Benefits, Rights and Features: Identifying, Testing and Amending

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What We’ll Cover

• What is a Benefit, Right or Feature (BRF)?
• How to apply the nondiscrimination tests to BRFs
• How to correct a nondiscrimination test failure

WHAT IS A BENFIT, RIGHT OR FEATURE?
Benefits, Rights and Features

- Treas. Reg. §1.401(a)(4)-4 provides that BRFs include:
  - Optional forms of benefits
  - Ancillary benefits
  - Other rights and features

What’s an Optional Form of Benefit?

- Distribution alternatives under a plan
- Includes all terms affecting distribution
  - payment schedule
  - timing
  - medium of distribution (e.g., in cash or in kind)
  - election rights
Defined Contribution Examples

- Hardship distribution
- In-service distribution at age 55
- Distribution in cash or in employer stock
- Installments over period of participant’s choice
- Lump sum distribution
- The survivor annuity percentage for a QJSA

Exceptions

- The following do not result in different distribution options:
  - Vesting (which has its own set of testing rules)
  - How the account balance or accrued benefit is determined
  - Different NRAs as long as they are a uniform normal retirement age under 1.401(a)(4)-12
  - Using 417(e) interest rates when required by law
What is an Ancillary Benefit?

- Social security supplements
- Ancillary life and health benefits
- Death benefits in a DC plan
- Pre-retirement death benefits in a DB plan
- Other similar benefits

What are Other Rights and Features?

- “Any right or feature applicable to employees under the plan” other than
  - Optional forms of benefits or ancillary benefits
  - Features specifically excluded in determining if a separate optional form of benefit exists (such as account balance, different NRAs that are uniform)
  - Features which can’t be expected to have meaningful value (administrative details)
- “Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature”
Examples of Rights and Features

- Plan loan provisions
- Right to direct investments
- Right to a particular form of investment (including voting rights)
- Right to make rollover contributions and transfers to and from the plan

More Rights and Features

- Right to make “each rate” of deferrals or after-tax contributions
  - Rate is based on plan’s comp definition (whether or not it is nondiscriminatory)
  - Different rates exist if different comp definitions or other requirements differ
- Ex: Participants may only defer out of “base pay”
More Rights and Features

• Right to “each rate” of matching contributions
  – Rate is based on plan’s comp definition (no similar parenthetical here)
  – Different rates exist if based on years of service or different comp definitions or other requirements differ
  – Determined after ADP/ACP corrections

What about Vesting?

• Vesting provisions aren’t BRF
• They have their own testing rule: 1.401(a)(4)-11(c)
  – Facts and circumstances
  – All statutory vesting schedules are equivalent
    • 6-year graded and 3-year cliff
  – It is deemed to be nondiscriminatory if it would be nondiscriminatory if it were a BRF
How 401(a)(4) Applies

• A plan fails 401(a)(4) unless each and every benefit, right or feature under the plan is available to a nondiscriminatory group of employees
How do you Show a BRF is Nondiscriminatory?

• A BRF is made available in a nondiscriminatory manner only if each BRF satisfies both:
  – Current availability
  – Effective availability

Current Availability in General

• Assume the plan benefits only those participants to whom the BRF is currently available
• Test this imaginary plan for IRC §410(b) coverage
BRF Coverage Test

- Must pass ratio percentage test, or
- Must pass nondiscriminatory classification test (do not run average benefit percentage test)
  - Reasonable objective classification
  - Numerical test
    - Coverage fraction > safe harbor percentage or
    - Coverage fraction > unsafe harbor and facts and circumstances favor employer
- Note: Nondiscriminatory classification test is always a lower threshold than the ratio percentage test

When is a BRF Currently Available?

- Look at current facts and circumstances
  - Compensation
  - Accrued benefit/account balance
  - Position
  - Net worth
  - Etc.
Age and Service

• Disregard age or service conditions only with respect to optional form of benefit or social security supplement
  – Unless time-limited
  – Example: In-service only available if age 55 by December 31, 2015

Examples

• Plan only permits in-service distributions at age 55 with 10 years of service
  – Not discriminatory even if only participant who is currently age 55 with 10 years of service is an HCE
  – Not discriminatory even if no NHCE can have 10 YOS by the time he/she reaches age 55
Age and Service

• No age and service exclusion for rights and features
• Example: Only participants over age 55 with 10 years of service can direct investments
  – Must test for nondiscrimination based on participants who are 55/10 years vs. those who are not 55/10 YOS

Other Disregarded Conditions

• These are disregarded in determining current availability for all BRFs (not just option forms of distributions)
  – Minimum vested percentage
  – Termination of employment
  – Death
  – Disability
  – Hardship
  – Family status
  – Loan default
  – Signing covenant not to compete
  – Ministerial acts
Dollar Limits

- Cash-out rule differences disregarded
- Condition that vested benefit (or present value) be less than or equal to dollar amount is disregarded (e.g., lump-sum only available if account is under $20,000)
- Condition that participant have account balance sufficient to receive $1,000 loan is disregarded (safe harbor)

Example

- Plan requires a $1,000 minimum for participant loans
  - All of the HCEs and only one of the ten NHCEs have accounts over $2,000
  - No need to test
- Assume the same facts except the loan minimum is $5,000
  - Plan will need to be tested each year
  - Plus there is a prohibited transaction issue under ERISA
Example

- Plan provides for mandatory distributions of amounts less than $5,000
  - No need to test
- Plan provides for installment payments only if account is over $20,000
  - Testing is required

Prospective Elimination

- If a BRF is eliminated prospectively but retained for old benefits, current availability is satisfied in the future if it satisfies current availability as of date the BRF is eliminated
  - For a DC plan, must generally include account balance adjusted for gains and losses
  - Permissible to not adjust for gains/losses if BRF is not a 411(d)(6) protected benefit
Example

• DC Plan is amended as of November 1, 2015 to only permit new loans to those with account balances in the plan as of November 1, 2015
• Plan passes current availability as of Nov. 1, 2015
• Retention of loan feature does not need to be tested in future for current availability provided:
  – Loans only based on account as of Nov. 1, 2015
  – Not required to be adjusted for earnings (loans are not 411(d)(6) protected benefits)

Effective Availability

• “Based on all of the relevant facts and circumstances, the group of employees to whom a benefit, right, or feature is effectively available must not substantially favor HCEs.”
• Smell test
Examples

• Plan’s investment policy amended to permit brokerage accounts
  – Annual fee of $500
  – HCE has account balance of $1.2 million
  – All NHCEs have accounts of less than $5,000

• Employer amends plan to add loans
  – Owner takes a loan
  – No notice of availability of loans given to other participants

Example

• Plan provides for in-service distributions if age 50 with 10 years of service
• 100% of HCEs can satisfy the requirement
• Only 20% of NHCEs will be able to satisfy the requirement (hired on or before 40)
  – Satisfies current availability (disregard age/service)
  – Fails effective availability
Special Rules

• Mergers and acquisitions
  – May retain BRF for acquired group of employees if:
    • Satisfy current and effective availability as of date of merger or transfer
    • No changes made to the BRF unless change is to inherently equal or greater value

Example

• Employer A has DB plan offering lump sum
• Employer B acquires Employer A
• Employer B’s plan does not offer lump sum
• Plan A is merged into Plan B and lump sums only offered to those who were in Plan A
• If Plan B satisfies current and effective availability as of date of merger, then it continues to pass in future years
Special Rules

• Frozen participants must be tested separately
• ESOPs do not fail tests solely because of compliance with diversification requirements
• May aggregate BRFs if inherently equal to or greater than BRF being aggregated with it

Permissive Aggregation

• Suppose you have two BRFs
  – BRF 1 is inherently equal to or more valuable than BRF 2 at any time and conditions
  – BRF 1 separately satisfies nondiscrimination
  – Then you can treat BRF 1 and BRF 2 as a single benefit and test them together
• Can apply this rule more than once
Special Rule for DB/DC Combos

• Special rule if BRF other than:
  – Lump sum
  – Loan
  – Ancillary benefit
  – Benefit commencement date (including in-service)

Special Rule for DB/DC Combos

• Satisfy current availability if the BRF is available to all NHCEs in the plan offering that BRF
• Effective availability rules take into account that it may be difficult or impossible to provide a type of benefit under a particular plan type (e.g., in-service at age 59 ½)
Examples

BRF Question 1

- X and Y are in a controlled group
- X sponsors a plan for its employees
  - Participant directed
- Y sponsors a separate plan for its employees
  - Not participant directed
- The plan satisfied coverage only after permissively aggregating the plans

Is there a problem that the plans have different rights?

- Yes, because the plans are tested together the employees must have the same features
- Perhaps, test the combined plan for current availability
- No, because the plans are aggregated only for testing coverage and nondiscrimination in amount
BRF Question 1

Is there a problem that the plans have different rights?

✓ Perhaps, test the combined plan for current availability

Continuing Question 2

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE</td>
<td>6</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>NHCE</td>
<td>20</td>
<td>80</td>
<td>100</td>
</tr>
</tbody>
</table>

- Direct investment:
  - 20% of NHCEs; 60% of HCEs; coverage fraction=33.33%
    - Concentration % = 90%
    - SH = 27.50% - Passes nondiscriminatory classification
- Trustee investment
  - 80% of NHCEs; 40% of HCEs; coverage fraction=200%
    - Passes ratio percentage
- Plan passes current availability for both BRF (needs to test each year)
- Nothing to indicate effective availability issue
BRF Question 2

- X plan allows participants to defer from bonus
- New plan; first year
- ADP-tested using prior year method and 3% rule
  - All HCEs defer 5% of bonus
- 20 out of 50 eligible NHCEs have bonus

Is there a BRF issue because some employees can’t defer?

- No BRF issue since same definition of compensation used for all
- Yes, because some participants can’t defer

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BRF Question 2

Is there a BRF issue because some employees can’t defer?

- ✔ No BRF issue since same definition of compensation used for all
  - But EEs who can’t defer aren’t benefiting for purposes of coverage
Facts for Questions 3 - 5

• X maintains both a DB and a DC plan
  – Some are in just the DB plan
  – Some are in just the DC plan
  – Some are in both
• The two plans are combined for coverage and nondiscrimination

BRF Question 3

• The DC plan allows in-service distributions at age 59 1/2; the DB at age 62

Do we need to test for BRF?

□ Yes, because different optional forms of benefit may result from differences in terms relating to the timing, commencement, or the portion of the benefit to which the distribution alternative applies; DB/DC current availability exception doesn’t apply
□ No because both plans allow in-service distributions
BRF Question 3

• The DC plan allows in-service distributions at age 59 1/2; the DB at age 62

Do we need to test for BRF?

✔ Yes, because different optional forms of benefit may result from differences in terms relating to the timing, commencement, or the portion of the benefit to which the distribution alternative applies; DB/DC current availability exception doesn’t apply

BRF Question 4

• The DC plan allows participant loans; the DB does not

Do we need to test for BRF?

☐ No, because loan provisions are not a “benefit”

☐ Yes; loan provisions are a right or feature; DB/DC current availability exception doesn’t apply
BRF Question 4

Do we need to test for BRF?

✓ Yes; loan provisions are a right or feature; DB/DC current availability exception doesn’t apply

• Note: Typically the DC plan will have more NHCEs than the DB plan, and thus it may well pass

BRF Question 5

• The DC plan allows participant-direction of investment; the DB cannot

Do we need to test for BRF?

☑ No, the plans are exempt because it is impossible for the DB plan to permit directed investments because participants do not have accounts; DB/DC exception applies

☑ Yes; no exemption applies
BRF Question 5

Do we need to test for BRF?

✓ Yes; no exemption applies

• The inability of the DB plan to have directed investments is a factor taken into account only in determining effective availability

Example: Match Rates

<table>
<thead>
<tr>
<th>Group</th>
<th>Match rate</th>
<th>HCE</th>
<th>NHCE</th>
<th>Cov. Fraction</th>
</tr>
</thead>
<tbody>
<tr>
<td>5+ YOS</td>
<td>100%</td>
<td>6</td>
<td>20</td>
<td>26.66%</td>
</tr>
<tr>
<td>0-4 YOS</td>
<td>50%</td>
<td>2</td>
<td>60</td>
<td>240%</td>
</tr>
<tr>
<td>No deferral</td>
<td>0%</td>
<td>0</td>
<td>20</td>
<td>---</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>8</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

• X has a 401(k) plan with matching contributions based on YOS
  – Concentration % = 90%
  – SH = 27.5%; UnSH = 20%

• Plan must test BRF for match rate as well as pass ACP test (one ACP test for plan)
  – 100% rate is in facts and circumstances range
Example: Combine Match Rates

<table>
<thead>
<tr>
<th>Group</th>
<th>Match rate</th>
<th>HCE</th>
<th>NHCE</th>
<th>Cov. Fraction</th>
</tr>
</thead>
<tbody>
<tr>
<td>7+ YOS</td>
<td>100%</td>
<td>4</td>
<td>40</td>
<td>100%</td>
</tr>
<tr>
<td>4-6 YOS</td>
<td>75%</td>
<td>6</td>
<td>10</td>
<td>13.33%</td>
</tr>
<tr>
<td>0-3 YOS</td>
<td>50%</td>
<td>0</td>
<td>50</td>
<td>Pass</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>10</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

- X has a 401(k) plan with matching contributions based on YOS, up to 4% of comp
- Match rates shown above
- Plan must test BRF for match rate as well as pass ACP test (one ACP test for plan)
  - 100% match inherently more valuable than 75%
  - Combine 100% and 75% groups for coverage fraction of 50%
    - Passes because highest SH% is 50%

"I haven't failed. I've just found 10,000 ways that won't work."
Thomas Edison
EPCRS

• “Demographic Failure” means a failure to satisfy the requirements of §§ 401(a)(4), 401(a)(26), or 410(b) that is not an Operational Failure or an Employer Eligibility Failure

• The correction of a Demographic Failure generally requires a corrective amendment to the plan adding more benefits or increasing existing benefits (see § 1.401(a)(4)-11(g))

1.401(a)(4)-11(g)

• 1.401(a)(4)-11(g) permits an amendment to be treated as effective as of the first day of the PY to which it applies

• For current availability, a corrective amendment may make the BRF available to participants with whom it was not previously available
Conditions

• No reduction of benefits
• Amendment must generally be effective for all purposes as of first day of PY
  – Exception if a BRF failure – may be effective as date of the adoption
• Must be adopted within 9 ½ months after end of PY to which it applies

Conditions for BRF Corrections

• May not be a pattern of amendments to correct repeated failures
• Provisions must remain in effect through end of PY beginning after the date of the amendment
Conditions for BRF Corrections

• Corrective amendment must either:
  – Eliminate the BRF – if permitted by 411(d)(6)
  – Expand group to whom the BRF is available to satisfy nondiscriminatory classification test of 410(b) with a ratio % greater than or equal to lesser of:
    • The plan’s applicable safe harbor %
    • The ratio % of the plan

Must Have Substance

• General rule is to disregard those who terminated in prior plan year and who will not benefit from the amendment
• Exception for BRF correction – only take into account those who will be entitled to the BRF after the date of the amendment
  – Deemed satisfied if you apply to all participants
Example

• Plan covers Division A and Division B
• Only Division A can direct investments
• In 2014 BRF passed 410(b)
• In 2015, due to attrition, it fails 410(b)
• Plan can be amended by 10/15/16 to expand ability to direct investments (or eliminate the provision)

Example (continued)

• If plan is amended after 12/31/15 then provision must remain in effect through end of 2017
• If plan is amended before 1/1/16 then provision must remain in effect through end of 2016
QUESTIONS?