

New Comparability Plans: The Potential Detrimental Impact of IRS-Proposed Regulations!

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Proposed Nondiscrimination Regulations

General Nondiscrimination Test

- If the plan meets a safe harbor test, no need to apply general test.
- However, apply general test every year plan does not meet a safe harbor.
- The general test is often referred to as “rate group testing.”

Rate Group Testing

- There are as many rate groups as there are HCEs with different allocation or equivalent benefit accrual rates (EBARs) rates.
- A rate group consists of an HCE plus all other non-excludable EEs (HCEs or NHCEs) that have an allocation rate or EBAR equal to or greater than the HCE's rate.
- An EE can be part of more than one rate group.
- With respect to each rate group, the ratio of NHCEs to HCEs must satisfy one of the two coverage tests.

Rate Group Testing

Rate groups can be determined based on contributions or equivalent benefit accrual rates (EBARs).

1. Determine allocation rates or EBARs.
2. Determine rate groups.
3. Test each rate group to show it passes either:
 - A. The ratio percentage (70 percent) test, or
 - B. The average benefit test (modified)
 - 1) Each rate group satisfies numerical nondiscriminatory classification test.
 - 2) ER satisfies the average benefit percentage test.

Average Benefit Test

Two-part test:

1. Average Benefit Percentage Test

NHCE average benefit percentage

HCE average benefit percentage ≥ 70 percent

2. Nondiscriminatory classification test requires each rate group to benefit a percentage of NHCEs which, when compared to the percentage of HCEs benefiting under the rate group, is at least equal to the mid-point between the safe and unsafe harbors.

Safe and Unsafe Harbors

- NHCE concentration percentage = includible NHCEs / includible employees
- Round concentration percentage down to nearest whole percentage

Concentration Percentage	Safe Harbor	Unsafe Harbor
0 - 60%	50.00%	40.00%
66%	45.50%	35.50%
70%	42.50%	32.50%
75%	38.75%	28.75%
80%	35.00%	25.00%
83%	32.75%	22.75%
90%	27.50%	20.00%
99%	20.75%	20.00%

Cross-Tested Plan (New Comparability)

- Cross-tested plan *tests* on the basis of EBARs factors but (unlike age-based plan) does not *allocate* on the basis of the actuarial factors.
 - Typical cross-tested plan design is profit-sharing plan with comp. to total comp. allocation formulas that apply to different “allocation groups” such as:
 - HCEs and NHCEs
 - Owners and non-owners or
 - Each employee in their own allocation group.
- Cross-testing approach only permissible if “gateway” requirements are satisfied.

Poll #1

What percentage of your business is cross-tested plans?

- A. None
- B. Less than 25 percent
- C. 25 to 50 percent
- D. 50 to 75 percent
- E. More than 75 percent

Minimum Gateway

Minimum Gateway Requirement

- In order to use cross-testing for DC nondiscrimination testing, a plan must provide a minimum gateway contribution (or be exempt under the “broadly available allocation rates” or “gradual age or service schedule...or uniform target benefit schedule” exceptions).
- Minimum gateway contribution is the lesser of:
 - ❑ Five percent (415 compensation) or
 - ❑ One-third of the highest allocation rate provided to any HCE (414(s) compensation).

Gateway Purpose

- Minimum gateway does not guarantee compliance with the nondiscrimination requirements.
- Rather, the minimum gateway allows the ER to use cross-testing.
- Gateway generally satisfied only through the use of non-elective contributions.

Poll #2

What percentage of you cross-tested plans are:

- A. DC only (none, <25, 25 to 50, 50 to 75, >75)
- B. DC/cash balance (...)
- C. DC/traditional DB (...)
- D. Cash balance only (...)

2016 Proposed Regulation

Proposed Change

- For purposes of the coverage test, the Nondiscriminatory Classification component of the average benefits test requires employees eligible to benefit do so under a “reasonable classification.”
- A “reasonable classification” is one that, based on all the facts and circumstances,
 - “...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 bone fide business criteria.
 - ***An enumeration by name or other specific criteria having substantially the same effect...is not considered reasonable.***

Application to Rate Group Testing

- Under existing regulations the reasonable classification component of the nondiscriminatory classification test doesn't apply to rate group testing.
- Under the 2016 proposal, **the formula** that is used to determine the allocation or benefit for each HCE must apply to a "... to a group of employees that satisfies the reasonable classification requirement."

Reasonable Classifications

- The test is unfair to small businesses since criteria having the effect of enumeration by name is, per se, unreasonable.
- Since small business job categories may only cover one or two people, categories such as this could be classified as enumeration by name.
- Since the test is based on “all the facts and circumstances,” there is very little assurance that any category, other than the few specified in the regulation, are business-related.

Reasonable Classifications

- The proposed regulation does NOT say that one person groups reflecting a valid business classification are unreasonable.
- However, EXAMPLE 6 in the proposed regulation IMPLIES that this may be the case.
- The “reasonable” definition is so vague as to call certain common classifications into question.

Poll #3

What percentage of your plans have allocation formulas that “name names?”

- A. None
- B. Less than 25 percent
- C. 25 to 50 percent
- D. 50 to 75 percent
- E. More than 75 percent

Poll #4

What percentage of your plans have a single owner-employee?

- A. None
- B. Less than 25 percent
- C. 25 to 50 percent
- D. 50 to 75 percent
- E. More than 75 percent

Reasonable Classifications

- Consider a plan for a large law firm that provides the following allocations:
 - Partners age 50+: 20%
 - Partners age 40 to 49: 15%
 - Partners under age 40: 10%
 - All others: 5%
- There is no guidance on whether ANY of these classifications are reasonable
 - Including “all others”

Reasonable Classifications

- There is no requirement that a formula be reasonable or nondiscriminatory. It's not the formula...it's the group to which the formula applies.
- Allocation formulas that place each employee in their own allocation group would not satisfy the reasonable classification test because each employee effectively has his own formula, which is clearly equivalent to choosing the group covered by the allocation formula by name.
- A “Super-Integrated” formula likely would qualify as reasonable since it is based on compensation.
- Other formulas are open to debate.
- And that's the problem, *i.e.*, the general test for nondiscrimination will now be subjective.

Allocation/Benefit Formula

- There is no definition of a formula.
- Years ago the IRS required a single allocation formula for all non-elective contributions under the plan, which precluded discretion once the total contribution was determined.
- Under that concept, a formula is any mathematically determined map that allocates all of the contributions made for an eligible group.
- Thus, a super-integrated allocation or a points-allocation would be just as much a formula as straight ratio of pay formula.
 - But the IRS definition of “formula” is unknown.
 - Much harder to tell if the group covered by a formula is reasonable, when there is no definition of formula.

DB Plans and DB/DC Combos

- The proposal to require that an HCE's benefit formula cover a reasonable classification in order for that HCE's rate group to use the Average Benefits Test applies to DB plans also.
- Also applies to BOTH PLANS in a DB/DC Combo.
 - Both the benefit formula applicable to the HCE in the DB plan and the allocation formula applicable to the HCE must cover reasonable classification or HCE's rate group must satisfy ratio percentage test.
 - Not clear if they have to cover the SAME reasonable classification.

Example

- Consider the Brady Plumbing Practice:
 - Brady is owned by Greg, Peter, and Bobby equally.
 - Brady sponsors a Cash Balance Plan and a Profit Sharing Plan for its eight employees.
 - The Profit Sharing Plan provides:
 - 5% of pay to all plumbers and
 - 7.5% of pay to all staff
 - The Cash Balance Plan provides:
 - A pay credit of \$100,000 to Greg, \$75,000 to Peter, and \$50,000 to Bobby and
 - 3% of pay to all staff
 - For 2015, the aggregated DB/DC plan easily passed the general test for nondiscrimination.
 - Greg's rate group had a ratio percentage result of 60% while
 - Peter and Bobby each had a ratio percentage of 80%.

Example (Continued)

- Under the proposed regulation, because the formula for each of the plumbers covers only that plumber by name, it does not cover a reasonable classification of employees.
- As a result, each of the rate groups must pass the Ratio Percentage Test, attaining a ratio percentage of at least 70%.
- Otherwise the plan will fail.
- There are two potential corrections for this:
- First, benefits or allocations could be increased for certain NHCEs to increase Greg's ratio percentage to at least 70%.

Example (Continued)

- Alternatively, the formulas for HCEs could be expanded to cover a reasonable classification of employees.
 - In this case, if all “plumbers” were to receive pay credits of \$100,000, the \$100,000 formula would cover a reasonable classification:
 - Then rate groups could use the Average Benefits Test and
 - The plan would pass the General Test.
 - Of course, the amendment would have to be adopted in a timely fashion, likely by year end.
 - This quicker timing is because an amendment **increasing** benefits only for HCEs is not eligible for the extended deadline offered to corrective amendments under 1.401(a)(4)-11(g).
 - Seems unusual to fix a nondiscrimination failure by increasing HCE benefits.

Adjustments to Gateways

- Averaging of NHCE rates to satisfy gateways.
- Current law:
 - An employer may treat each NHCE benefiting under the DB plan as having an equivalent allocation rate equal to the average equivalent allocation rate for benefiting NHCEs.
- Proposed regulation:
 - The employer may also treat each NHCE benefiting under the DC plan as having an allocation rate equal to the average allocation rate for benefiting NHCEs.

Adjustments to Gateways

- Proposed regulation (continued)
 - These averaging techniques are for DB / DC combos only
 - Not for stand-alone DC plans.
 - Both the DB and the DC averages must limit each individual to a 15% allocation rate (or EAR)
 - Increase the cap to 25% if the DB plan provides a benefit under which the EAR increases with age or service.
 - Traditional DB – yes.

Adjustments to Gateways

- Proposed regulation:
 - DB/DC combos that include a matching contribution may apply the average match for NHCEs toward the gateway.
 - Average match for NHCEs determined by the ACP (without after-tax contributions) for the NHCE group.
 - On a current year testing basis.
 - Including restrictions on counting bottom-up contributions.
 - Average is limited to three percent.
 - Ability to use match toward gateway does not apply to DC-only plans.

Other Gateway Changes

- Lower Interest Rate Rule:
 - A DB/DC Combo is exempt from the minimum allocation gateway if it would pass the general test on a benefits basis using a testing interest rate of six percent.
 - As opposed to a standard interest rate of 7.5% to 8.5%.
 - Again this applies only to DB/DC combos.
 - Does NOT apply to stand-alone DC plans.

Other Gateway Changes

- Closed Plan Rule:
 - Closed DB Plan:
 - DB Plan closed to new entrants as of the closure date.
 - Closed Plan Rule:
 - Only applies to plans in effect for five years prior to closure.
 - Applies beginning on the first day of the plan year beginning on or after fifth anniversary of the closure date.
 - No amendments since five years before closure date (limited exceptions).
 - Plan must have met 401(a)(4) without being subject to the minimum allocation gateway since closure date.
 - DB safe harbor, stand-alone DB general test, primarily DB in nature, broadly available separate plans.

Other Gateway Changes

- Closed Plan Rule:
 - If all conditions met, plan is no longer subject to any gateways.
 - Permitted amendments:
 - Five-year period ending on closure date.
 - Cannot increase any accrued benefit or future accruals.
 - Cannot expand coverage.
 - Cannot decrease RPT result under any non-discrimination test.
 - After closure date:
 - Cannot decrease RPT result under any non-discrimination test.
 - » Can add NHCEs to pass coverage.
 - Deminimis changes to benefit formula allowed.

Other Gateway Changes

- Defined Benefit Replacement Allocations (DBRAs):
 - DBRAs are DC allocations reasonably designed to replace benefits that would have accrued under a closed DB plan.
 - DB Plan must have provided DBRA participants with an accrual that generated equivalent allocation rates that increased with age.
 - Existing regulations:
 - The DBRA must cover a 410(b) group.
 - The DB plan cannot be amended for five years before closure.
 - The DBRA cannot be amended post-closure.
 - Same exceptions to pre-closure amendments to closed DB as with gateways.
 - General restriction on amendments to DBRAs.

Other Gateway Changes

- Defined Benefit Replacement Allocations (DBRAs):
 - Proposed regulations:
 - Expands definition of DBRAs to include allocation that replaces some or all of lost closed plan accruals.
 - Provides that the requirement for the DBRA to meet 410(b) applies for only five years.
 - Expands increasing allocation rate requirement to include equivalent allocation rates that increase with service.
 - Expands the list of allowable amendments before and after closure.
 - If an allocation satisfies DBRA requirements, it is ignored in determining if the plan has broadly available allocation rates.

Other Closed Plan Changes

- BERFs for closed plans and closed formulas:
 - BERFs available to grandfathered participants in a closed plan, or a matching contribution rate (or schedule of rates) available only to a grandfathered group as a result of a closure would be subject to a special BERF rule under proposed regulations.
 - BERF had to have been in place for the five years before closure.
 - Special rule says that if the BERF described above is currently and effectively available to a 410(b) group for the five plan years beginning on or after the closure date, the BERF is deemed to satisfy current and effective availability thereafter.

Other Closed Plan Changes

- BERFs for closed plans and closed formulas
 - Restrictions on grandfathered BERFs
 - For closed formulas:
 - For instance, where a traditional DB is converted to a cash balance for new entrants.
 - Relief is only available if the amendment restricting the BERF resulted from a significant change in the type of formula requiring the restriction.
 - » For instance, a change from a two percent times YOS traditional DB to a one percent times YOS traditional is NOT a significant change requiring a restriction on any BERF.

What's Next for the Regulation?

- Comment letter due April 28, 2016.
- ASPPA/ACOPA Task Force has been appointed to consider response.
- Regulation slated to be effective for plan years beginning on or after the date published as a final regulation in the federal register.

What's Being Done

- Our message:
 - Should be no “reasonable classification” where gateway is met.
 - Small business must be able to have more than one “reasonable classification.”
 - Common sense says “owner” is a reasonable business classification even if there is only one owner.
- Message delivery:
 - Comment letter of course, but also
 - Educate Congress – let them know this is an anti-small business proposal, and ask them to weigh in.

What You Can Do

- Talk to your clients about the impact of this proposal.
- Ask them to get involved by:
 - Permitting you to provide us with their name and some basic information to share with their members of Congress and
 - Sending a letter (email).

What You Can Do

- Provide us with information on affected on clients willing to let us tell their members of Congress that they will be affected.
 - Company names and addresses are critical to showing members of Congress know small businesses in their district will be hurt by the proposal.
 - This information will *not* be shared with Treasury.
- Use the online form found at:
<http://www.asppa-net.org/Crosstested-Plan-Impact-Information-Sheet>

What You Can Do

- Send letters
 - Sign a group comment letter to Treasury, and encourage your clients to do the same.
 - Send letter to Congress. Easy to use sample letters will be available by March 1:
 - One for practitioners.
 - One for plan sponsors.



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