) that is included for the group of nonhighly compensated common-law employees. (This calculation is to be performed consistent with the rules for determining whether an alternative definition of compensation is nondiscriminatory, except that highly compensated common-law employees are disregarded.)

The plan's alternative definition may also limit the compensation of some or all self-employed individuals who are also highly compensated employees to a portion of the equivalent compensation.

Specialists are reminded that plans may have multiple definitions of compensation (one for section 415 purposes, one for allocation purposes, etc.). It is only the plan's administrable definition for purposes of providing allocations under the plan that must meet the section 414(s) requirements.

1.414(s)-1(g)

Employee Benefit Plan**Nondiscrimination Requirements: Defined Contribution Plans****(Worksheet Number 5 – Determination of Qualification)**

Instructions – All items must be completed. A “Yes” answer generally indicates a favorable conclusion is warranted, while a “No” answer indicates a problem exists. Please use the space on the worksheet to explain any “No” answer. If the employer is not required to address a particular item, the question related to that item should be answered “N/A.” See Publication 6393, Explanation Number 5, for guidance in completing this form.

The technical principles in this worksheet may be changed by future regulations or guidelines

Name of plan

I. Nondiscriminatory Contributions of Benefits	Plan Reference	Yes	No	N/A
a. Has the employer indicated that the plan is intended to satisfy a design-based safe harbor? (If “No”, skip remainder of this checksheet.)				
II. Designed-Based Safe Harbors	Plan Reference	Yes	No	N/A
a. If this is a plan (other than a target benefit) that provides for nonelective employer contributions, does it have a uniform allocation formula that satisfies the safe harbor in the final regulations? [0520]				
b. For submissions of pre-approved target benefit specimen documents only, does the plan satisfy the target benefit safe harbor at 1.401(a)(4)-8(b)(3) of the regulations? [0524]				
III. Nondiscriminatory Compensation	Plan Reference	Yes	No	N/A
a. Does this design-based safe harbor plan use a nondiscriminatory definition of compensation for purposes of computing contributions? [0522]				
b. In the case of a plan that covers self-employed individuals, does the plan define compensation for these individuals in a manner that satisfies section 414(s)? [0523]				

**Employee Plan Deficiency Checksheet
Attachment Number 5**

Nondiscrimination Requirements: Defined Contribution Plans

For IRS Use	Please furnish the amendment(s) requested in the section(s) checked below.
520 II.a.	Section _____ of the plan should be amended to provide a uniform allocation formula that will satisfy the safe harbor described in section 1.401(a)(4)-2(b)(2) of the regulations. IRC section 401(a)(4) and Reg. section 1.401(a)(4)-2(b)(2).
522 III.a.	The definition of compensation contained in section _____ of the plan should be amended to conform to one of the definitions described in sections 1.414(s)-1(c)(2) and 1.414(s)-1(c)(3) of the regulations. IRC section 414(s) and. Reg. section 1.414(s)-1.
523 III.b.	Section _____ of the plan should be amended to define compensation for self-employed individuals in the manner described in section 1.414(s)-1(g)(1) of the regulations. IRC section 414(s) and Reg. section 1.414(s)-1(g)(1).
524 II.b.	Section _____ of the plan should be amended to provide that benefits under the plan's target benefit formula will meet the target benefit safe harbor at Reg. section 1.401(a)(4)-8(b)(3).

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