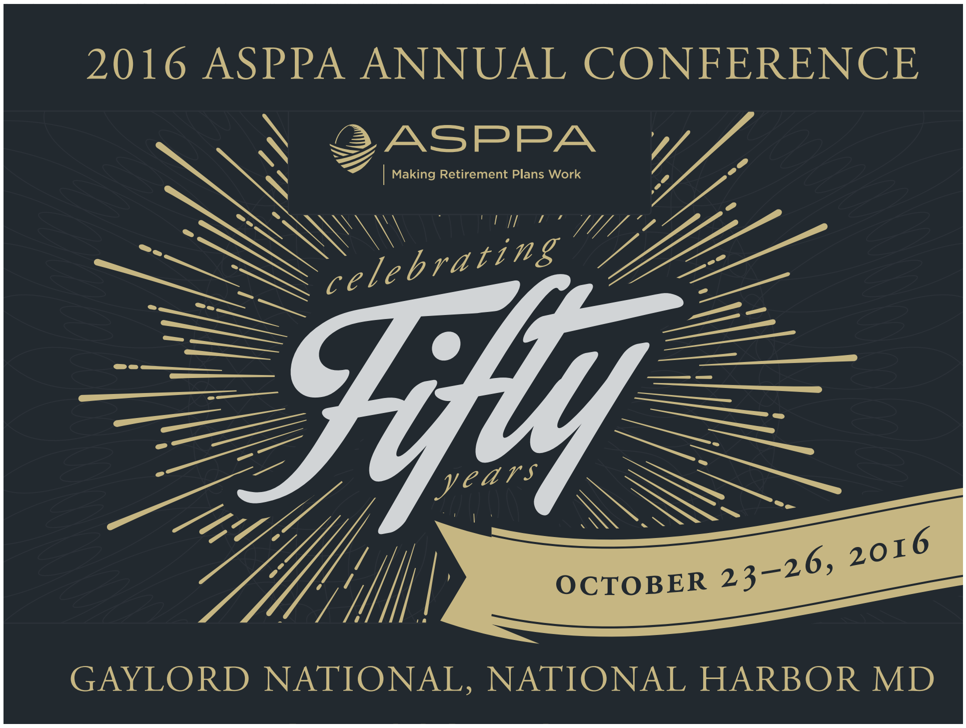

Advanced Compliance Testing – How to Put the Rules to Work for Plan Sponsors

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Introduction

- Discrimination testing encompasses a plan satisfying a number of rules.
- In particular, discrimination rules require meeting the requirement of IRC §§ 410, 401(a)(4), and 401(a)(26).
  - Last requirement only applies to DB plans, and requires a minimum number, or percentage, of employees benefit (no aggregation for this purpose).
  - Our emphasis will be IRC §§410(b) and 401(a)(4)

Review of 410(b)

- To pass §410 a plan must meet the requirements of §410(a) and benefit a group of employees that satisfies §410(b). For this latter purpose, multiple plans may be
  - aggregated for testing, and/or
  - disaggregated (either on a permissive or mandatory basis) for testing

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Review of 410(b)

- §410(b) requires that a plan either:
  - Satisfy the Ratio Percentage Test;
  - Satisfy the Average Benefits Test;
  - Not benefit any Highly Compensated Employees (HCEs); or
  - The employer has no non-excludable Non-highly Compensated Employees (NHCEs).

Review of 410(b)

- To satisfy the "Ratio Percentage Test" a Plan must have a "Coverage Ratio" of at least 70%.
  - Plan's coverage Ratio:
    - NHCE coverage ratio ÷
    - HCE coverage ratio

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Review of 410(b)

- NHCE Coverage Ratio:
  - NHCEs benefiting under the plan ÷
  - Non-excludable NHCEs (even if excluded from plan)
- HCE Coverage Ratio:
  - HCEs benefiting under the plan ÷
  - Non-excludable HCEs (even if excluded from plan)
- "Benefiting" simply means receiving an allocation (or accruing a benefit); amount not relevant

Review of 410(b)

- Amount of benefit only relevant for non-discrimination testing under IRC 401(a)(4)
- Important to understand that all non-excludable employees considered in denominator. Including:
  - Non-excludable employees excluded from plan
    - Even those signing waiver of participation
  - Participants not benefiting under terms of plan
    - E.g., last day or 1,000 requirement

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Review of 410(b)

- Consider employer that has 11 non-excludable employees
  - 3 HCEs – Husband, wife, son
  - 8 NHCs
- Desire to cover husband and wife
  - HCEs coverage ratio = 2/3 = 66.67%

Review of 410(b)

- To pass <u>ratio test</u> need to cover 4 NHCs
  - Need coverage ratio of at least 70%
  - 70% * 66.67% = 46.67%
  - 46.67% * 8 (NHCs) = 3.73 (round to 4)
- Plan's coverage ratio (if only 4 NHCs covered)
  - NHC ratio 50% / HCE ratio 66.67% = 75%
  - At least 70% so ratio test passed

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Review of 410(b)

- Plan could therefore exclude 4 of 8 NHCs
  - By class
  - By name
- Or cover by inclusion
  - i.e. only those specifically named are in plan
  - Not uncommon in 'carve-out' DB plans

Non-excludable Employees

- Non-excludable employees means all employees except [1.410(b)-6)]:
  - Those that fail to meet age & service -
    - BUT, why exclude 20 year old NHC? Can be VERY helpful in testing –> lose age requirement?
  - Non-resident aliens with no US income
  - Employees subject to collective bargaining
  - Terminated employees with no more than 500 hours
  - Employees of QSLOBs

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Non-excludable Employees

- Exclusion of ees failing to meet statutory age & service requirements
  - Where plan has more liberal eligibility may exclude these "otherwise excludable" employees from testing
    - If excluded from testing don't need gateway for example
  - BUT, if there are otherwise excludable ees that are HCEs then either:
    - Test otherwise excludables separately, or
    - Test without using exclusion

Non-excludable Employees

- Exclusion of ees failing to meet statutory age & service requirements
  - Who are otherwise excludable employees?
  - Assume plan has 21/1 and qtrly entry
  - Employee hired 8/15/14, enters plan 10/1/15
  - Is this employee excludable?
  - IRS Chief Counsel Memo 201605013 says yes, this is a reasonable interpretation

Non-excludable Employees

- Terms with ≤ 500 hours only excludable if
  - Plan requires minimum hours and/or EOY employment to receive benefit/allocation
  - And employee:
    - Is eligible to participate in the plan;
    - Does not benefit under the plan for the year;
    - Fails to receive benefit/allocation solely because of above requirement(s); *and*
    - Terminates with no more than 500 hours of service

Non-excludable Employees

- So, e.g., employee excluded from plan not excludable -
  - Employee not eligible to participate
  - i.e., a terminated employee with ≤ 500 hours of service that was excluded from participation in plan is NOT an excludable employee and therefore must be counted in denominator when determining coverage ratio
    - This is a hidden danger in DB care outs
    - i.e., for 401(a)(26) purposes these people are IN the denominator

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Non-excludable Employees

- Employee receiving 3% SH not excludable -
  - Employee is <u>benefiting</u>
  - So e.g. they need gateway

Non-excludable Employees

- Similarly, PS plan with <u>no</u> hours or EOY requirement may NOT exclude from testing terminees ≤ 500 hours to whom employer could have but decided not to give an allocation-
  - Termination ≤ 500 hours not <u>SOLE</u> <u>reason</u> allocation not provided

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Non-excludable Employees

- Exclusion of such terminees from testing is elective and consistency is only required within a plan year -
  - So in a given year if you exclude such folks from testing you must exclude all terminated NHCs and HCEs with no more than 500 hours of service
  - But you may, e.g.,
    - exclude such folks from testing in years where it helps testing – i.e. you're excluding from testing non-benefiting NHCs
    - But include such folks in years when it helps testing – i.e. you're including in testing non-benefiting HCEs.

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Non-excludable Employees

- Consider an employer with 3 HCEs and 9 NHCs
- All covered under employer's PS plan
- Under plan each employee in own class for purposes of PS allocation
  - Employer determines on ee by ee basis who gets PS $$
  - Terms with ≤ 500 hours may not get allocation
  - Goal is to allocate $$ to actives only

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Non-excludable Employees

- Assume 3 of 9 NHCs terminate
  - 1 of whom worked ≤ 500 hours
- Ignoring terminee rule ratio test fails
  - NHC ratio = 6 / **9** = 66.67%
  - HCE ratio = 3 / 3 = 100%
  - 66.67% / 100% = 66.67% < 70%

Non-excludable Employees

- But may exclude terminee ≤ 500 hrs from test
- Ratio test passes
  - NHC ratio = 6 / **8** = 75%
  - HCE ratio = 3/3 = 100%
  - 75% / 100% = 75% > 70%
- Important that under terms of plan terminee could not receive an allocation
  - But was otherwise a participant

Non-excludable Employees

- Assume instead that all 3 NHCs termed with more than 500 hours
- But an HCE also termed but with ≤ 500 hours
- If elect to exclude terms ≤ 500 hours from testing ratio test fails
  - NHC ratio = 6 / 9 = 66.67%
  - HCE ratio = 2 / **2** = 100%
  - 66.67% / 100% = 66.67% < 70%

Non-excludable Employees

- Here we would not elect to exclude terms ≤ 500 hours from testing
- Ratio test passes
  - NHC ratio = 6 / 9 = 66.67%
  - HCE ratio = 2 / **3** = 66.67%
  - 66.67% / 66.67% = 100% > 70%

Non-excludable Employees

- A special applies under the regs for plans that cover otherwise excludable employees
- Such a plan may be bifurcated and tested as two plans
  - One covering otherwise excludable employees
  - One covering not otherwise excludable employees
- Or may be tested as single plan

Non-excludable Employees

- In either case need to compare what eligibility can be (i.e. 21/1) and what it is (e.g. 3 months)
- Where tested as single plan non-excludable employee definition expanded to all who have met more liberal eligibility

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Non-excludable Employees

- Where tested separately
  - One plan would include in testing those that would be non-excludable if plan had statutory requirements (21/1)
  - Other would include in testing those that did not meet such requirements but did meet lesser requirements (3 months)

Average Benefits Test

- To satisfy the Average Benefits Test for of 410(b) purposes a Plan must pass both the average benefit percentage test & the nondiscriminatory classification test
  - A plan passes the nondiscriminatory classification test if the plan benefits a classification of employees that is both <u>reasonable</u> and <u>nondiscriminatory</u>

Average Benefits Test

- A plan satisfies the average benefit percentage test (ABPT) if plan's average benefit percentage at least 70%
- Average benefit percentage determined by dividing actual benefit percentage of NHCEs by actual benefit percentage of HCEs
- Actual benefit percentage of NHCEs (HCEs) is average of employee benefit percentages for each non-excludable NHCE (HCE)

Average Benefits Test

- With certain exceptions all plans of employer aggregated when calculating employee benefit percentages for ABPT
- Elective deferrals and matching contributions under a 401(k) plan are taken into account in determining employee benefit percentages for ABPT
  - Even though otherwise disaggregated for coverage and nondiscrimination testing
  - Same for ESOPs

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Average Benefits Test

- Employee benefit percentages determined on *either* contributions or benefits basis,
  - consistently for all plans in testing group
- This is same rate that would be determined for purposes of rate group testing but with all plans are aggregated
- For example, if employee benefit percentages are determined on a benefits basis, and there are both DC and DB plans in testing group, an employee's employee benefit percentage is his/her aggregate normal accrual rate but *with* the inclusion of elective deferrals and matching contributions

Average Benefits Test

- Plans with differing plan years
- In general plans must have the same plan year to be combined for testing
- However, for purposes of the average benefits percentage test all plans must be aggregated
- Accordingly, the regs provide that employee benefit percentages in such a case are determined based on all plan years ending with or within the same calendar year

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Average Benefits Test

- There is a special rule, for purposes of the average benefits percentage test only, that allows EBARs to be averaged over the current and prior year or the current and two prior years
  - Assume sole HCE with ABPT EBAR of 10% in 2015, 8.5% in 2014 and 7% in 2013
  - The only NHC has EBAR of 6% for each of the 3 years
    - i.e. numerator 6% whether or not average used
  - Looking at 2015 ABPT is 6% / 10% = 60% and fails
  - Averaging 2015 and 2014 is 6% / 9.25% = 64.6% & fails
  - Averaging all 3 years -> 6% / 8.5% = 70.5% & passes
  - **CAN BE VERY HELPUL IN RATE GROUP TESTING**

Average Benefits Test

- A plan passes the first part nondiscriminatory classification test if it covers a classification of employees that is "reasonable and is established under objective business criteria"
  - Examples under regs are "specified job categories, nature of compensation, geographic location"
  - "An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification."

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Average Benefits Test

- The second piece of the nondiscriminatory classification test requires the plan to have a coverage ratio that is
  - at least as high as the Safe Harbor Percentage, or
  - at least as high as the Un-Safe Harbor Percentage <u>and</u> pass a facts and circumstances test

Average Benefits Test

- <u>Safe harbor</u> percentage is 50%, less .75% for each <u>whole</u> point by which the "NHCE concentration percentage" exceeds 60%
  - ***So safe harbor never greater than 50%***
- <u>Unsafe harbor</u> is 40%, less .75% for each whole point by which the NHCE concentration exceeds 60%, but not less than 20%
- <u>NHCE concentration percentage</u> = % of non-excludable employees who are NHCEs

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Average Benefits Test

- Let’s Return to our employer with 3 HCEs and 9 NHCs
- Let’s further assume that 4 of the NHCs were hired after 12/31/2012 and the plan was frozen to new participants as of such date
- So only 5 of 9 NHCs are covered under the plan
- Plans coverage ratio is therefore 55.56%
  - Since over 50% we know safe harbor passed
    - no facts and circumstances determination required

Average Benefits Test

- All participants receive allocation of 9% of comp
- All NHCs under taxable wage base
- All HCEs over $265K
- Let’s first look at average benefits percentage test
  - As indicated on next slide ABPT over 70% so passes

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Average Benefits Test

PERMITTED DISPARITY ON ALLOCATION BASIS

A	Unadjusted allocation rate	9.00%	9.00%
B	Plan Year comp.	265,000	30,000
C	TWB	118,500	118,500
D	Covered comp (lesser B/C)	118,500	30,000
E	PD rate (5.7%)	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.70%
G	Theoretical Disparity Allocation (F*D)	6,755	1,710
H	Imputed PD G/B	2.55%	5.70%
I	Adjusted allocation base (B - (.5*D))	205,750	15,000
J	Max adjusted allocation rate (A*B/I)	11.59%	18.00%
K	Adjusted allocation rate (lesser A+H or J)	11.55%	14.70%
L	Average HCE - > 3/3 all get same	11.55%	
M	Average NHC - 5 of 9 all get same (others zero)		8.17%
	Average benefit percentage M / L		70.71%

Average Benefits Test

- But is our classification reasonable?
- Specifically asked in Q&A 18 of 2015 Gray Book
- “Such a classification is reasonable as long as it is not a substitute for listing by name. Regulation 1.410(b)-4 provides that a reasonable classification is based on objective business criteria … There is nothing to indicate date of hire would not be an “objective” business classification.”

Average Benefits Test

- What if all 9 were covered under the plan but 4 of the 9 terminated (with more than 500 hours) and this is why they did not receive an allocation?
- All of the math is the same
- Only question is whether those employed at end of year is a "reasonable" classification
- IRS has given conflicting answers to this question at ASPPA meetings – I have zero concern –
  - In my opinion it clearly IS a reasonable classification

Rate Group Testing

- Rate Group Testing requires that a "Rate Group" be formed for each HCE.
- The rate group includes all HCEs and NHCEs who
  - benefit under the plan, and
  - have a Normal (and, if DB plan included in testing, Most Valuable) EBAR at least as high as that of the HCE for whom the Rate Group was formed.

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Rate Group Testing

- Each Rate Group must then satisfy 410(b) as though it were a plan.
- To pass 410(b) a Rate Group must either:
  – pass the Ratio Percentage Test; or
  – pass a modified Average Benefits Test.
- A Rate Group passes the Ratio Percentage Test if its NHCE coverage ratio is at least 70% of its HCE coverage ratio.

Rate Group Testing

- To pass the modified Average Benefits Test, Rate Group must satisfy -
  – The Nondiscriminatory Classification Test,
  – AND
  – The Average Benefits Percentage Test.

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Rate Group Testing

- To satisfy the Nondiscriminatory Classification Test a Rate Group must have a Coverage Ratio of at least the midpoint between the Safe and Unsafe Harbor Percentages.
  - A Rate Group's Coverage Ratio is the NHCE coverage ratio ÷ the HCE coverage ratio.
  - ***No reasonable classification requirement.***
    - ***This was the issue that was covered and then withdrawn in recent proposed regs***
      - ***i.e. proposal was to add such a requirement***

Rate Group Testing

- Safe harbor percentage is 50%, less .75% for each whole point by which the "NHCE concentration percentage" exceeds 60%.
- Unsafe harbor is 40%, less .75% for each whole point by which the NHCE concentration exceeds 60%, but not less than 20%.
- NHCE concentration percentage = % of non-excludable employees who are NHCEs.
- **Midpoint never greater than 45%.**
  - Where concentration 60% or less

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Rate Group Testing

- Example
- Employer has 5 non-excludable NHCs and 1 non-excludable HCE
  - Concentration percentage = 5/6 = 83.33%
  - Which is 23 whole points above 60%
  - 23 times .75% = 17.25%
  - Safe harbor % = 50% - 17.25% = 32.75%
  - Unsafe harbor % = 40% - 17.25% = 22.75%
  - Midpoint = 27.75%

"EBAR"

- As used above, EBAR stands for
  - Employee Benefit Allocation Rate if testing on a contributions basis.
    - aka allocation %.
  - OR
  - Employee Benefit Accrual Rate if testing on a benefits basis.
    - aka - Equivalent Benefit Accrual Rate.

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“EBAR”

- The basic formula for an EBAR is
  - Increase in Benefit ÷
  - Testing Service (one if testing using Annual Method) ÷
  - Testing Compensation.

“EBAR”

- Testing may also be done on the basis of dollar amounts vs percentages.
  - E.g., all participants that receive an amount of allocation equal to or greater than that of a HCE are in the HCE’s Rate Group, irrespective of comp., when testing on dollar amounts.
  - Can be effective way to increase lower paid HCEs to dollar amount of higher paid NHCEs.

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Increase in Benefit

- The increase in benefit is the increase during the "Measurement Period".
  - In a defined contribution plan tested on a contributions basis it is the allocation of employer contribution plus forfeitures allocated for the plan year. This does not include allocations of trust earnings.
    - Basically this is the annual additions under §415.

Increase in Benefit

- In a DC plan tested on a benefits basis it is the normalized benefit that is the equivalent of the increase in the account balance during the Measurement Period (attributable to employer contributions and forfeitures), including earnings on the account. Again normalization is done using Standard Assumptions.
    - If using Annual Method earnings may be ignored.

Measurement period

- The Measurement Period is the period over which the increase in benefits is considered. It is generally either the current plan year (the Annual Method) or the current plan year and all prior plan years (the Accrued-to-Date Method).

Measurement period

- Must use Annual Method when testing on contributions basis.
- When using a "Fresh Start" prior plan years are only years after the Fresh Start Date.
  - Fresh start involves dividing account balance (or accrued benefit if DB plan) into pre- and post-fresh start date pieces and testing only latter. Pre-Fresh Start date balance (benefit) , and earnings thereon, are ignored. Testing Service is then years benefiting after Fresh Start Date.

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Testing Service

- Recall the basic formula for an EBAR is
  - Increase in Benefit ÷
  - ***Testing Service*** ÷
  - Testing Compensation
- When using Annual Method (i.e., Measurement Period is current plan year only), Testing Service is one.
- When using Accrued-to-Date method in a DC plan, Testing Service means number of years in measurement period employee received an allocation.
  - Only allowable when cross testing

Testing Compensation

- Two basic definitions of compensation,
  - Average Compensation, and
  - Plan Year Compensation.
- Where testing on a contribution basis, must use Plan Year Compensation.
- In all cases must use 414(s) definition in testing – may include or exclude deferrals

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Testing Compensation

- Where testing on a benefits basis, must use average compensation.
  - However may use Plan Year Compensation if using Annual Method.
- ***When using Plan Year Compensation may limit to period of participation.***
  - ***IRS may challenge using compensation for very short periods of participation***

Testing Compensation

- When using average compensation in testing, average must be over at least a 3-year "averaging period" (or less if less than 3-years of history).
  - Averaging period may begin at anytime but must end in current year.
  - Must use highest consecutive 3 (or more) years during averaging period.

Testing Compensation

- Average comp. often works to improve cross-testing as comp. of NHCEs tends to increase for two reasons – merit and inflation – while that of HCEs (at least those over comp. limit) increases only with inflation.
- Remember, idea is to increase NHCE EBARs and decrease HCE EBARs.

Testing Compensation

- Consider 2009-2011 where the comp limit did not increase at all.
- Using a 3-year average to test HCE at compensation limit in 2011 would have left HCE's EBAR unchanged.
  - i.e., current and 3-year average both = $245k.

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Testing Compensation

- Consider NHCE earning $34,000; $37,000; $40,000 during the same period.
  - Current comp = $40,000.
  - 3-year average comp. = $37,000.
  - Assume equivalent benefit of $2,000 from PS allocation (details of how to do this later).
  - EBAR = $2,000 / $40,000 = 5.00%.
  - EBAR = $2,000 / $37,000 = 5.41%.
    - Could be the difference between passing and failing.

Testing Compensation

- Can be even more powerful when you bring in year of hire or other short year.
- Consider same employee had been hired late-2009 and earned $5,000.
- 3-year average now $27,333.
  - EBAR = $2,000 / $40,000 = 5.00%.
  - EBAR = $2,000 / $27,333 = 7.32%.

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Fresh Start

- A note about Fresh starts
- Often in plans we've taken over we don't have the information needed to do accrued-to-date testing
- In such cases it may make sense to separately track account balances from takeover date
- The account balance then is bifurcated between pre and post takeover, and accrued-to-date testing is performed on the post takeover piece only – i.e. the piece where you know how many years an allocation was given
- This is not only time fresh start can be used
  - i.e. can always pick a point in time and test fwd

Permitted Disparity

- A plan may increase the EBAR to reflect the value of Social Security Benefits.
- It is not permissible to impute disparity into the portion of the benefit attributable to 401(k) contributions, 401(m) contributions, or 401(k) safe harbor contributions.

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Permitted Disparity

ALLOCATION BASIS			
A	Unadjusted allocation rate	20.00%	16.85%
B	Plan Year comp.	265,000.00	30,000.00
C	TWB	118,500.00	117,000.00
D	Covered comp (lesser B/C)	118,500.00	30,000.00
E	PD rate (5.7%)	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.70%
G	Theoretical Disparity Allocation (F*D)	6,754.50	1,710.00
H	Imputed PD G/B	2.55%	5.70%
I	Adjusted allocation base (B - (.5*D))	205,750.00	15,000.00
J	Max adjusted allocation rate (A*B/I)	25.76%	33.70%
K	Adjusted allocation rate (lesser A+H or J)	22.55%	22.55%

Permitted Disparity

BENEFITS BASIS			
	Year of birth	1955	1969
A	Unadjusted accrual rate	3.51%	3.08%
B	Average Comp.	265,000.00	30,000.00
C	Social Security Retirement Age	67	67
D	Covered comp (RR 2016-5)	88,886.00	111,763.00
E	Maximum PD	0.65%	0.65%
F	Disparity Comp. (lesser B/D)	88,886.00	30,000.00
G	Theoretical disparity benefit (E*F)	577.76	195.00
H	Imputed PD G/B	0.22%	0.65%
I	Adjusted accrual rate comp. (B - (.5*F))	220,557.00	15,000.00
J	Max adjusted accrual rate (A*B/I)	4.22%	6.16%
K	Adjusted accrual rate (lesser A+H or J)	3.73%	3.73%

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Permitted Disparity

- Note in benefits basis formula "covered compensation" is substituted for taxable wage base. Covered compensation is average of TWBs for 35 years through the individual's SSRA (presuming current TWB remains constant).
  - IRS annually publishes Revenue Ruling of covered comps based on year of birth
- Maximum PD factor in benefit calc based on SSRA and is .65% if SSRA 67; .70% if SSRA is 66; and .75% if SSRA 65. May use .65% for all.
  - Adjusted where testing age less than 65

Restructuring

- A plan may be restructured into two or more component plans if:
  - The plan passes 410(b) pre-restructuring, and
  - Each of the component plans passes 410(b).
- Each component plan is then treated as a separate plan, benefiting just those in it, for purposes of satisfying 401(a)(4).

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Restructuring

- The advantage of restructuring is that there is no requirement for consistency between how the component plans satisfy 401(a)(4).
  - One component plan is tested on a contribution basis while another is tested on a benefits basis.
  - One plan is tested using the Annual Method while another uses Accrued-to-Date.
  - One Plan is tested using Average Compensation while another uses Plan Year Compensation.
  - ETC, ETC, ETC.

Restructuring

- The group of employees assigned to each component plan may be determined in any manner.
- The composition of the groups may change from year to year.
- Each employee is included in one and only one component plan for a plan year.

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Restructuring

- Generally, the same rules apply to a component plan in satisfying 410(b) as would be applied to any plan.
  - Normally need to pass the Ratio Percentage Test as the assignment of employees into component plans likely not done in a manner that would satisfy reasonable classification piece of the Average Benefits Test.

Restructuring

- Because of this certain mixes will preclude restructuring.
- E.g. if there are 2 HCEs and 3 NHCs you cannot come up with two component plans that will pass 70%.
  - i.e., one plan would have coverage ratio of $2/3 \div 1/2 = 133\ 1/3\%$.
  - While other would have coverage ratio of $1/3 \div 1/2 = 66\ 2/3\%$.

Restructuring

- It is important to understand restructuring requires two independent tests – 410(b) and 401(a)(4) - just like regular plan testing.
  - As indicated, will need each component plan to pass 410(b) using Ratio Percentage Test.
    - For this purpose those covered are those in the component plan with any current benefit – irrespective of amount – i.e., not concerned if at or above HCE EBAR within component plan – leave that for 401(a)(4) testing.
    - Those not in component plan considered not covered.

Restructuring

- 401(a)(4) (Rate Group) testing then performed for each component plan as if it is a separate plan.
  - For this purpose those covered are those both in the component plan and with EBAR at or above HCE for whom Rate Group exists.
  - Those not in component plan considered not covered.
  - Again, methods used in Rate Group Testing need not be consistent from one component plan to another.
- More on restructuring later in outline.

Corrective amendments

- Post year-end amendments may be made to "correct" failed 410(b) or 401(a)(4) tests. Such amendments may either –
  - Increase benefits for existing participants; or
  - Create benefits for employees that otherwise did not benefit under plan
- Such amendments must meet each of the following requirements:

Corrective amendments

- Benefits may not be reduced
- The amendment must be made by the 15th day of the 10th month after the plan year-end
- The increase in benefits must satisfy 410(b) and 401(a)(4) on a standalone basis
  - automatic if only NHCEs increased / added
- The increase must have substance
  - E.g., cannot increase benefits to non-vested terminees

Corrective amendments

- Consider the following:
  - Owner, comp $265K
  - EE1 - Non-excludable– comp $200K – NHC due to prior year comp
    - Or top-paid group election
  - EE2 - Newly hired (excludable) earned $10K
    - Not yet eligible for plan

Corrective amendments

A	Unadjusted allocation rate	20.00%	19.17%
B	Plan Year comp.	265,000	200,000
C	TWB	118,500	118,500
D	Covered comp (lesser B/C)	118,500	118,500
E	PD rate (5.7%)	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.70%
G	Theoretical Disparity Allocation (F*D)	6,755	6,755
H	Imputed PD G/B	2.55%	3.38%
I	Adjusted allocation base (B - (.5*D))	205,750	140,750
J	Max adjusted allocation rate (A*B/I)	25.76%	27.24%
K	Adjusted allocation rate (lesser A+H or J)	22.55%	22.55%

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Corrective amendments

- Consider amending plan to lower eligibility and bring in EE2
- Provide EE2 with allocation of 20% of comp
- And give EE1 desired 5%
- Total cost now $12K

Corrective amendments

A	Unadjusted allocation rate	20.00%	5.00%	20.00%
B	Plan Year comp.	265,000	200,000	40,000
C	TWB	118,500	118,500	118,500
D	Covered comp (lesser B/C)	118,500	118,500	40,000
E	PD rate (5.7%)	5.70%	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.00%	5.70%
G	Theoretical Disparity Allocation (F*D)	6,755	5,925	2,280
H	Imputed PD G/B	2.55%	2.96%	5.70%
I	Adjusted allocation base (B - (.5*D))	205,750	140,750	20,000
J	Max adjusted allocation rate (A*B/I)	25.76%	7.10%	40.00%
K	Adjusted allocation rate (lesser A+H or J)	22.55%	7.10%	25.70%
L	Average HCEs	22.55%		
M	Average NHCs			16.40%
	Average benefit percentage M / L			72.74%

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Corrective amendments

- Things to note from previous example
- Coverage did not fail – 100% before amendment
  - But to pass 401(a)(4) would have been costly
  - Bringing in new employee coverage still 100%
    - Definition of non-excludable employee broadened
    - But 401(a)(4) passes much less expensively

Corrective amendments

- Must perform rate group testing
- Single rate group (one HCE)
  - Rate Group includes those with benefit of at least 22.55%
- One of two NHCs in rate group (EE2 = 25.7%)
- Rate group coverage ratio = 50%
  - Always enough to pass if ABPT passes
  - i.e., midpoint never greater than 45%
  - No need to check gateway as not cross testing

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Corrective amendments

- Recall earlier discussion of plan covering otherwise excludable employees
  - i.e., eligibility something less than 21/1
- With corrective amendment we have such a case
  - And we're testing as single plan – <u>not</u> bifurcating
- What if EE2 had 3 months of service and a second new employee (EE3) was hired the same day?

Corrective amendments

- EE3 would need to be brought into the testing
- Coverage would now be 2/3 / 1/1 = 66.67%
  - Would probably fail as under 70% and likely not a reasonable classification
- ABPT would also fail as a zero would need to be averaged in
- Would therefore likely need to also cover EE3

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Corrective amendments

- But if EE3 hired any later than EE2 could avoid by making eligibility with corrective amendment such that EE3 still excludable
- e.g. if EE3 had 2 months of service and EE2 had 3 months of service broaden eligibility to 3 months

Good Habits

- For maximum flexibility put each participant in own class for allocation purposes – i.e., avoid pre-determined classes.
  - Most pre-approved plans now allow this.
  - Allows ability to give greater dollars to lower paid NHCEs that might otherwise be in same class without increasing all others.
  - Or ability to give younger HCEs less dollars where younger HCEs causing testing issues.

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Good Habits

- Get rid of last day and end of year requirements to receive allocation.
  - Terminated employees are likely lower paid and not fully vested such that they can often help pass testing less expensively than increasing benefits for active employees.
  - Unlike in case of corrective amendment, allocations to non-vested terms considered in testing.

Good Habits

- With 3% non-elective safe harbor 401(k) plan exclude HCEs from receiving SH.
  - Gives flexibility to give lower allocations to HCEs which can help testing.
  - Then provide allocations to HCEs via profit sharing to the extent possible.
    - Avoids Jr. blowing up plan along with company.
  - Very useful in conjunction with each participant in his/her own class.

Case Studies

- Unless otherwise stated all case studies assume following:
  - Testing Age 65.
  - Compensation =
    - 415 compensation =
    - 414(s) compensation =
    - Plan Year Compensation.
  - 1971 GAM male at 8.5% used for testing.
    - 8.5% interest pre retirement also.
    - Annual APR at age 65 = 7.9
      - Monthly = 94.7986

Case Study 1 – Participation comp

- Consider cross-tested PS plan. 43 year-old owner, compensation of $200,000, receives allocation of $50,000
- Only other participant age 25, enters plan mid-year. Full year comp. $40K; comp. while participant $20K. PS allocation is TH min. of $1,200 - 3% of full-year comp.

Case Study 1 – Participation comp

- Owner's EBAR = 19.04%
  - $50,000 X (1.085^22) / 7.9 = $38,089
  - $38,089 / $200,000 = 19.04%
- EE's EBAR
  - $1,200 X (1.085^40) / 7.9 = $3,970
  - $ 3,970 / $40,000 = 9.92%
  - Rate Group fails as EBAR < 19.04%

Case Study 1 – Participation comp

- EE's EBAR using participation comp.
  - $1,200 X (1.085^40) / 7.9 = $3,970
  - $ 3,970 / $20,000 = 19.94%
  - Rate Group passes as EBAR > 19.04%
- EE allocation (TH minimum) based on full year compensation;
  - OK to test based on comp. while participant
  - **Testing comp. and plan comp. can differ**

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Case Study 1 – Participation comp

- Gateway may also be tested on comp. while a participant and therefore passes
  - I.e., $1,200 / $20,000 = 6%

Case Study 2 – Average comp

- Consider cross-tested PS plan. Owner age 43, comp. of $160,000, receives allocation of $50,000. Comp. was $245K for years 2009-2011
- Only other participant age 25, comp. of $60,000 (hi-3 year average $55,000). PS allocation $3,000 (5% gateway)

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Case Study 2 – Average comp

- Owner's EBAR = 23.81%
  - $50,000 X (1.085^22) / 7.9 = $38,089
  - $38,089 / $160,000 = 23.81%
- EE's EBAR = 16.54%
  - $3,000 X (1.085^40) / 7.9 = $9,924
  - $ 9,924 / $60,000 = 16.54%
- Testing on current compensation fails

Case Study 2 – Average comp

- But testing on average comp. passes
- Owner's EBAR = 15.55%
  - $50,000 X (1.085^22) / 7.9 = $38,089
  - $38,089 / $245,000 = 15.55%
- EE's EBAR = 18.04%
  - $3,000 X (1.085^40) / 7.9 = $9,924
  - $ 9,924 / $55,000 = 18.04%

Case Study 3 –Net comp

- Consider PS plan
- Owner
  – comp. of $300K
  – defers $18K
- Only other participant
  – comp. $40K
  – defers $5K

Case Study 3 –Net comp

- Testing owner comp. w/o excluding deferrals = min of $300K or $265K = $265K
- Testing owner comp. excluding deferrals = min of $282.5K or $265K = $265K
- Testing ee comp. w/o excluding deferrals = minimum of $40K or $265K = $40K
- Testing ee comp. excluding deferrals = minimum of $35K or $265K = $35K

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Case Study 3 –Net comp

- Ignoring details it's clear test results will be improved as benefit rate for NHCE will go up when excluding deferrals (as compensation/denominator goes down) while that of HCE unchanged

Case Study 4

- Consider following 2015 data:
- HCE1 (DAD), age 54, comp. $265K (*414s and 415*), PS allocation $53,000 (20%)
- NHCE1, age 34, comp. $40K, PS allocation $2,000 (5%)
- NHCE2, age 54, comp. $60K, PS allocation $3,000 (5%)

Case Study 4

	Age	Years To 65	Comp.	Allocation	To 65 at 8.5%	SLA APR	SLA	EBAR
HCE1	54	11	$265K	$54,000	$130,018	7.9	15,837	6.21%
NHCE1	34	31	40K	2,000	25,081	7.9	3,175	7.94%
NHCE2	54	11	60K	3,000	7,360	7.9	932	1.55%

NHCE concentration 66.67%; i.e., 6 whole points over 60%; So safe harbor % = 50% - (.75%*6) = 45.5%; Unsafe harbor % = 40% - (.75%*6) = 35.5%; midpoint = 40.5%

NHCE1 has an EBAR higher than HCE; therefore sole Rate Group has Coverage Ratio of 50% (1/2 NHCEs ÷ 1/1 HCEs) --> greater than midpoint of 40.5%

ABPT: = [(7.94% + 1.55%) / 2] / 6.21% = 76.4% --> greater than 70%

Rate Group passes 410(b) as both prongs of Average Benefits Test passed

Minimum allocation gateway met as each NHCE has allocation of 5% of 415 compensation

Case Study 4A

- Now consider following 2016 data, same except everyone year older, and add:
  - HCE2 (Son) , age 25, comp. $40K, PS allocation $2,000 (5%)
- Begin by cross - testing like 2015

Case Study 4A

	Age	Years To 65	Comp.	Allocation	To 65 at 8.5%	SLA APR	SLA	EBAR
HCE1	55	10	$265K	$53,000	$119,832	7.9	14,596	5.72%
HCE2	25	40	40K	2,000	52,266	7.9	6,616	16.54%
NHCE1	35	30	40K	2,000	23,117	7.9	2,926	7.32%
NHCE2	55	10	60K	3,000	6,783	7.9	859	1.43%

HCE2 has EBAR of 16.54%. No NHCE has EBAR at that level. So his Rate Group Coverage Ratio will be 0% on cross-tested basis, absent changes. NHCE1's EBAR would need to more than double to get into HCE2's Rate Group. With little history we have it's likely we can only get there by significantly increasing NHCE1's allocation. Note also that ABPT fails (7.32 + 1.43) / (5.72 + 16.54) = 39.28%

Case Study 4A

- Consider testing on contributions basis
- Ignoring Permitted Disparity we have
  - HCE1 (Dad) at 20%
  - HCE2 (Son) at 5%
  - NHCE1 at 5%
  - NHCE2 at 5%
  - ABPT = (5 + 5) / (20 + 5) = 40%

Case Study 4A

- Now Dad is our problem
- I.e., Son's Rate Group with 5% EBAR contains father, son and two NHCEs so has Coverage Ratio of (2/2) / (2/2) = 100%
  - Remember, Rate Group includes HCE and each other employee same or higher EBAR.
- But there are no NHCEs at Dad's 20%

Case Study 4A

- First look at who is helping where and who is not. Recall our two sets of EBARs

	Cross-test	Cont. basis
– HCE1	5.72%	20%
– HCE2	16.54%	**5%**
– NHCE1	7.32%	5%
– NHCE2	1.43%	**5%**

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Case Study 4A

- In the cross-testing case NHCE 1 (with an EBAR of 7.32%) is in HCE1's Rate Group (with an EBAR of 5.72%), whereas NHCE2 is of no help at all.
- When testing on a contributions basis both NHCE1 and NHCE2 have the same EBAR (5%) as HCE2.

Case Study 4A

- Recall the restructure rules.
  - First, we place each employee into one, and only one, component plan.
  - Each component plan must pass 410(b) standing on its own, treating only those assigned to the plan as benefiting, and must then pass 401(a)(4)

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Case Study 4A

- When we assign people to component plans we look at who's helping and who's not. NHCE2 is of no help to HCE1, whereas NHCE1 is.
  - So component plan 1 will consist of HCE1 and NHCE1
  - And component plan 2 of HCE2 and NHCE2

Case Study 4A

- For purposes of 410(b) each of the component plans has a Coverage Ratio of 100% (1/2) / (1/2)
  - We pass the Ratio Percentage Test so no need to worry about reasonable classification
- We then test each of the component plans for 401(a)(4) using any available technique but considering only those in such plan

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Case Study 4A

- Component plan 1’s participants have the following EBARs

	Cross-test	Cont. basis
– HCE1	5.72%	20%
– NHCE1	7.32%	5%

– Testing on a cross-tested basis HCEs 1’s Rate Group has a Coverage Ratio of 100%
  - » (1/2) / (1/2)
  - » all non-excludable employees still in denominators

Case Study 4A

- Component plan 2’s participants have the following EBARs

	Cross-test	Cont. basis
– HCE2	16.54%	5%
– NHCE2	1.43%	5%

– Testing on a contributions basis HCE2’s Rate Group has a Coverage Ratio of 100%
  - » (1/2) / (1/2)

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Case Study 4A

- Recall that the Average Benefits Percentage Test failed (was under 70%) both on a cross-tested basis and a contributions basis
- <u>This is not relevant as both Rate Groups passed the Ratio Percentage Test so passing the ABPT was not necessary</u>

Case Study 4A

- So we pass Rate Group Testing
- We also pass through minimum allocation gateway as each NHCE has allocation of 5% of 415 compensation
- So Dad says “Can we get Son any more?”
- What if we increase Son to $3,000 PS?
  - Recall we can test on dollar amount

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Case Study 4B

- With Son at $3,000 our EBARs look as follows (note additional column)

	Cross	Cont	Dollar
– HCE1	5.72%	20%	$52,000
– HCE2	24.81%	7.5%	**3,000**
– NHCE1	7.32%	5%	2,000
– NHCE2	1.43%	5%	**3,000**

Case Study 4B

- We again restructure, with same folks in the two component plans
- I.e., HCE1 and NHCE1 in plan 1
  - Nothing about this component plan changes
    - Testing on benefits basis (i.e., cross-tested)
    - Coverage Ratio of (1/2) / (1/2) = 100% for both 410(b) and 401(a)(4)

Case Study 4B

- Component plan 2 however would now fail 401(a)(4) if tested on basis of allocation %
  - I.e., HCE2 now has EBAR of 7.5% - no NHCE at that level so Rate Group Coverage 0%
- However we can instead test component plan 2 on a dollar basis.
  - I.e., HCE2's Rate Group includes anyone with an allocation of at least $3,000
    - » Rate Group Coverage Ratio now (1/2) / (1/2) = 100%

Case Study 4C

- Assume NHCE1 is age 40 in 2016 instead of 35; EBAR now 4.87% (Recall HCE1's EBAR is 5.72%)
  - $2,000 * (1.085^25) = 15,734
  - 15,734 / 7.9 = 1,946
  - 1,946 / 40,000 = 4.87%
  - Now no NHCE is in HCE1's Rate Group

Case Study 4C

- But consider HCE1 / NHCE1 comp. history as follows
  - – 2013 255,000 / 6,000
  - – 2014 260,000 / 36,000
  - – 2015 265,000 / 38,000
  - – 2016 265,000 / 40,000
    - 4-year avg 261,250 / 30,000

Case Study 4C

- EBARs (using hi-4 year average comp, averaging period beginning in 2013)
- HCE1
  - – $53,000 * (1.085^10) = 119,832
  - – (119,832 / 7.9) / 261,250 = 5.81%
- NHCE1
  - – $1,946 / 30,000 = 6.49% (> 5.81%)

Case Study 4C

- Note 3-year avg would not have worked
- HCE1
  – (119,832 / 7.9) / 263,333 = 5.76%
- NHCE1
  – $1,946 / 38,000 = 5.12% (< 5.76%)
- So we stretched average to 4 years

Case Study 4C

- Recall:
  – Averaging period may begin at any time and must end in current plan year
  – Average over at least 3-years (using highest consecutive years in averaging period)
  – Must be consistent with all participants in the plan being tested.
    – In our case plan being tested was CP1 so no need to get this info and use for those in CP2

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Case Study 5

- Consider 2-participant takeover where PS previously comp to comp
  - Owner age 45 only HCE
  - EE1 only NHCE, age 42
  - Want to give NHCE 5% in '16 but max HCE
  - At first glance not great candidate for cross-testing as only 3-year age difference
  - But let's look at history and consider ATD

Case Study 5

	2016	2015	2014	2013	2012	2011	6- year avg
HCE comp	$265,000	$265,000	$260,000	$255,000	$250,000	$245,000	$256,667
HCE PS	$53,000	$53,000	$52,000	$0	$50,000	$49,000	
HCE Acct bal	$275,837						
NHCE Comp	$40,000	$38,000	$36,000	$34,000	$32,000	$30,000	$35,000
NHCE PS	$2,000	$7,000	$7,200	$0	$6,400	$6,000	
NHCE Acct bal	$31,625						

Case Study 5

- First look at annual method with avg comp
  - HCE EBAR = 13.47%
    - $53,000 * (1.085 ^ 20) = $270,938
    - $ 270,938 / 7.9 = $34,296
    - $ 34,296 / 256,667 = 13.36%
  - NHCE EBAR = 4.72%
    - $2,000 * (1.085 ^ 23) = $13,059
    - $13,059 / 7.9 = $1,653
    - $1,653 / 35,000 = 4.72%
      - » Obviously this does not pass

Case Study 5

- Instead look at using accrued-to-date
- Note no allocation in 2013 so testing svc = 5
  - i.e., testing service in DC plan is years receiving an allocation
- Recall EBAR definition
  - Inc in Ben ÷ **Testing Svc** ÷ Testing comp
  - Thus far testing on annual basis so = 1

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Case Study 5

– HCE EBAR = 13.91%
  - $275,837 * (1.085 ^ 20) = $1,410,090
  - $ 1,410,090 / 7.9 = $178,492
  - $ 178,492 **/ 5** / 256,667 = 13.91%

– NHCE EBAR = 14.94%
  - $31,625 * (1.085 ^ 23) = $206,500
  - $206,500 / 7.9 = $26,139
  - $26,139 **/ 5** / 35,000 = 14.94%
    - » And rate group passes