



Combo Plan Design

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Combo Plan Issues

- Deduction Limits
- Top Heavy coordination
- Testing – 410b, 401(a)(4), DB/DC gateway, 401(a)(26), benefits rights and features
- Plan document coordination



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Combined Deduction Limit under 404a7

- IRC Section 404(a)(7) applies where employer maintains both DB and DC plan and at least one person covered by both plans
- Covered by PBGC? If so, no combined deduction limit.
- If not covered by PBGC, subject to 401a7:
 - If PS cont is \leq 6% of pay, normal DB deduction limit
 - If PS cont is $>$ 6% of pay, combined deduction limit is 31% of Comp
 - So if the sponsor is maximizing on the CB side PS cont will be limited to 6%.
- **BUT, only Comp of DC beneficiaries considered in determining ignored 6%**



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PBGC covered?

- DB plans exempt from PBGC coverage
 - Plans of professional group if plan never covered more than 25 active participants
 - Physicians, dentists, D.O.s, O.D.s, lawyers, CPAs, P.E.s, architects, actuaries, others where license requires “advance study”
 - » Not APAs, QPAs, RIAs, real estate prof, etc.
 - ERISA 4021(b)(13), 4021(c)(2)
 - Plans covering only substantial (more than 10%) owners
 - Attribution rules of IRC 1563(e) apply
 - ERISA 4021(b)(9), 4021(d)



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Deduction Example 1

- Kevin D, Inc. sponsors a PS/401(k) plan for 2015.
 - Kevin is the only employee.
 - He is age 55
 - W2 salary is >\$265,000
 - He defers \$18,000 plus a \$6,000 catch up
 - PS contribution for 2015 is planned to be \$35,000 to maximize the annual addition at \$53,000 and is under the normal 25% of comp PS plan deduction limit



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Deduction Example 2

- Kevin decides to set up a Cash Balance plan for 2015 and will maximize his contribution. Assume deduction limit is \$184,000.
- CB plan is exempt from PBGC coverage
- His PS contribution decreases to $.06 \times 265,000 = \$15,900$
- He defers \$18,000 plus a catch up of \$6,000



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Deduction Example 3

- Kevin decides to set up a Cash Balance plan for 2015 but still wants to maximize his PS cont at \$35,000. Why? Because he's a moron and already funded the \$35,000 when I expressly told him not to.
- CB plan is exempt from PBGC coverage
- PS cont = \$35,000
- He defers \$18,000 plus a catch up of \$6,000
- Max allowable CB plan deduction = $(.31 \times \$265,000) - \$35,000 = \$47,150$.



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Deduction Example 4

- In 2016 Kevin's employee, age 25, becomes eligible for both plans. Employee has no ownership interest. He earns \$30,000.
- Kevin D. Inc. is a manufacturer so the plan is covered by PBGC in 2016.
- Assume ee's CB credit is \$2,000 and assume the CB plan maximum deductible cont is \$186,000 and they contribute and deduct this much.



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Example 4, cont'd

- PS conts:
 - Kevin \$35,000
 - Employee \$ 3,000 (assume this passes testing for now)
 - Aggregate PS cont is under 25% of pay
 - No combined limit



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Example 5

- Same as Example 4, except the employee is a 10% owner in 2016. So now the plan is exempt from PBGC coverage.
- Aggregate PS cont must decrease to 6% of pay of CB cont stays at \$186,000
- Total PS cont cannot exceed $.06 \times (\$265,000 + \$30,000) = \$17,700$



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Example 6

- Kevin and Lynn, a Partnership, sponsors a CB plan and a PS 401(k) plan.
- Kevin PC and Lynn PC are the 50/50 partners
- They have one NHCE who is age 25 and earns \$30,000 and is eligible for both plans. Employee is paid by the partnership.
- They are actuaries so the CB plan is exempt from PBGC coverage.
- They each earn \$265,000 paid from their PCs



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Example 6 cont'd

- Its an affiliated service group so each entity has its own deduction limit.
- CB credits:
 - Kevin & Lynn \$125,000 each
 - Employee \$ 2,000
- PS conts
 - Kevin PS \$15,900 (6% of comp)
 - Lynn PS \$15,900(6% of comp)
 - Employee \$2,100 (7% of comp)
 - Each entity in PS satisfies 404(a)(7) separately



Example 8

- Kevin, Lynn and Sheri, A Partnership, sponsors a CB plan. They are 1/3rd partners.
- The plan document excludes Sheri by name.
- IRS say the deduction should be allocated on partnership interest without any other specific language in the partnership agreement.
- If Sheri is excluded from the CB plan it makes no sense that she is allocated 1/3rd of the CB plan contribution.
- Make sure you tell the client to get this language into their partnership agreements.



Top Heavy Minimums

- The "required aggregation group" is defined in IRC 416(g)(2)(A)(i). It consists of each plan of the employer in which a key employee participates during the determination date year (or participated in during any of the four preceding years), and any other plan of the employer which, during this period, is aggregated with a plan in which a key employee participates to meet the nondiscrimination requirements of IRC 401(a)(4) or IRC 410.
- If the required aggregation group is top-heavy, each plan in the required aggregation group is top-heavy, even if it would not be top-heavy if tested independently, or if it covered no key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy.



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Top Heavy Minimums

- The plan may use one of four alternative safe harbor methods to provide top-heavy minimums. The plan must specify the method selected. See Treas. Regs. 1.416-1, M-12 and M-15.
- Only the defined benefit plan must provide the minimum benefit.
- A floor offset arrangement under which the defined benefit plan minimums can be offset by the defined contribution plan benefits.
- Both the defined contribution plan and the defined benefit plan together, using comparability analysis, provide benefits at least equal to the defined benefit plan minimum.
- A safe harbor defined contribution minimum of contributions and forfeitures equal to 5% of the compensation of each non-key employee.



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Top Heavy Cont'd

- DB or Cash Balance (CB) plans don't work well if they provide the TH minimum:
 - The DB top heavy minimum is an age-weighted benefit that is more expensive for older employees.
 - It will significantly override the CB account for older participants.
 - The DB TH minimum is subject to 417(e) which blows up the concept of a Cash Balance plan



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Top Heavy cont'd

- Almost always cheapest in aggregate to provide the dual plan minimum via the 5% of pay safe harbor contribution in lieu of the DB minimum. And its an age neutral contribution.
- Need coordinating plan language!
 - Both documents must say where the minimum is provided and how, and who it goes to (keys and non-keys, or non-keys only?)
 - Check document language carefully to make sure it does not force a 5% of pay minimum if that is not necessary.
- Remember the TH min is based on full years comp.



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401(a)(26)

- Must provide “meaningful benefits” to lesser of 50 employees or 40 percent of the non-excludable employees (regardless of whether the benefiting participants are HCEs or NHCEs) [Treas. Reg. §1.401(a)(26)-3(c)(1)]
- Regulations provide no bright line test to determine if benefits being provided are meaningful
- Facts and circumstances [Treas. Reg. §1.401(a)(26)-3(c)(2)]



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401a26 – the Minimum Participation Requirement

- IRS follows the Shultz memo which defines meaningful as an annuity benefit at NRA of .5% of Compensation.
- This is a benefit at NRA, not a CB credit of .5% of Comp!
- Impact on 401a26? Could a CB credit for a principal of \$10,000 not be meaningful under 401a26? Yes, it may not be under the Shultz standard.



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401(a)(26)

- The generic professional group combo DB plan tested with a PS plan is some version of this:
 - Tier 1 – Shareholders 10% of AMC per YOP max 10
 - Tier 2 – All others - .5% of AMC per YOP max 10
- The generic professional group combo CBplan tested with a PS plan is some version of this :
 - Tier 1 – Shareholders \$100,000 or 38% of comp if lower
 - Tier 2 – All others - \$1000, or 1% of comp



401(a)(26)

- There is a tendency among some actuaries to design the DB or CB plan as a “carve-out”, only covering just enough employees to satisfy the 40% test.
- Example: 4 owners, 6 employees, DB plan excludes all non-owners.
- What happens in year 2 if there are 11 eligible employees? They work poorly in small groups because frequent corrective amendments are needed to add participants as the group increases and also as rank and file employees covered by the plan terminate.



401(a)(26)

- Carve outs work well in large stable groups.
Example: Clinic has 200 employees and 70 doctors. CB plan covers doctors only. The CB plan is tested with the PS plan which covers all employees.



Understanding 401(a) testing



Cash Balance/401(k) Combo Example

	Compensation	Age
HCE 1 – owner	\$ 245,000	60
HCE 2 – non owner	245,000	44
NHCE 1	30,000	30
NHCE 2	30,000	46
NHCE 3	30,000	60
NHCE 4	30,000	60
NHCE 5	30,000	44
NHCE 6	30,000	31
Total	\$ 670,000	

Cash Balance/401(k) Combo –PBGC Covered DBP

	PS/SH	Cash Balance	Total Employer	401(k)	Total
HCE 1	\$ 32,500	\$183,500	\$ 216,000	\$ 22,000	\$ 238,000
HCE 2	7,350	-0-	7,350	16,500	23,850
NHCE 1	2,100	750	2,850		2,850
NHCE 2	2,100	750	2,850		2,850
NHCE 3	2,100	750	2,850		2,850
NHCE 4	2,100	750	2,850		2,850
NHCE 5	2,100	750	2,850		2,850
NHCE 6	2,100	750	2,850		2,850
Total	\$ 52,450	\$188,000	\$240,450	\$ 38,500	\$ 278,950

Non-discrimination rules- items to note

- Items to note
 - Testing plans as single plan
 - Employer provided benefits under DC plan and benefits provided under DB plan treated as though provided under single plan
 - Treas. Reg. §§1.410(b)-7(d) & 1.401(a)(4)-9(b)
 - Combined plan tested on a benefits basis
 - Contribution and interest credits under cash balance plan and employer contributions under profit sharing plan turned into benefits payable at future age



Non-discrimination rules – General test

- Rate Group testing – mid point
 - Total of 8 non-excludable employees, including 6 NHCEs, for an NHCE concentration percentage of 6/8 or 75%: 15 whole percentage points over 60%
 - Safe harbor percentage is 38.75% (50% less .75% times 15)
 - Unsafe harbor percentage is 28.75% (40% less .75% times 15)
 - Rate group satisfies nondiscriminatory classification test portion of average benefits test if its ratio percentage is greater than or equal to 33.75% (midpoint between 38.75% and 28.75%)



Determination of Accrual Rates

- Determination of accrual rates for HCE 1
- Recall data from Example 3:
 - Compensation \$245,000
 - Age 60
 - Cash balance contrib. credit 183,500
 - Profit sharing allocation (including safe harbor) 32,500
 - 401(k) deferral used for ABT only 16,500 (catch-up ignored for testing)



Determination of Accrual Rates – Cash Balance Plan

- Aggregate Normal Accrual Rate
 - Cash balance plan
 - Assumptions:
 - Testing compensation = plan compensation
 - Testing age = NRA (since uniform NRA of 65/5)
 - Normal accrual rate determined by dividing increase in accrued benefit by testing compensation - Treas. Reg. §1.401(a)(4)-3(d) (Where NRA not same as Testing age would “normalize” from NRA to TA)



Determination of Accrual Rates – Cash Balance Plan

- HCE 1 contribution credit of \$183,500
 - Increase from age 60 to age 65 at interest crediting rate of 5% = 234,198
 - Divide by APR using plan rates (age 65, 2009 417(e) table and 5%) = 144.053
 - Accrued benefit = 274,401 / 144.053 = 1,625.77
 - Normal accrual rate = 1,625.77 X 12 / 245,000 = 7.96%



Determination of Accrual Rates – Profit Sharing Plan

- HCE 1 allocation of \$32,500
 - Increase from age 60 to age 65 at 8.5% = 48,869
 - Divide by APR (using 1971 GAM male, 8.5% age 65 = 94.7986)
 - Equivalent benefit = 48,869/94.7986 = 515.50
 - Equivalent benefit accrual rate (EBAR) = 515.50 X 12 / 245,000 = 2.52%



Determination of Accrual Rates – Aggregate Normal Accrual Rate

- HCE 1
 - Normal Accrual rate
from Cash balance plan 7.96%
 - EBAR from PS plan 2.52%
 - Aggregate normal
accrual rate 10.48%



Determination of Accrual Rates - MVAR

- Most Valuable Accrual Rate (MVAR)
 - Determined by calculating “normalized” Qualified Joint & Survivor Annuity (QJSA) associated with accrued benefit potentially payable in current and each future plan year and selecting largest
 - Treas. Reg. §1.401(a)(4)-3(d)(1)(ii)



Determination of Accrual Rates - MVAR

- Convert accrued benefit increase to QJSA payable at each age from current age to Testing Age
- Each QJSA normalized by converting to actuarially equivalent straight life annuity commencing at TA

Determination of Accrual Rates - MVAR

Age	Proj Val	JS APR Plan	JS Pay	JS APR Testing	Accum factor	SLA APR	Norm Benef	Accrual Rate
60	183,500	172.945	1,061.03	114.226	1.504	94.7986	1,922.38	9.42
61	192,675	169.771	1,134.91	112.330	1.386	94.7986	1,863.69	9.13
62	202,309	166.513	1,214.97	110.358	1.277	94.7986	1,806.58	8.85
63	212,424	163.171	1,301.85	108.310	1.177	94.7986	1,751.00	8.58
64	223,045	159.757	1,396.15	106.185	1.085	94.7986	1,696.78	8.31
65	234,198	156.259	1,498.78	103.988	1.000	94.7986	1,644.06	8.05

Determination of Accrual Rates - MVAR

- Notes for above table
 - Projected value at each age represents current value (\$183,500) adjusted for interest at the interest crediting rate (5%) to each age
 - “JS pay” is QJSA payable under plan at such age, based on projected value and plan’s interest rate and mortality table (5%, 417(e) table)
 - “JS APR testing” determined using 1971 GAM and 8.5% (testing rates)



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Determination of Accrual Rates - MVAR

- Accumulation factor is compounding effect of 8.5% from age at which the potential QJSA is payable to age 65 (testing age)
- Normalized benefit = result of

$$\frac{\text{JS Pay} \times \text{JS APR testing} \times \text{Accum factor}}{\text{SLA APR at testing age (testing rates)}}$$

- Accrual rate at each age = normalized benefit divided by testing compensation (\$245,000)



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Determination of Accrual Rates – Aggregate MVAR

- No separate determination of MVAR for the profit sharing contributions
- Instead, “aggregate” MVAR is sum of EBAR attributable to profit sharing contributions and MVAR from cash balance plan [Treas. Reg. §1.401(a)(4)-9(b)(2)(ii)(B)]
- HCE 1’s aggregate MVAR is therefore 11.94% (9.42% - the MVAR from the cash balance plan, plus 2.52% - the EBAR from the profit sharing contribution)



Determination of Accrual Rates

	EBAR PSP	Normal Accrual rate DBP	Aggregate NAR	MVAR DBP	Aggregate MVAR
HCE 1	2.52	7.96	10.48	9.42	11.94
HCE 2	2.11	-0-	2.11	-0-	2.11
NHCE 1	15.40	1.15	16.55	3.45	18.85
NHCE 2	4.17	.53	4.70	.96	5.13
NHCE 3	1.33	.27	1.60	.31	1.64
NHCE 4	1.33	.27	1.60	.31	1.64
NHCE 5	4.91	.58	5.49	1.12	6.03
NHCE 6	14.19	1.09	15.28	3.18	17.37



General Test Results

	Aggregate NAR	Aggregate MVAR	HCE 1 Rate Group	HCE 2 Rate Group
HCE 1	10.48	11.94	Y	Y
HCE 2	2.11	2.11		Y
NHCE 1	16.55	18.85	Y	Y
NHCE 2	4.70	5.13		Y
NHCE 3	1.60	1.64		
NHCE 4	1.60	1.64		
NHCE 5	5.49	6.03		Y
NHCE 6	15.28	17.37	Y	Y
HCE coverage			1/2 = 50%	2/2 = 100%
NHCE coverage			2/6 = 33.33%	4/6 = 66.67%
Coverage %			66.67%	66.67%

General Test Results

- Each rate group must pass Code Section 410(b) either by
 - having a coverage ratio of at least 70%
 - or by passing the average benefits test
- Each rate group under 70%
 - But greater than midpoint of 33.75%
 - To pass must also pass average benefits percentage test

General Test Results – Average Benefits Percentage Test

	Aggregate NAR	NAR Deferrals	Total NAR	HCE Avg.	NHCE Avg.
HCE 1	10.48	1.29	11.77		
HCE 2	2.11	4.72	6.83	9.30	
NHCE 1	16.55	-0-	16.55		
NHCE 2	4.70	-0-	4.70		
NHCE 3	1.60	-0-	1.60		
NHCE 4	1.60	-0-	1.60		
NHCE 5	5.49	-0-	5.49		
NHCE 6	15.28	-0-	15.28		7.54
				ABP	81.03



General Test Results

- Average benefits percentage test passed
- Each rate group passes Section 410(b)
- Combined plan therefore passes general test of Treas. Reg. §1.401(a)(4)-3(c)(1)



General Test Results – Special Rule for DB/DC combinations

- To pass nondiscrimination in amounts test must also satisfy one of following :
 - primarily defined benefit in character
 - broadly available separate plans, or
 - minimum allocation gateway
- Treas. Reg. §1.401(a)(4)-9(b)(2)(v)



General Test Results – Special Rule for DB/DC combinations

- Primarily defined benefit in character
 - DB/DC combination primarily DB in character where the normal accrual rate (NAR) attributable to benefits provided under the DB plan(s) exceeds the equivalent benefit accrual rate (EBAR) attributable to contributions under the DC plan(s) for more than 50% of NHCs
 - Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(B)
 - In above design EBAR from DC plan is greater than NAR from DB plan for each NHCE – so combined plan not primarily DB in character



General Test Results – Special Rule for DB/DC combinations

- Broadly available separate plans
 - DB/DC plan consists of broadly available separate plans if the DC plan and the DB plan, tested separately, would each pass
 - Coverage under Section 410(b), and
 - The nondiscrimination in amount requirement of Treas. Reg. §1.401(a)(4)-1(b)(2)(i)
 - In above design cash balance plan standing on own will obviously not pass the latter condition



General Test Results – Special Rule for DB/DC combinations

- Minimum aggregate allocation gateway passed if each NHCE has an “aggregate normal allocation rate” (ANAR) as follows:
 - If the highest ANAR of any HCE does not exceed 25% of compensation, each NHCE must have an ANAR of the *lesser* of (i) one third (1/3) of the ANAR of the HCE with the highest such rate, or, (ii) 5%
- Essentially another level of testing on a contributions basis over and above 401(a)(4) testing



General Test Results – Special Rule for DB/DC combinations

- If the highest HCE ANAR exceeds 25% of compensation, the ANAR for each NHCE must be at least 5% increased by one percentage point for each 5% (or portion thereof) by which the HCE rate exceeds 25%. For example, NHCE minimum is 6% where highest HCE rate exceeds 25% but not 30%, and 7% where the highest HCE rate exceeds 30% but not 35%
- Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(D)(1)

General Test Results – Special Rule for DB/DC combinations

- In any event, deemed to satisfy the gateway if the ANAR for each NHCE is at least 7.5% of Section 415(c)(3) compensation (may use compensation while a participant)
- Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(D)(2)

General Test Results – Special Rule for DB/DC combinations

- Which NHCEs must get gateway ?
- Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(D) states that each “NHCE” must receive the applicable minimum
- Treas. Reg. §1.401(a)(4)-12 defines a NHCE as “an employee who is not a HCE” (emphasis added)



General Test Results – Special Rule for DB/DC combinations

- Treas. Reg. §1.401(a)(4)-12 defines “employee” as follows:
 - With respect to a plan for a given plan year, employee means an employee (within the meaning of section 1.410(b)-9) who benefits as an employee under the plan for the plan year (within the meaning of section 1.410(b)-3). (emphasis added)
- Therefore, each NHCE who receives any DC allocations or any increase in accrued benefit under DB plan must receive gateway
- Where there is 3% nonelective safe harbor therefore all NHCEs in k plan must get gateway



General Test Results – Special Rule for DB/DC combinations

- A participant's aggregate normal allocation rate (ANAR) is the sum of his "allocation rate" and his "equivalent normal allocation rate"
- Allocation rate and equivalent normal allocation rate are determined under Treas. Reg. §§1.401(a)(4)-2(c)(2) and 1.401(a)(4)-8(c)(2), respectively
- Treas. Reg. §1.401(a)(4)-9(b)(2)(ii)(A)



General Test Results – Special Rule for DB/DC combinations

- A participant's allocation rate is the sum of the employer contributions and forfeitures allocated to his/her account under the employer's defined contribution plan(s), expressed as a percentage of plan year compensation



General Test Results – Special Rule for DB/DC combinations

- A participant's equivalent normal allocation rate is the “actuarial present value” of the increase in the participant’s accrued benefit under the employer’s defined benefit plan(s), expressed as a percentage of plan year compensation
- The actuarial present value of the increase in the participant’s accrued benefit is determined using a standard interest rate and a standard mortality table
- Treas. Reg. §1.401(a)(4)-8(c)(2)(ii)



General Test Results – Special Rule for DB/DC combinations

- HCE 1 DC allocation rate:
$$- 32,500/245,000 = 13.27\%$$



General Test Results – Special Rule for DB/DC combinations

- HCE 1 equivalent normal allocation rate:
 - Increase in accrued benefit \$ 1,625.77
 - Age 65 APR (71 GAM 8.5%) 94.7986
 - Value of benefit at TA 154,121
 - PV age (60) at 8.5% 102,497
 - Compensation 245,000
 - Eq. normal allocation rate 41.84%
- Not based on contribution credit of \$183,500



General Test Results – Special Rule for DB/DC combinations

- ANAR for HCE 1:
 - HCE 1 DC allocation rate 13.27%
 - Eq. normal allocation rate 41.84%
 - ANAR 55.11%
- Gateway lesser of
 - 11% of 414(s) comp. or
 - 7.5% of 415 comp.
 - Comps same in our case so gateway = 7.5%
 - Each NHCE above receiving PS allocation of 7%; need additional .5% from DB or higher PS cont



General Test Results – Special Rule for DB/DC combinations

- In determining ANARs, may treat each NHCE who benefits under DB plan as having an equivalent normal allocation rate equal to average equivalent normal allocation rate for all NHCEs benefiting under DB plan
 - Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(D)(3)
- Math will show that average NHCE .93%
 - So each NHCE ANAR = 7% + .93% = 7.93%
 - i.e., each over 7.5% so gateway passed



Coordination issues with PS plan

- Tested together for 410b? If yes, then tested together for all other purposes:
 - 401a4
 - Benefits, rights and features
 - Problems with life insurance in the CB plan –is it possible for this be non-discriminatory?
- Both plans must have the same plan year for them to tested together.



Corrective amendments

- 1.401a4-11g allows a corrective amendment to pass testing within 9 ½ months after year end
- A corrective amendment to pass a26 that cherry picks the youngest people to pass may blow the similarly situated employee rule for CB plans ...do it by ascending comp or some other bona fide business criteria instead.



Document Issues

- Define tiers and credits carefully to avoid inadvertent issues
- Consistent HCE definition between DB and PS documents.
- TH minimum defined consistently in both documents.
- Use individual allocation groups in PS plan, no last day, 1 hour for a PS allocation. Avoids corrective amendments to the PS plan.



The End

- Questions?
- norman@summitbenefit.com
- Thanks to Kevin Donovan for letting me use his testing slides and example.



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