EMPLOYEE BENEFIT PLANS
EXPLANATION NO. 5B
PERMITTED DISPARITY

The purpose of Form 9639, Worksheet Number 5B, is to identify major problems relating to permitted disparity requirements of section 401(l) of the Code. This worksheet is to be used in reviewing plans that are intended to satisfy a design-based safe harbor and that provide for a disparity in the rate of employer contributions (in the case of a defined contribution plan) or employer-provided benefits (in the case of a defined benefit plan) that favors highly compensated employees.

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.

Department of the Treasury
Internal Revenue Service
Document 9241 (Rev. 4-2000)

I. PERMITTED DISPARITY: Defined Contribution Plan (Other Than Target Benefit Plan)

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line a. If the plan is a design-based safe harbor defined contribution plan that provides for permitted disparity, complete this part of the worksheet to determine whether the disparity satisfies the requirements of section 401(l). (Note that this part of the worksheet applies to defined contribution plans that are not target benefit plans. For target benefit plans, see Part II of the worksheet.)

401(l)

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line b. A defined contribution plan will not satisfy section 401(l) unless the integration level under the plan is a uniform dollar amount for all participants that is not in excess of the taxable wage base (TWB) in effect under the Social Security Act as of the beginning of the plan year. For this purpose, the integration level is the amount of compensation specified in the plan at or below which the rate of contributions is less than the rate for compensation above this amount. If the integration level under the plan is less than the TWB, the maximum permitted disparity may be less than the disparity permitted if the integration level were the TWB. See line e., below.

1.401(l)-1(c)(20)
1.401(l)-2(d)

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line c. A defined contribution plan will not satisfy section 401(l) unless the base contribution percentage and the excess contribution percentage are uniform for all participants. This means that the plan should use the same base and excess contribution percentages for all employees. For an employee who has reached the cumulative disparity limit, contributions must be allocated on all compensation at the excess percentage rate. In the case of a non-FICA employee, a plan is permitted to allocate contributions on all compensation at the excess percentage rate. The base contribution percentage is the rate at which contributions and forfeitures are allocated on compensation at or below the integration level. The excess contribution percentage is the rate at which contributions and forfeitures are allocated on compensation above the integration level.

1.401(l)-2(c)(1) and (2)

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line d. The excess contribution percentage may not exceed the base contribution percentage by more than the maximum excess

allowance. The maximum excess allowance is the lesser of the base contribution percentage or the percentage described in line f., below.

1.401(l)-2(b)

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line e. The second part of the maximum excess allowance limitation (referred to in the worksheet as the "maximum permitted disparity") generally limits the amount by which the excess contribution percentage may exceed the base contribution percentage to the greater of 5.7 percentage points or the percentage rate of tax under section 3111(a) (in effect at the beginning of the plan year) which is attributable to the old age insurance portion of OASDI (Old Age, Survivors and Disability Insurance). However, this is reduced if the integration level is less than TWB but in excess of the greater of $10,000 or 20% of TWB. For years in which the factor used to determine the maximum excess allowance is 5.7 percent, the reduced factors to be used where the integration level is less than TWB but in excess of the greater of $10,000 or 20% of TWB are shown in the following table:

Integration level	**Reduced factor**
More than the greater of $10,000 or 20 percent of TWB, but not more than 80 percent of TWB	4.3 percent
More than 80 percent of TWB, but less than 100 percent of TWB	5.4 percent

1.401(l)-2(b)(2)
1.401(l)-2(d)

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line f. A plan must provide that the overall permitted disparity limits may not be exceeded and must specify how contributions are adjusted, if necessary, to satisfy these limits. The plan must contain provisions to insure that both the annual overall permitted disparity limit and, for years beginning after 1994, the cumulative permitted disparity limit are satisfied. In order to satisfy the annual overall disparity limit, the plan must (1) provide that no other plan can impute disparity under section 1.401(a)(4)-7 for a covered employee and (2) provide that either no employee can be covered by another section 401(l) plan or if employees are covered by another section 401(l) plan how the disparity is reduced to insure that the total annual disparity fraction does not exceed one. For plan years beginning after 1994, the plan must contain provisions to preclude the possibility that any employee's cumulative disparity fraction will exceed 35. The plan must also provide that any employee

whose fraction would exceed 35 will receive an allocation based on all compensation at the excess percentage rate. A defined contribution plan is deemed to satisfy the cumulative disparity limit prior to the 1995 plan year.

1.401(l)-2(c)(2)
1.401(l)-5

II. PERMITTED DISPARITY: Defined Benefit/Target Benefit Plans

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line a. If the plan is a design-based safe harbor defined benefit plan that provides for permitted disparity, complete this part of the worksheet to determine whether the disparity satisfies the requirements of section 401(l). A safe harbor target benefit plan that provides for disparity is generally required to satisfy the same permitted disparity rules that apply to defined benefit plans, with certain exceptions. Therefore, this part of the worksheet should also be completed for target benefit plans that provide for disparity.

401(l)

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line b. A defined benefit (or target benefit) plan will not satisfy section 401(l) unless the integration level (or in an offset plan, the offset level) is one of the following amounts:

(i) Each participant's covered compensation in effect at the beginning of the current plan year or a prior plan year. If the integration level is covered compensation in a prior plan year, such prior year must be the same year for all participants and not earlier than the later of the plan year five years earlier, or the plan year beginning in 1989. Covered compensation is defined generally as the average of the taxable wage bases over the 35-year period ending in the year the participant attains social security retirement age. (See Attachment I of Notice 89-70, 1989-2 C.B., for the covered compensation table for plan years beginning in 1989). A transitional rule (available for plan years up to 1995) allows a plan to use a 35-year average ending in the year prior to the year the participant attains social security retirement age. (See Attachment II of Notice 89-70 for covered compensation for plan years beginning in 1989 for purposes of this transitional rule.)

(ii) A uniform percentage of each participant's covered compensation (more than 100% but not greater than the taxable wage base in an excess plan or final average compensation in an offset plan).

(iii) A single dollar amount (specified in the plan or determined under a formula specified in the plan) not more than the greater of $10,000 or one-half of the covered compensation of a person attaining social security retirement age during the plan year (the safe-harbor integration level.)

(iv) A single dollar amount (specified in the plan or determined under a formula specified in the plan) more than the safe-harbor integration level but not more than the taxable wage base in an excess plan or final average compensation in an offset plan. For this purpose, an offset level of each participant's final average compensation is considered a single dollar amount under a formula specified in the plan.

The integration level is the amount of average annual compensation (or, if so used in an accumulation plan, plan year compensation) specified in an excess benefit plan at or below which the rate of benefits is less than the rate of benefits above this amount. The offset level is the amount of final average compensation used in determining the offset.

Final average compensation is the average of the employee's annual section 414(s) for the 3-consecutive year period ending in the plan year or for the employee's period of employment if shorter. For this purpose, the year in which the employee terminates may be disregarded.

If choice (ii) is used in a plan, reductions are required to be made to the 0.75 percent factor in the maximum excess or offset allowance. (See line d.(iv), below.)

If the plan uses choice (iv), the 0.75 percent factor in the maximum excess or offset allowance must be reduced to the lesser of the factor determined under line d.(iv) or 80 percent of the otherwise applicable factor. Alternatively, the employer can demonstrate that the demographics requirements of section 1.401(l)-3(d)(8) of the regulations are satisfied. In these requirements are satisfied, the 0.75 percent factor must still be reduced as provided in line d.(iv). If the employer submits such a demonstration, refer to the requirements of section 1.401(l)-3(d)(8) of the regulations.

1.401(l)-3(d)

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line c. A defined benefit (or target benefit) excess plan will not satisfy section 401(l) unless the plan uses the same base benefit percentage and the same excess benefit percentage for all participants with the same number of years of service. The base benefit percentage is the rate at which benefits are accrued with respect to compensation at or below the integration level. The excess benefit percentage is the rate at which benefits are

accrued with respect to compensation above the integration level.

A defined benefit offset plan will not satisfy section 401(l) unless the plan uses the same gross benefit percentage and the same offset percentage for all participants with the same number of years of service. The gross benefit percentage is the rate at which benefits are accrued (before application of the offset) with respect to compensation. The offset percentage is the rate at which the benefit is reduced expressed as a percentage of final average compensation up to the offset level.

A plan may be uniform even though it has different percentages based on different years of service provided they are uniform with respect to each amount of service. If the percentages are different for different levels of service, the different percentages must each satisfy section 401(l).

There are several exceptions to the uniformity requirements under which disparity may be deemed to be uniform. Among these exceptions are the following:

First, a plan that is using a fractional rule accrual formula may contain special accrual provisions that are exceptions to the uniformity requirements. See Regulation section 1.401(l)-3(c)(2)(ii) and (iii) for those deemed uniformity rules.

Second, in accordance with the requirements described in line d.(vi), the plan may reduce the 0.75 percent factor in the maximum excess or offset allowance for employees with social security retirement ages greater than 65.

Third, in accordance with the requirements described in line d.(iv), a plan with an integration or offset level greater than each employee's covered compensation makes individual reductions to the 0.75 percent factor in the maximum excess or offset allowance by increasing these individual employees' base benefit percentages or reducing their offset percentages.

Fourth, the plan provides nondisparate benefits in accordance with section 1.401(l)-3(c)(2)(vi) of the regulations for employees who have reached the cumulative permitted disparity limit.

Fifth, the plan is a "PIA offset plan with a section 401(l) overlay." That is, the plan is an offset plan that defines the offset as the lesser of a specified percentage of the employee's primary insurance amount (PIA) under the Social Security Act or an offset that satisfies the requirements of section 401(l) (referred to as the "section 401(l) overlay"). The percentage of the PIA must generally be uniform for all employees with the same number of years of service. A PIA offset plan without the

section 401(l) overlay does not satisfy section 401(l) and therefore cannot be a safe harbor plan. An employer may be able to demonstrate that, however, that a PIA offset plan satisfies the general test.

1.401(l)-3(c)

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line d.(i) In an excess benefit plan, the excess benefit percentage may not exceed the base benefit percentage by more than the maximum excess allowance. The maximum excess allowance for a year is the lesser of 0.75 percent of compensation or the base benefit percentage. In an offset plan, no participant's benefit may be reduced by an offset (expressed as a percentage of final average compensation) that exceeds the maximum offset allowance. The maximum offset allowance for a year is the lesser of (1) 0.75 percent multiplied by the participant's final average compensation (up to the offset level), or (2) one-half of the benefit that would be provided, prior to the application of the offset, multiplied by the following fraction (not to exceed one):

$$\frac{\text{average annual compensation}}{\text{final average compensation up to the offset level}}$$

1.401(l)-3(b)((2) and (3)

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line d.(ii) In determining whether the disparity in a defined benefit plan satisfies the permitted disparity requirements of section 401(l), only employer-provided benefits may be taken into account. If the plan is a contributory plan (i.e., it provides for employee contributions not allocated to separate accounts), the employer-provided benefit must first be determined as provided in Part XIII of Worksheet 5A.

If the plan satisfies either the cessation of employee contributions method or the government plan method described in Part XIII of the Worksheet 5A, all benefits are treated as employer-provided and this line can be answered yes.

If the plan satisfies the composition-of-workforce method, the employer provided-benefit is determined by reducing the base and excess benefit percentages (or the gross benefit percentage) by subtracting therefrom the product of the employee's contribution rate and a factor. (A special calculation of the employee contribution rate is described in section 1.401(a)(4)-6(b)(2)(iii)(B)(2) and (3).) The factor is based on the average entry age for the plan (i.e., the average attained age of employees in the plan minus average years of participation) and whether the formula bases benefits on compensation averaged over a period no greater than five years. The factors are shown in the following table:

	Factors	
Average Entry Age	**Average Comp. Formula**	**Other Formula**
less than 30	0.5	0.75
30 to 40	0.4	0.6
over 40	0.2	0.3

If the employer's demonstration of the composition-of-workforce method does not specify the plan's factor, the employer may be asked to demonstrate this.

If the plan satisfies the minimum benefit method, the same process is used to determine the employer-provided benefit, except that the age of all employees is assumed to be 30 to 40 (i.e., use factors of 0.4 or 0.6).

Employers determining the employer-provided benefit under the grandfather method or using the rules of section 411(c) may be asked to demonstrate the determination of employer-provided benefits for the purpose of determining whether the plan satisfies section 401(l).

1.401(a)(4)-6
1.401(l)-3(h)

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line d.(iii) With respect to total employer-derived benefits provided under the plan for all years of service, the maximum excess or offset allowance is limited to the 0.75 percent factor multiplied by the participant's total years of service (not to exceed 35). Thus, the maximum excess or offset allowance may not exceed 26.25 percent of average annual compensation (or final average compensation in the case of an offset plan) for any participant in any plan year reduced pro rata for each year of service less than 35.
1.401(l)-3(b)(1)
1.401(l)-5

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line d.(iv) The 0.75 percent factor in the maximum excess or offset allowance must be reduced under certain circumstances. These reductions are applied on a cumulative basis; that is, each reduction is calculated independently of, and in addition to, any other reduction. If the plan's integration level is one described in (ii) in line b. above, the 0.75 percent factor is required to be reduced in accordance with the table below. If the plan's integration level is one described in (iv) in line b. above, the 0.75 percent factor is required to be reduced to the lesser of 80 percent of the otherwise applicable factor or the reduced factor determined under the table below. (Only the

adjustment under the table below is required, however, if the demographics requirement referred to in line b. is satisfied.)

Integration or offset level as a percent of covered compensation	**Reduced factor**
100%	0.75%
125%	0.69%
150%	0.60%
175%	0.53%
200%	0.47%
Taxable wage base or final avg. comp.	0.42%

If the integration or offset level is a single dollar amount, this table can be applied in one of two ways as specified under the plan. First, it can be applied uniformly to all participants by comparing the single dollar amount to the covered compensation of an individual attaining social security retirement age in the year in which the plan year begins. Alternatively, the plan may provide for individual reductions by comparing the single dollar amount to each employee's covered compensation.
1.401(l)-3(d)(3)(iii)
1.401(l)-3(d)(5)(iv)
1.401(l)-3(d)(6)(ii)
1.401(l)-3(d)(9)

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line d.(v) (If this is a target benefit plan, check N/A on this line of the worksheet.) The maximum excess allowance may not be exceeded with respect to any optional form of benefit. A plan may violate this rule, for example, if it provides the maximum excess allowance with respect to its normal form and applies an actuarial equivalence factor greater than 1.0 in converting the normal form into an optional annuity form. In the case of an optional form of benefit payable other than as a level annuity over a period of not less than the life of the participant (for example, a lump sum), the optional form must first be normalized to a straight life annuity using reasonable actuarial assumptions. A plan that provides no optional forms of benefit other than level annuities payable over a period of not less than the life of the participant will satisfy this rule automatically if it designates the least valuable form of benefit available under the plan (generally a single life annuity) as the normal form and the plan does not exceed the maximum excess allowance with respect to this form.

A plan does not fail to satisfy section 401(l) where the excessive disparity is the result of the application of the interest rate restrictions of section 417(e) to a benefit subject to such restrictions.

If it cannot be determined that this requirement is met, this line should be checked No and the sponsor should be asked to demonstrate that the requirement is met.

1.401(l)-3(b)(4)(iii)

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line d.(iv) The 0.75 percent factor in the maximum excess or offset allowance is reduced for benefits commencing before social security retirement age, (including benefits payable at normal retirement age, early retirement age, and disability benefits, other than qualified disability benefits as defined in section 1.401(l)-3(e)(4) of the regulations).

(In a target benefit plan this reduction is required only where the plan's NRA is earlier than SSRA. Where NRA is not earlier than SSRA, no reduction is required for early payment in a target benefit plan. Likewise, where NRA is before SSRA in a target benefit plan, no additional reduction is required for payment prior to NRA.)

A table of these reduced factors is contained in section 1.401(l)-3(e)(3) of the regulations. Note that if a defined benefit plan with a NRA of 65 limits the disparity factor to 0.65, reductions are required only for distributions prior to NRA.

If it cannot be determined that the maximum allowance cannot be exceeded at any age, this line should be checked No and the sponsor should be asked to demonstrate that the requirement is met.

If the offset in an offset plan is reduced payment before NRA under these rules, the benefit provided under the plan's formula prior to the application of the offset must be reduced by a percentage that is no less than the percentage reduction required for the offset.

1.401(l)-3(c)(2)(iv)
1.401(l)-3(e)
1.401(l)-3(f)(2)

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line e. If a defined benefit plan is fully insured within the meaning of section 411(b)(1)(F), the plan satisfies the permitted disparity rules of section 401(l) if each participant's benefit under the plan satisfies the rules generally applicable to defined benefit plans, including any required reductions to the maximum excess (or offset) allowance. However, the 3/4 of one percent (as adjusted) in the maximum excess (or offset) allowance, must be further reduced by a factor of .8. The same reduction is required in the case of a target benefit plan.

1.401(a)(4)-3(b)(5)(viii)
1.401(a)(4)-8(b)(3)(i)(C)

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line f. A plan must provide that the overall permitted disparity limits may not be exceeded and must specify how benefits are adjusted, if necessary, to satisfy these limits. The plan must contain provisions to insure that both the annual overall permitted disparity limit and the cumulative permitted disparity limit are satisfied. In order to satisfy the annual overall disparity limit, the plan must (1) provide that no other plan can impute disparity under section 1.401(a)(4)-7 for a covered employee and (2) provide that either no employee can be covered by another section 401(l) plan or if employees are covered by another section 401(l) plan how the disparity is reduced to insure that the total annual disparity fraction does not exceed one. The plan must contain provisions to preclude the possibility that any employee's cumulative disparity fraction will exceed 35. The plan must also provide that any employee whose fraction would exceed 35 has a benefit for each year of service determined with respect to total compensation at a rate equal to the nondisparate percentage.

The nondisparate percentage is generally the excess or gross benefit percentage otherwise applicable to an employee with the same number of years of service. However, in the case of a unit credit safe harbor plan, the nondisparate percentage for an employee is limited to 133 1/3 percent of the smallest base benefit percentage (or 133 1/3 percent of the smallest difference between the gross benefit and offset percentage), determined under the benefit formula as applied to employees with no more service than the employee. For a fractional accrual rule safe harbor plan, the benefit formula must provide for the nondisparate percentage with respect to years of service after the employee would reach the cumulative disparity limit (determined using the disparity provided under the benefit formula).

1.401(l)-3(c)(2)(vi)
1.401(l)-5
