Solving Cross-Testing Conundrums
Tuesday, April 30, 2013
Norman Levinrad, FPSA, CPC
Summit Benefit & Actuarial Services, Inc.
Major Issues to Discuss

• Accrued-to-date testing method
• Restructuring
• Benefits rights and features issues for plans tested together
• Plan Design to avoid problems
Accrued-to-Date Testing

- Under this method, the amount that is normalized is the increase in the participant’s account balance or benefit during the measurement period in which the employee benefitted under the plan
- 1.401(a)(4)-8(b)(2)(ii)
- Why use accrued-to-date testing?
  - Younger HCE with short service
  - Long-service NHCEs with large account balances
Accrued-to-Date Testing

• Average compensation must be used
• If the measurement period includes prior years, testing service is generally the number of years of service during the measurement period, as defined in the plan for purposes of applying the benefit formula. Treas. Reg. § 1.401(a)(4)-3(d)(1)(iv).
• For DC plans, gains on the beginning balance are disregarded. So for example if your 12/31/12 test is done on this basis, it would use the 1/1/12 balance plus 2012 allocations.
• Cannot use accrued-to-date testing in the determination of whether the gateway has been met
Accrued-to-Date Testing

• So PS plan tested under this method, you would:
  • Use the total PS account balance but back off gains for current year? Use average compensation
  • Use the period of service over which the non-elective account balance was accrued for that participant
  • Exclude years that the participant did not benefit under the PS plan – how do you get this info? Do you track this?
Accrued to Date – Fresh Start

• Assume that the participant has been in the PS plan since 1990
• You choose a fresh start date of 1/1/95. Why would you do this? If contributions were higher for some years than others.
• Bifurcate the account balance
  • 12/31/94 balance plus earnings
  • Post 12/31/94 balance plus earnings
• Denominator: years of service after 12/31/94
How this is Abused?

• CB Plan tested with a PS plan
• CB plan was set up in 2007
• PS Plan was set up in 2000
• Dr House was hired in 1980
• For the accrued-to-date test in 2012, the practitioner used Dr. House’s service from 1980
• Clearly this gives Dr. House a very low EBAR for his rate group test since the calc uses 32 years of service
• And it is incorrect, his service from 2000 should be used since this is the period of service over which the benefits were earned.
Accrued to Date Example

- Dr. Enamel graduates from the Navy and buys a dental practice from Dr. Molar. Enamel is 40 years old. Dr. Molar retires.
- Dr. Molar sponsored a PS plan in the past and provided a PS contribution of 10% of pay to everyone for many years.
- Census:
  - Enamel HCE, age 40, Comp $250,000, DOP 1/1/12
  - NHCE1, age 40, Comp $30,000, DOP 1/1/02
  - NHCE2, age 45, Comp $30,000, DOP 1/1/07
  - NHCE3, age 22, Comp $30,000, DOP 1/1/12
Example cont’d

Goal for 2012 is for Enamel to get a PS cont of $50,000 at the DC gateway of 5% of pay for staff

• Test on Current Basis:
  - EBAR
  - Enamel: 19.73%
  - NHCE1: 5.68%
  - NHCE2: 4.00%
  - NHCE3: 21.78%
  - Ratio of rate group = 33.33%
  - AB% = 53.15%
  - Fails as we would expect
Example cont’d

• But…..you realize that 2012 is Enamel’s first year in the plan and the plan provided large PS conts to staff in the past
  • NHCE1 Svc for calc = 11 years, Av comp = $29,000, PS balance for calc at 12/31/12 = $66,500
  • NHCE2 Svc for calc = 6 years, Av comp = $29,000, PS balance for calc at 12/31/12 = $26,500
• Genius! You decide to test on an accrued-to-date basis.
Example, cont’d

Test on Accrued to Date Basis:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EBAR</td>
<td>19.73%</td>
</tr>
<tr>
<td>Enamel</td>
<td>20.93%</td>
</tr>
<tr>
<td>NHCE1</td>
<td>20.93%</td>
</tr>
<tr>
<td>NHCE2</td>
<td>10.51%</td>
</tr>
<tr>
<td>NHCE3</td>
<td>21.78%</td>
</tr>
</tbody>
</table>

Ratio = 66.67%
AB% = 89.91%
Passes! Who’s da’ man?
What is Restructuring?

- A plan may be treated as consisting of two or more component plans for purposes of determining whether the plan satisfies 401(a)(4).
- If each component plan satisfies all of the requirements of 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying Code Section 401(a)(4).
How are Component Plans Identified?

- Each component plan consists of all allocations, accruals, and other benefits, rights, and features provided to a selected group of employees
- May select the group of employees used for this purpose *in any manner*
- Composition of the groups may be changed from plan year to plan year
- Each employee must be included in only one component plan under the same plan for a plan year
How does a Component Plan Satisfy Code Section 401(a)(4)?

- The same rules that apply to a plan in satisfying 401(a)(4) are applied to a component plan.
- Whether a component plan satisfies the uniformity and other requirements applicable to safe harbor plans under Treas. Reg. §§ 1.401(a)(4)-2(b) and -3(b) is determined on a design basis.
When is Restructuring Not Available?

- The safe harbor in § 1.401(a)(4)-2(b)(3) for plans with uniform points allocation formulas is not available in testing (and thus cannot be satisfied by) contributions under a component plan.
- In ADP/ACP testing of 401(k) plans
- To show that a DC plan provides:
  - “Broadly available” allocation rates
  - A gradual age or service schedule
  - A uniform target benefit allocation,
  - Satisfies the gateway test.
- [Reg. § 1.401(a)(4)-9(c)(3)(ii)]
How does a Component Plan Satisfy 410(b)?

• Generally, the same rules apply in satisfying 410(b) as would be applied to a plan

• A component plan is deemed to satisfy the average benefit percentage test if the plan of which it is a part satisfies § 1.410(b)-5 without disaggregating for collectively bargained employees
How does a Component Plan Satisfy 410(b)?

• A component plan that does not satisfy the ratio percentage test can still pass testing by satisfying:
  • Nondiscriminatory classification test (the ratio % exceeds the SH % which depends on concentration %) and
  • The reasonable classification test – facts and circumstances based on bona fide business criteria.
Why is it preferable to satisfy the Ratio Percentage Test rather than the Average Benefit Test?

- If a plan fails the ratio percentage test, it must pass the three components of the Average Benefit Test:
  - Nondiscriminatory classification test
  - *Reasonable classification test*
  - Average benefit percentage test (ABPT)
Why is it preferable to satisfy the Ratio Percentage Test rather than the Average Benefit Test?

- Main testing advantage in using restructuring is to have the ability to pick and choose each person for a particular component plan
- Otherwise, the reasonable classification test must be used and would be more difficult to satisfy
Why would Restructuring be used as a Testing Technique?

• Can generally provide more favorable testing results in the following circumstances:
  • When an early retirement window is provided
  • When greater benefits/contributions are desired for a younger HCE or when equal benefits/contributions are desired for all HCEs
  • When there are short-service and long-service employees and one testing method doesn’t work (e.g. annual method vs. accrued-to-date)
  • When multiple safe harbor formulas are used
Does the plan document need to reflect the fact that restructuring is used?

- No, restructuring is simply a testing choice
- Can be used or not used on an annual basis
Example

• Piker’s Law Firm sponsors a cross-tested profit sharing plan. The plan provides for three tiers:
  • Partners
  • Law clerks
  • Secretaries
• Rate group testing is failed for HCE 3 and HCE 4
<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Comp</th>
<th>Contr</th>
<th>% of Pay</th>
<th>EBAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE 1</td>
<td>60</td>
<td>220,000</td>
<td>44,000</td>
<td>20%</td>
<td>3.784%</td>
</tr>
<tr>
<td>HCE 2</td>
<td>55</td>
<td>220,000</td>
<td>44,000</td>
<td>20%</td>
<td>5.689%</td>
</tr>
<tr>
<td>HCE 3</td>
<td>35</td>
<td>220,000</td>
<td>44,000</td>
<td>20%</td>
<td>29.083%</td>
</tr>
<tr>
<td>HCE 4</td>
<td>38</td>
<td>220,000</td>
<td>44,000</td>
<td>20%</td>
<td>22.769%</td>
</tr>
<tr>
<td>NHCE 1</td>
<td>50</td>
<td>20,000</td>
<td>3,400</td>
<td>17%</td>
<td>7.100%</td>
</tr>
<tr>
<td>NHCE 2</td>
<td>26</td>
<td>20,000</td>
<td>1,000</td>
<td>5%</td>
<td>15.151%</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>920,000</td>
<td>180,400</td>
<td>19.61%</td>
<td></td>
</tr>
</tbody>
</table>
Example 1

- Separate into component plans: demonstrate that each component plan passes 401(a)(4)

- **Component Plan #1:** Consists of HCE 1, HCE 2, and NHCE 2. This component plan satisfies the ratio percentage test:

  1 NHCE benefiting / 2 NHCEs
  2 HCEs benefiting / 4 HCEs
Example 1

- It also satisfies 401(a)(4) tested on a benefits basis:

- The gateway test is passed because each NHCE receives at least 5% of pay.

<table>
<thead>
<tr>
<th>Name</th>
<th>% of pay</th>
<th>EBAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE 1</td>
<td>20%</td>
<td>3.784%</td>
</tr>
<tr>
<td>HCE 2</td>
<td>20%</td>
<td>5.689%</td>
</tr>
<tr>
<td>NHCE 2</td>
<td>5%</td>
<td>15.151%</td>
</tr>
</tbody>
</table>
Example 1

- **Component Plan #2**: Consists of HCE 3, HCE 4, and NHCE 1. This component plan satisfies the ratio percentage test.
- It also satisfies 401(a)(4) tested on a contributions basis using permitted disparity.
- Gateway test is passed because each NHCE receives at least 5% of pay.
Example 2

A medical practice has seven employees - two physicians and five other employees. They are interested in a PS plan.

<table>
<thead>
<tr>
<th>Ee</th>
<th>Age</th>
<th>Comp</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ph 1</td>
<td>52</td>
<td>200,000</td>
<td>A</td>
</tr>
<tr>
<td>Ph 2</td>
<td>48</td>
<td>200,000</td>
<td>B</td>
</tr>
<tr>
<td>St 1</td>
<td>45</td>
<td>40,000</td>
<td>C</td>
</tr>
<tr>
<td>St 2</td>
<td>30</td>
<td>28,000</td>
<td>B</td>
</tr>
<tr>
<td>St 3</td>
<td>35</td>
<td>25,000</td>
<td>B</td>
</tr>
<tr>
<td>St 4</td>
<td>30</td>
<td>20,000</td>
<td>A</td>
</tr>
<tr>
<td>St 5</td>
<td>20</td>
<td>20,000</td>
<td>A</td>
</tr>
</tbody>
</table>
Example 2

- The physicians wish to maximize their contribution and minimize contributions to the staff.
- Customized contribution formulas are designed in which such contributions accrue at different rates and some NHCEs receive a lower contribution:
  - For participants in Group A, 8 percent of Comp
  - For participants in Group B, 5 percent of Comp.
  - Group C is excluded from participation in the plan.
Example 2

• This design satisfies the nondiscrimination requirements by restructuring the plan into two separate plans with safe harbor formulas.

• Groups A and B each independently satisfy the minimum coverage requirements of IRC § 410(b) and thus can be tested as separate plans.
Benefits, Rights and Features and Aggregated Plans

• If Plans are aggregated for 410(b) or 401(a)(4), they are tested together for all purposes.

• Remember that plans must have the same plan year to be aggregated.

• If plans are tested together, they are tested together for purposes of benefits, rights and features testing.
Distribution Issues for Aggregated Plans

- Timing of distributions; right to in-service distributions; optional forms of benefits provided; availability of loans must all be provided on a non-discriminatory basis across the tested plans.

- This means you have to test for current availability and effective availability.
Distribution Issues for Aggregated Plans

- Current availability may be easy to satisfy if everyone is covered in both plans.
- Effective availability is a facts and circumstances issue. Example from regs:
  - A plan was amended to provide for a single lump sum distribution to any employee who terminated employment within six months of the plan amendment. The availability of the benefit was conditioned on an employee having a particular disability at the time of termination. The only individual who met the disability requirement at the time of the amendment was a highly compensated employee and no other employee became disabled in the six-month period. This amendment violated the effective availability test.
What Design Avoids Things Going Bad?

• Keep it Simple
• Always ask yourself: “what’s the worst that can happen and how would this design deal with it?”
• Don’t design for year 1 only.
• Make sure clients understand the mechanics of benefits testing…that favorable results usually depend on the youngest participants.
• Use the same Eligibility Requirements and Entry Dates for all sources of money
• Use total compensation for all purposes
• Use individual allocation groups with 1 hour and no end of year employment requirement for Profit Sharing allocations
The End

• Questions?