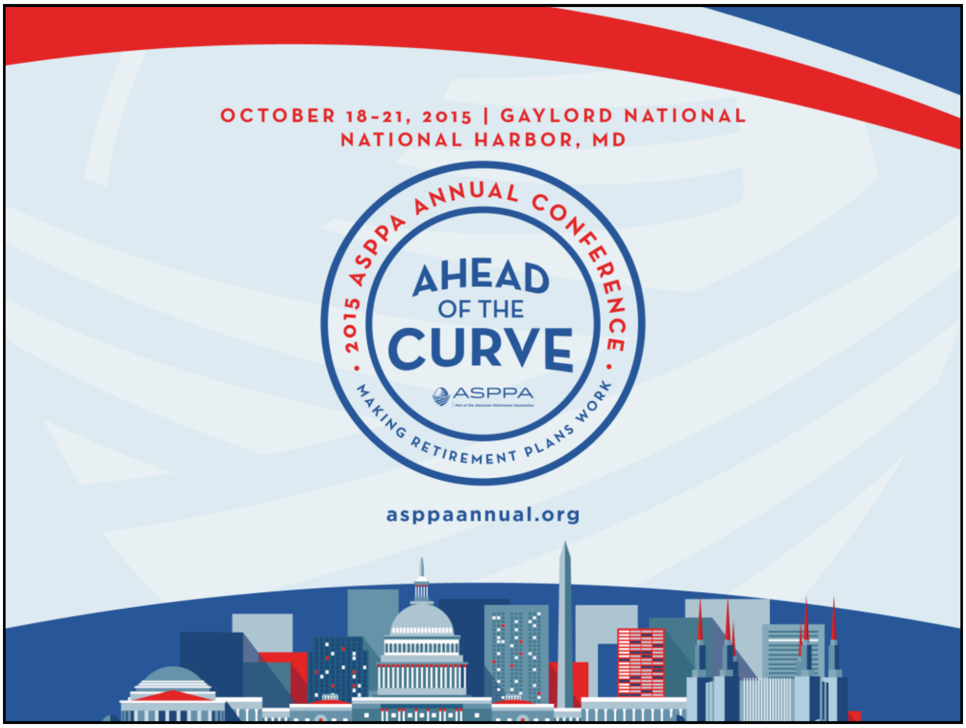

Workshop 56: 401(k)/Cash Balance 101 for DC Administrators

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What is a DC Plan?

- Defined Contribution (DC) plan
- Plan Sponsor promises to make annual contributions to each participant's account
- The *contribution* is defined; there is no guaranteed benefit
  - E.g. 3% of compensation will be deposited to participant's account each year

What is a DB Plan?

- Defined Benefit (DB) plan
- Plan Sponsor promises to pay a specific *benefit* at retirement
- Benefit is determined according to the formula in the plan document
  - E.g. 10% of average compensation times years of service (subject to a maximum of 10 years)

What is a DB Plan?

- Benefit is an annuity payable at Normal Retirement Age (e.g. age 62 or age 65)
  - Payable for the lifetime of the participant
  - Optional forms (e.g. lump sum) available

Comparison of DB and DC Plans

Defined Benefit (including Cash Balance)	Defined Contribution
Stated benefit	Stated contribution
Guaranteed benefit	Account balance – subject to investment performance
Required employer contribution	Flexible employer contribution (except when needed to pass testing)
Trustee directed investments	May allow for participant investment direction
Must have annuity distribution options	May allow for lump sum only distributions
Top heavy requirement: 2% accrual	Top heavy requirement: 3% contribution
Maximum *benefit* at age 62: lesser of \$210,000 and 100% of average comp paid as an annual life annuity	Maximum annual *contribution*: lesser of \$53,000 (+ \$6,000 catch-up if age 50+) and 100% of compensation

What is a CB Plan?

- Cash Balance (CB) plan
- A DB plan that looks like a DC plan (aka "hybrid" plan)
- Plan Sponsor promises to ***credit*** annual amounts ***and interest*** to each participant's ***hypothetical*** account
  - Compare against DC plan: Plan Sponsor promises to make annual contributions to each participant's account
  - E.g. $100,000 credit plus 5% interest annually

What is a CB Plan?

- Hypothetical account balance
  - Paper account only
  - Plan assets not actually divided into individual accounts
- Hypothetical account balance is credited with
  - Contribution credits (aka pay credits); and
  - Interest credits at rate defined in plan document
- Benefit is not based on actual asset returns

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What is a CB Plan?

- Example

Age	Beginning Balance	Interest Credit	Cash Balance Credit	Ending Balance
50	0	0	100,000	100,000
51	100,000	5,000	100,000	205,000
52	205,000	10,250	100,000	315,250
53	315,250	15,763	100,000	431,013
54	431,013	21,551	100,000	552,564
55	552,564	27,628	100,000	680,192
56	680,192	34,010	100,000	814,202
57	814,202	40,710	100,000	954,912
58	954,912	47,746	100,000	1,102,658
59	1,102,658	55,133	100,000	1,257,791

What is a CB Plan?

- A cash balance plan is <u>not</u> a profit sharing plan
  - Cash balance contributions are not discretionary
  - Cash balance plans must be "permanent"
    - Client must commit to 3-5 year of contributions, subject to change in business conditions

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Cash Balance FAQs

Question	Answer
Can multiple owners have different CB credits?	Absolutely.
Does a CB plan have to cover everyone?	No. However, they must provide "meaningful benefits" to the lesser of: -40% of eligible employees; or -50 employees
What may be used for the interest crediting rate defined in the plan document?	Final regulations allow the following: -Fixed rate up to 6% -Treasury yields + fixed basis points -Segment rates used for funding -Investment return on plan assets -Investment return on mutual funds -Annuity contract rates

Cash Balance FAQs

Question	Answer
Can the interest crediting rate be changed?	Yes. However, the prior rate must be protected on balances as of the date of the change.
Can the cash balance credits be changed?	Usually. However, I recommend not changing frequently due to the "definitely determinable benefit" requirement.
When do I need to amend the plan to change cash balance credits?	If increasing the benefit, then before the end of the plan year in which the increase occurs. If decreasing the benefit, then before that credit is earned for the year (normally before working 1,000 hours)

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Cash Balance FAQs

Question	Answer
How long do I need to keep the plan?	In general, the plan should be in place 3-5 years before terminating it.

Why CB Over Traditional DB?

- A CB plan is easier to understand than a traditional DB plan
  - CB benefits are determined as a lump sum
  - Traditional DB benefits are determined as a life annuity
- It's easier to design more equitable benefits for multiple owners under a CB plan than a DB plan
  - Equal pay credit for all owners; or
  - Owners receive varying amounts based on age, compensation, and/or other factors
- Lump sums aren't subject to interest rate swings as in a DB plan

Why a DB (or CB) Plan?

The contribution limits for a DB plan far exceed those for a DC plan

Age	Defined Contribution	Cash Balance
40	53,000	87,000
45	53,000	112,000
50	59,000	143,000
55	59,000	184,000
60	59,000	236,000

- Cash balance amounts may differ based on actuarial equivalence, Normal Retirement Age, and any early retirement subsidies
- Cash balance amounts can be sustained for approximately 10 years
- Assumes adequate compensation to support the maximum dollar limit

Maximum CB Credits

- The §415 limit indirectly determines the maximum CB credit
- The §415 limit for 2015 is $210,000, which is the maximum annual annuity payable at age 62
  - Prorated for fewer than 10 years of participation
  - Assumes 100% of average compensation limit does not apply

Age	415 $ Limit at Age 62	Equivalent Annuity at Current Age	Maximum Lump Sum at Current Age	1/10 of Maximum Lump Sum
40	210,000	53,000	875,000	87,000
45	210,000	70,500	1,122,000	112,000
50	210,000	95,000	1,439,000	143,000
55	210,000	130,000	1,846,000	184,000
60	210,000	182,000	2,368,000	236,000

§401(a)(26): Minimum Participation

- Under §401(a)(26), a <u>standalone</u> DB plan (or CB plan) must provide "meaningful benefits" to lesser of:
  - 40% of the non-excludable employees; or
  - 50 employees
- It doesn't matter if benefiting participants are HCEs or NHCEs

§401(a)(26): Minimum Participation

- What is a "meaningful benefit"?
  - Regulations provide no bright line test to determine if benefits being provided are meaningful
  - Instead say based on "facts and circumstances"
  - 0.5% accrual rate (<u>not</u> CB credit) is considered "meaningful"

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§401(a)(26): Minimum Participation

- Accrual Rate
  - Increase in benefit ÷
  - Testing service ÷
  - Testing compensation
- For a CB plan, the increase in benefit is the cash balance credit projected to NRA and converted to an annuity

§401(a)(26): Minimum Participation

- Example:
  - Given
    - \$600 cash balance credit
    - 5% interest crediting rate
    - Compensation = \$40,000
    - Normal Retirement Age = 62
    - Monthly annuity conversion factor at age 62 = 156.59474
  - Accrual rate for participant age 30
    - Accrual = \$600 * $(1.05)^{32}$ ÷ 156.59474 = \$18.26
    - Accrual rate = \$18.26 * 12 ÷ \$40,000 = 0.54% → meaningful
  - Accrual rate for participant age 40
    - Accrual = \$600 * $(1.05)^{22}$ ÷ 156.59474 = \$11.21
    - Accrual rate = \$11.21 * 12 ÷ \$40,000 = 0.33% → not meaningful

§401(a)(26): Minimum Participation

Age	Cash Balance Credit as a % of Pay 1.50%	2.00%	2.50%	3.00%
30	0.54%	0.73%	0.91%	1.09%
31	0.52%	0.69%	0.86%	1.04%
32	0.49%	0.66%	0.82%	0.99%
33	0.47%	0.63%	0.78%	0.94%
34	0.45%	0.60%	0.75%	0.90%
35	0.42%	0.57%	0.71%	0.85%
36	0.40%	0.54%	0.68%	0.81%
37	0.38%	0.51%	0.64%	0.77%
38	0.37%	0.49%	0.61%	0.74%
39	0.35%	0.47%	0.58%	0.70%
40	0.33%	0.44%	0.56%	0.67%
41	0.32%	0.42%	0.53%	0.64%
42	0.30%	0.40%	0.50%	0.60%
43	0.29%	0.38%	0.48%	0.58%
44	0.27%	0.36%	0.46%	0.55%
45	0.26%	0.35%	0.43%	0.52%

- Accrual rates may vary based on actuarial equivalence and Normal Retirement Age

Why a 401(k)/CB Combo Plan?

- Often clients already have a 401(k) plan; the CB plan is an add-on
- A CB plan substantially benefiting the owner(s) will not pass nondiscrimination testing on a standalone basis
- Profit sharing plans have more funding flexibility than cash balance plans
- For testing purposes, profit sharing contributions provide more valuable benefits than cash balance credits (we'll discuss later)

Combo Plan Requirements

- §410(b) and regulations (coverage) require a certain percentage of Non-Highly Compensated Employees (NHCEs) to benefit from the plan
- §401(a)(4) and regulations (nondiscriminatory benefits) require that benefits do not favor Highly Compensated Employees (HCEs) "too much"
- §404(a)(7) (combined plan limit) places an additional limit on the aggregate deductions when the employer sponsors a combo DB/DC plan

Combo Plan Requirements

- Permissive aggregation (1.410(b)-7(d))
  - Plans (or part of plans) must not be mandatorily disaggregated
  - Plans must have the same plan year (not just the same plan year end)
  - Test as a single plan
    - Single coverage test
    - Single 401(a)(4) test

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Combo Plan Requirements

- Mandatory disaggregation (1.410(b)-7(c))
  - 401(k) plans must be separated from non-401(k) plans
  - 401(m) plans must be separated from non-401(m) plans
  - ESOPs must be separated from non-ESOPs
  - Plans covering employees of a SLOB, if such employees are treated as excludable
  - Plans covering union employees must be separated from plans covering non-union employees
  - If the plan covers employees of more than one employer (i.e. a multiple employer plan), those different employers are separated

Combo Plan Requirements

- Special rule for the Average Benefits Percentage Test (ABPT) (1.410(b)-7(e)): <u>For purposes of ABPT only</u>, the plan being tested <u>must</u>:
  - Include 401(k) plans, 401(m) plans, and ESOPs;
  - Exclude union plans and plans of other QSLOBs (if doing ABPT within a QSLOB); and
  - Use plan years ending in the same calendar year

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Combo Plan Requirements

- Example
  - Employer maintains 2 plans:
    - 401(k) profit sharing plan with 12/31 plan year end
    - Cash balance plan with 6/30 plan year end
  - Plans for testing (other than ABPT)
    - 401(k) portion is disaggregated
    - Profit sharing plan and cash balance plan may not be aggregated because they have different plan years
  - Plans for testing the ABPT
    - All plans are aggregated

Combo Plan Requirements

- Example
  - Employer maintains 2 plans:
    - 401(k) profit sharing plan with 12/31 plan year end
    - NEW cash balance plan with 12/31 plan year end
  - Plans for testing (other than ABPT)
    - If effective date of cash balance plan is 1/1, then plans may be aggregated
    - If effective date of cash balance plan is NOT 1/1, then plans may not be aggregated because they have different plan years
  - Plans for testing the ABPT
    - All plans are aggregated, since they all have 12/31 plan year ends

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Highly Compensated Employees

- Under §414(q), a HCE is an employee who:
  - During the current or prior plan year owned more than 5% of the employer; or
  - Earned in excess of a certain amount in the prior year
    - Adjusted annually for cost of living
    - Use the limit for the lookback year – e.g. use $115,000 in 2014 for determining HCE status for 2015
    - Use the limit in effect at the beginning of the plan year – e.g. for determining HCE status for July 1, 2014 through June 30, 2015 status, use the 2013 HCE compensation limit

Highly Compensated Employees

- Under §414(q)(3), the employer may make a top paid group election
  - Restrict the compensation test to only those employees who:
    - Earned in excess of the HCE compensation limit in the prior year; and
    - Were one of the top 20% highest paid employees for the lookback year
  - Notice 97-45
    - Same election must apply for all plans of the employer that begin with or within the same calendar year
    - Election must be stated in the plan document only if the plan document contains the definition of HCE

Highly Compensated Employees

What if DC plan made a top paid election but DB plan did not (or vice-versa)? From 2008 ASPPA Annual Conference:

Question	Answer
Do the plans need to be amended during the first year in which they were both in existence to fix the inconsistency, or can it be done retroactively in the following year?	Rev. Proc. 2007-44: You need to amend the plan by the end of the plan year in which the plan amendment is effective You may have to do it before participants accrue benefits or contributions to avoid a 411(d)(6) cutback. For example, if the amendment made someone an HCE who was not previously, and that person got a smaller contribution allocation, that would be a cutback

Highly Compensated Employees

What if DC plan made a top paid election but DB plan did not (or vice-versa)? From 2008 ASPPA Annual Conference:

Question	Answer
If the plans pass testing regardless of whether they use the top paid group, is there still a problem with inconsistent plan documents?	Yes, because you cannot follow both documents and do the testing correctly
Is this correctible under the Self-Correction Program?	No

§410(b): Coverage

- §410(b) requires that either:
  - Plan satisfies the Ratio Percentage Test;
  - Plan satisfies the Average Benefits Test;
  - Plan does not benefit any HCEs; or
  - The employer has no non-excludable NHCEs

§410(b): Coverage

- An employee is benefiting only if the employee actually:
  - Accrues an additional benefit in a DB plan; or
  - Receives an allocation of contributions or forfeitures in a DC plan
- Special rule for 401(k)/(m) plans:
  - Employee is considered benefiting if eligible to participate
  - It does not matter if employee actually makes a deferral or receives an employer match

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Ratio Percentage Test

- To satisfy the "Ratio Percentage Test", a plan must have a "Ratio Percentage" of at least 70%
  - Ratio Percentage = NHCE ratio % ÷ HCE ratio %
    - NHCE ratio % = number of NHCEs benefiting under the plan ÷ total number of non-excludable NHCEs
    - HCE ratio % = number of HCEs benefiting under the plan ÷ total number of non-excludable HCEs
  - For this purpose, the amount someone is benefiting is irrelevant

Average Benefits Test

- To satisfy the Average Benefits Test (ABT), the plan must pass both:
  - Nondiscriminatory classification test; and
  - Average Benefits Percentage Test (ABPT)
    - Average benefits for NHCEs must be at least 70% of the average benefits for HCEs
    - Include 401(k) plans, 401(m) plans, and ESOPs
    - Look at all plans of the employer with plan years <u>ending in the same calendar year</u> (not just those with the same plan year)
  - Few small plans rely on the ABT to pass §410(b)
  - Small plans commonly need to pass ABPT to pass §401(a)(4)

§401(a)(4): Nondiscrimination

- Nondiscrimination rules under§401(a)(4) require that contributions or benefits do not discriminate in favor of HCEs
- The following must get tested:
  - Amount of benefits;
  - Benefits, rights, and features (BRFs);
  - Plan amendments; and
  - Vesting, service crediting

§401(a)(4): Nondiscrimination

- To pass §401(a)(4), a plan must:
  - Satisfy §401(k) in case of a 401(k) plan;
  - Satisfy §401(m) in case of a 401(m) plan;
  - Not benefit any HCEs;
  - Have no non-excludable NHCEs;
  - Have a safe harbor formula (including use of permitted disparity); or
  - Satisfy the General Test

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Combined Plan Testing

- DC plans may be aggregated with DB plans and tested on a benefits basis if:
  - The aggregated plans are primarily defined benefit in nature (i.e. the percentage of NHCEs benefiting primarily in the defined benefit plan is at least 50%);
  - The aggregated plans consist of Broadly Available Separate Plans (will likely never use);
  - The aggregated plans provide a specified minimum allocation ("Gateway"); or
  - The lowest NHCE allocation rate is 7.5% or greater based on §415(c) compensation

Gateway Test

- The Gateway Test is satisfied if:
  - The highest HCE allocation rate is less than 15% and is no more than 3 times the lowest NHCE allocation rate;
  - The highest HCE allocation rate is 15% to 25%, and the lowest NHCE allocation rate is 5%; or
  - The highest HCE allocation rate exceeds 25%, and the lowest NHCE allocation rate is at least 5% plus 1% for each 5% increment (or portion thereof) that the highest HCE allocation rate exceeds 25%

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Gateway Test

- Must use a definition of compensation under §414(s)
- May use compensation from date of participation
- May use the average Equivalent Allocation Rate of all NHCEs benefiting under the DB plan, rather than using the individual rates of the NHCEs

Gateway Test

- Each NHCE who receives <u>any</u> DC allocations or <u>any</u> increase in accrued benefit under DB plan must receive Gateway
  - Non-excludable employees must get Gateway if:
    - They get a 3% nonelective safe harbor contribution → regardless of hours or end of year employment status
    - They get a minimum top heavy contribution
  - **As a result, the profit sharing contributions to NHCEs are <u>not</u> discretionary while the DB plan exists**
  - Matching contributions do <u>not</u> count toward Gateway

Top Heavy

	Defined Benefit	Defined Contribution
Must the participant work ≥ 1,000 hours?	Yes	No
Must the participant work on the last day of the plan year?	No	Yes

- Terminated participants with < 1,000 hours need no top heavy minimum in either plan
- Anyone who participates in both plans with ≥ 1,000 hours and employed at year-end will need the 5% top heavy minimum from the DC plan
- Anyone (e.g. non-key HCEs) who does not participate in the DB plan only needs the 3% top heavy minimum from the DC plan

Normal Allocation Rate

- Normal Allocation Rate (NAR)
  - DC plan: contribution ÷ compensation
  - CB plan: <u>NOT</u> CB credit ÷ compensation
    - Determine the increase in the accrued benefit over the plan year
    - Calculate the present value of the annuity at testing age
      - Use standard interest rate (i.e. 7.5% to 8.5%)
      - Use standard mortality table listed in the regs
    - Discount PV to current age using standard interest rate (i.e. 7.5% to 8.5%)
    - Divide by Plan Year Compensation

Normal Allocation Rate

- Example
  - Given:
    - Employee age: 60
    - Testing age: 65
    - Compensation: $265,000
    - Profit sharing contribution (including 3% safe harbor): $35,000
    - Cash balance credit: $125,000
    - Standard Assumptions used: 8.5% and 71 GAM male mortality
    - Annuity conversion factor at age 65 using Standard Assumptions: 94.79854
    - Annuity conversion factor at age 65 using plan's actuarial equivalence: 141.52905

Normal Allocation Rate

- Example (continued)
  - NAR for profit sharing plan = 13.21%
    - $35,000 ÷ $265,000 = 13.21%
  - NAR for cash balance plan = 23.79%
    - Accrual = $125,000 * $(1.05)^5$ ÷ 141.52905 = $1,127.23
    - Present value at age 65 using Standard Assumptions: $ 1,127.23 * 94.79854 = $106,860
    - Discount to age 60 using 8.50%: $106,860 ÷ $(1.085)^5$ = $71,067
    - Divide by compensation: $71,067 ÷ $265,000 = 26.82%
  - Aggregate allocation rate = 13.21% + 26.82% = 40.03%
  - Therefore, lowest NHCE allocation rate must be lesser of 9.00% of §414(s) compensation or 7.50% of §415(c) compensation

General Test

- For each HCE tested on a benefits basis, a rate group is defined that includes all employees with the same or higher aggregate normal accrual rate **and** same or higher aggregate most valuable accrual rate
- Each rate group must satisfy §410(b) by either:
  - Passing the Ratio Percentage Test (i.e. each rate group has a Ratio Percentage of at least 70%); or
  - Passing a modified Average Benefits Test

Normal Accrual Rate

- Normal Accrual Rate (NAR)
  - Increase in normal retirement benefit over the Measurement Period ÷
  - Testing Service ÷
  - Testing Compensation
- For today's discussion, we will use:
  - Measurement Period = current year
  - Testing service = 1
  - Testing compensation = plan year compensation
  - No normalization or imputed permitted disparity

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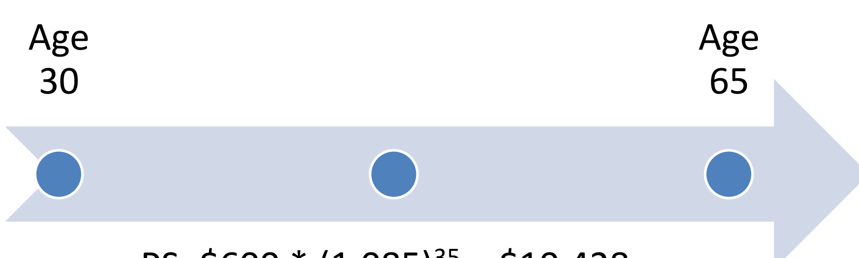
Normal Accrual Rate

- When testing on a benefits basis, the contribution (or cash balance credit) is:
  - Projected to testing age (assume age 65),
    - Profit sharing contributions are projected using an annual return of 7.5%-8.5%
    - Cash balance credits are projected using the interest crediting rate (assume 5%)
  - Converted to an annuity, then
  - Calculated as a % of pay

Normal Accrual Rate



PS: $600 * $(1.085)^{35}$ = $10,428

CB: $600 * $(1.05)^{35}$ = $3,310

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Testing Compensation

- Plan year compensation may limit compensation to the period of participation
- Testing Compensation is the same for both the DB and DC NARs, since it's one aggregated "plan"

Testing Compensation

- Example
  - Employer maintains 2 calendar year plans that are permissively aggregated for testing:
    - 401(k) profit sharing plan that excludes pre-participation comp
    - Cash balance plan that includes pre-participation comp
  - If participant enters both plans on 7/1, you may use 7/1-12/31 compensation for testing
  - If participant enter one plan on 1/1 and the other plan on 7/1, then you must use full year's compensation for testing

Normal Accrual Rate

- Example
  - Given:
    - Employee age: 60
    - Testing age: 65
    - Compensation: $265,000
    - Profit sharing contribution (including 3% safe harbor): $35,000
    - Cash balance credit: $125,000
    - Standard Assumptions used: 8.5% and 71 GAM male mortality
    - Annuity conversion factor at age 65 using Standard Assumptions: 94.79854
    - Annuity conversion factor at age 65 using plan's actuarial equivalence: 141.52905

Normal Accrual Rate

- Example (continued)
  - NAR for profit sharing plan = 2.51%
    - Project allocation to age 65 using 8.50%: $35,000 * $(1.085)^5$ = $52,628
    - Convert to a straight life annuity at age 65: $52,628 ÷ 94.79854 = $555.16 monthly = $6,661.92 annually
    - Divide by compensation = $6,661.92 ÷ $265,000 = 2.51%
  - NAR for cash balance plan = 23.79%
    - Project allocation to age 65 using 5.0%: $125,000 * $(1.05)^5$ = $159,535
    - Convert to a straight life annuity at age 65: $ 159,535 ÷ 141.52905 = $1,127.23 monthly = $13,526.76 annually
    - Divide by compensation = $13,526.76 ÷ $265,000 = 5.10%%
  - Aggregate NAR = 2.51% + 5.10% = 7.61%

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Most Valuable Accrual Rate

- Most Valuable Accrual Rate (MVAR)
  - The Qualified Joint and Survivor Annuity (QJSA) is the most valuable annuity
  - Look at the QJSA associated with the accrued benefit potentially payable in any future plan year
  - Applies to DB plans only
    - For DC plans, MVAR = NAR
  - Calculation is beyond the scope of this session

Modified Average Benefits Test

- To pass the modified ABT, each rate group must pass both:
  - Average Benefits Percentage Test; and
    - Average EBAR for NHCEs must be at least 70% of the average EBAR for HCEs
    - May test on a contributions or benefits basis, but it must be consistent for all plans in the testing group
    - All plans are taken into account, including 401(k) elective deferrals and 401(m) matching contributions
    - EBAR used for ABPT =
      - EBAR used for Rate Group Testing +
      - EBAR for elective deferrals (ignoring catch-up) +
      - EBAR for matching contribution

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Modified Average Benefits Test

– Nondiscriminatory classification test
  - Each rate group is deemed a reasonable classification (i.e. no reasonable classification requirement)
  - Ratio Percentage must be greater than or equal to the lesser of:
    – The midpoint between the plan's safe harbor and unsafe harbor percentages; and
      » NHCE concentration percentage (CP) = % of non-excludable employees who are NHCEs → rounded down to the nearest whole %
      » Safe harbor percentage = 50% - ¾ (CP – 60%)
      » Unsafe harbor percentage = 40% - ¾ (CP – 60%)
    – The plan's Ratio Percentage

Modified Average Benefits Test

- Example
  – 3 non-excludable NHCEs, 1 non-excludable HCE
  – CP = 3 ÷ 4 = 75%
  – Safe harbor percentage = 50% - ¾ (75% – 60%) = 38.75%
  – Unsafe harbor percentage = 40% - ¾ (75% – 60%) = 28.75%
  – Midpoint = 33.75%
  – A rate group satisfies the nondiscriminatory classification test portion of the modified ABT if it's ratio percentage is greater than or equal to 33.75%

Rate Groups

- A rate group exists for each HCE
- A rate group includes all employees with
  - Same or higher Normal Accrual Rate (NAR); and
  - Same or higher Most Valuable Accrual Rate (MVAR)

Rate Groups

Employee	HCE	Age	Comp	Cash Balance	Profit Sharing	NAR	MVAR	NAR: / MVAR:	7.61% / 8.52%
HCE 1	Y	60	265,000	125,000	35,000	7.61%	8.52%		1
NHCE 1		40	40,000	600	3,000	7.73%	8.24%		*
NHCE 2		30	40,000	600	3,000	17.20%	18.58%		1
NHCE 3		20	40,000	600	3,000	38.44%	41.93%		1

Number of HCE's in group:	1
Total number of HCE's:	1
Percent of HCE's:	100.00%
Number of NHCE's in group:	2
Total number of NHCE's:	3
Percent of NHCE's:	66.67%
Ratio percent:	66.67%
	PASS

ABPT:	PASS
NHCE concentration:	75.00%
Safe harbor:	38.75%
Unsafe harbor:	28.75%
Midpoint:	33.75%

- Note that if the rate group included only 1 NHCE, then the ratio percent would be 33.33% and the plan wouldn't pass

§404(a)(7): Combined Plan Limit

- Under §404(a)(7), there is a combined plan maximum deductible contribution
  - The DB + PS contributions are essentially limited to 31% of compensation
- This limit applies when:
  - Employer contributes to both DB and DC plan for same tax year; and
  - At least one employee is a beneficiary in both plans
- This limit does not apply when:
  - The DB plan is covered by the PBGC; or
  - The PS contribution is no more than 6% of compensation

PBGC-Covered Plans

- Pension Benefit Guaranty Corporation (PBGC) required covered plans to pay premiums each year
  - Flat rate premium of $57 per participant (in 2015)
  - Variable rate premium based on funding level ($0 if overfunded)
- Only DB plans (including CB plans) are covered
- Plans exempt from coverage are generally owner-only plans and "professional service employers" with fewer than 26 active participants:
  - Exempt: doctors, attorneys, CPAs, actuaries, etc.
  - Not exempt: RIAs, real estate agents, insurance agents, etc.

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§404(a)(7): Combined Plan Limit

- Example
  - Eligible compensation = $385,000
  - 31% of eligible compensation = $119,350
  - Employer-provided contribution
    - Profit sharing (including 3% safe harbor): $44,000
    - Cash balance: $126,800
    - Total: $170,800
  - Test result
    - If PBGC-covered, then PASS
    - If not PBGC-covered, then FAIL
      - To correct, it's usually best to limit PS contribution to 6% of comp

Good Candidates for Combo Plan

- Owner(s) with high, consistent income looking to defer large amounts of $ for retirement
- Older owner(s) with younger employees
  - Best if average age of owner(s) is at least 10 years older than average age of employees
- Willingness to accommodate required contributions for several years
- Willingness to contribute 7.5%+ of pay on behalf of employees

Case Study

- In this case study, we maximize the owner in both the cash balance and profit sharing plans
- Assume the plan is not PBGC-covered, so the combined plan deduction limit applied
- Part A is an example where the owner is 22.5 years older than the average age of employees
- Part B is an example where the owner is 12.5 years older than the average age of employees

Case Study Part A

				Employer Contributions			Employee Deferrals			
Name	**HCE**	**Age**	**Plan Comp**	Profit Sharing	Cash Balance	Total	401(k)	Catch-Up	Total	**Total**
Owner	Y	50	$265,000.00	$35,000.00	$143,000.00	$178,000.00	$18,000.00	$6,000.00	$24,000.00	$202,000.00
Employee 1		30	$40,000.00	$2,900.00	$500.00	$3,400.00	$0.00	$0.00	$0.00	$3,400.00
Employee 2		25	$40,000.00	$2,900.00	$500.00	$3,400.00	$0.00	$0.00	$0.00	$3,400.00
Total for Owners			**$265,000.00**	**$35,000.00**	**$143,000.00**	**$178,000.00**	**$18,000.00**	**$6,000.00**	**$24,000.00**	**$202,000.00**
Total for Non-Owners			**$80,000.00**	**$5,800.00**	**$1,000.00**	**$6,800.00**	**$0.00**	**$0.00**	**$0.00**	**$6,800.00**
Grand Total			**$345,000.00**	**$40,800.00**	**$144,000.00**	**$184,800.00**	**$18,000.00**	**$6,000.00**	**$24,000.00**	**$208,800.00**

- Average age of employees = 27.5
- Cash balance
  - $143,000 for owner
  - $500 for employees
- 401(k) profit sharing
  - Maximum for owner
  - 7.25% of compensation for employees

Case Study Part B

Name	HCE	Age	Plan Comp	Employer Contributions: Profit Sharing	Employer Contributions: Cash Balance	Employer Contributions: Total	Employee Deferrals: 401(k)	Employee Deferrals: Catch-Up	Employee Deferrals: Total	Total
Owner	Y	50	$265,000.00	$12,300.00	$143,000.00	$155,300.00	$18,000.00	$6,000.00	$24,000.00	$179,300.00
Employee 1		40	$40,000.00	$4,200.00	$700.00	$4,900.00	$0.00	$0.00	$0.00	$4,900.00
Employee 2		35	$40,000.00	$4,200.00	$700.00	$4,900.00	$0.00	$0.00	$0.00	$4,900.00
Total for Owners			**$265,000.00**	**$12,300.00**	**$143,000.00**	**$155,300.00**	**$18,000.00**	**$6,000.00**	**$24,000.00**	**$179,300.00**
Total for Non-Owners			**$80,000.00**	**$8,400.00**	**$1,400.00**	**$9,800.00**	**$0.00**	**$0.00**	**$0.00**	**$9,800.00**
Grand Total			**$345,000.00**	**$20,700.00**	**$144,400.00**	**$165,100.00**	**$18,000.00**	**$6,000.00**	**$24,000.00**	**$189,100.00**

- Average age of employees = 37.5
- Cash balance
  - $143,000 for owner
  - $700 for employees → needed for §401(a)(26)
- 401(k) profit sharing
  - $12,300 for owner → needed for §404(a)(7)
  - 10.50% of compensation for employees → needed for Rate Group Testing
- Employee cost increases from $6,800 to $9,800 when employees are 10 years older

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Coordinating Plan Documents

- Make sure plan years are the same
  - One plan cannot have a short plan year while the other does not
- Make sure HCE elections are the same
  - Top 20% highest paid group
  - Calendar year compensation
- Make sure both plans provide the 5% minimum top heavy contribution in the DC plan

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Coordinating Plan Documents

- Make sure DC plan has individual allocation groups
  - Most pre-approved plans now allow this
  - Avoids pre-determined classes
    - Can give more dollars to lower paid NHCEs without increasing all other NHCEs that would otherwise be in the same class
    - Can give fewer dollars to younger HCEs when they're causing testing issues

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Coordinating Plan Documents

- It would be good to remove the hours or last-day requirement for discretionary profit sharing contributions
  - With individual allocation groups, you can give someone $0 if not needed for testing
  - Unlike a corrective amendment, allocations to non-vested terms are considered in testing

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Coordinating Plan Documents

- If you want to have a safe harbor DC plan, use a 3% nonelective contribution instead of a safe harbor match
  - Remember, the match cannot be considered in the Gateway or Rate Group Test
- With 3% non-elective safe harbor 401(k) plan, exclude HCEs from receiving safe harbor contribution
  - Allow flexibility to give smaller allocations to HCEs
  - Provide allocations to HCEs via profit sharing to the extent possible

Coordinating Plan Documents

- It would be good to have the same entry dates
- It would be good to be consistent about pre-participation compensation
- It would be good to have the same Normal Retirement Age
- It would be good to remove any fail-safe provisions

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Corrective Amendments

- Post year-end amendments may be made to "correct" failed §410(b), § 401(a)(4), or § 401(a)(26) tests
- Amendments may either:
  - Increase benefits for existing participants; or
  - Create benefits for employees that otherwise did not benefit under the plan

Corrective Amendments

- Amendments must meet each of the following requirements:
  - Benefits may not be reduced
  - Amendment must be adopted by the 15th day of the 10th month after plan year-end (i.e. October 15 for calendar year plan)
  - The increase in benefits must satisfy §401(a)(4) on a standalone basis
    - If only NHCE benefits are increased, then this automatically passes
  - The increase must have substance
    - You cannot increase the benefit of a non-vested terminated employee

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Questions?

- Thank you!