Advanced Testing Issues for 401(k)

Great Lakes Benefits Conference

June 13-14, 2013

Hotel Sofitel

Chicago, IL

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Topics

- Testing Elections and Corrections
- Keeping Afloat in Safe Harbors
- Automatic Contributions- Glass is ½ Full
- Matching Contributions-
- Roth Contributions/Conversions
- Defining Compensation
- Distributions
- Other Frolics

Performing ADP/ACP Tests

- Multiple Employers/Single Plan
  - 1 test on related employers
  - 1 test on each unrelated employer
  - Leasing companies
    - Convenience and cost savings to small ER's
    - Generally service recipient is actual ER
    - Therefore treated as multiple ER plan/separate tests

Performing ADP/ACP Tests

- Single employer/Multiple plans
- Follow §410(b) testing
  - If plans must be aggregated for 410(b), then 1 test
  - If plans must be separated for 410(b) then separate tests
  - If either works, there is a choice
- HCE's deferrals, match, and compensation combined for all plans in each plan in which the HCE is tested

Determining the Employer

- All members of a controlled group are treated as 1 employer
- All members of an affiliated service group are treated as 1 employer
  - Sometimes lacks the bright line character of CG
  - Is there a single or multiple ASG's
  - Obtain determination letter for better clarity
    - Still possible to request DL for ASG on Form 5300

Testing Elections

- Plan document includes only those testing elections required to be stated in plan.
  - Split testing
    - May be selected on a year to year basis without plan amendment
  - Top Paid Group
    - Must be elected in the plan document by year end
  - Prior Year/Current Year
    - Must be elected in the plan document by year end
- Interaction of different requirements:
  - Coverage
  - Non-discrimination
  - Top heavy
  - Gateway

Plan Design By Testing Elections

- Split Testing
  - Plan eligibility requirements are less than statutory maximum 1 year service/ age 21 with semi-annual entry dates
  - Short service employees have lower ADR's
  - Allows short service employees to be separated for ADP/ ACP tests

Plan Design By Testing Elections

- Split Testing
- 2 Methods
  - Regulatory: §1.410(b)-6(b)(3)
  - Run 2 ADP/ ACP Tests:
  - Those who have not met the maximum age and service requirements assuming semi-annual entry
  - All others
  - Follow plan definition for measuring compensation
  - This follows coverage testing groups under the regulation

Plan Design By Testing Elections

- Split Testing
- 2 Methods
  - Statutory: §401(k)(3)(F)
  - One ADP/ACP Test
  - All HCE's
  - NHCE's with 1 year of service, age 21 as of PYE
  - Every day is an entry date
  - Must be able to pass "split" coverage test under §410(b)(4)
  - Often works best where HCE's appear in less than 1 year service group

Plan Design By Testing Elections

- Split Testing
- Plan language must be consistent with these methods
  - Careful with individually drafted plans
- However, the plan does not have to specifically authorize these methods

Split Testing Example for 2013

Name	Status	DOH	ADR
Laura	HCE	01-01-01	5%
Larry	NHCE	07-01-12	1%
Lonnie	NHCE	10-01-12	0%
Louie	NHCE	06-01-12	5%

HCE ADP=5%
NHCE ADP no split=2% Test Fails
NHCE ADP with split=3% Test Passes

Bifurcated Eligibility

- Employer wishes to permit 401(k) deferrals upon hire or short service requirement
  - Advice: Probably better to tie service requirement to months not number of days. E.g. 1^{st} day of month following hire date, not 30 days after hire.
- High levels of short service employees such as staffing firms

  Employer wishes to pay contributions only for those participants with over 1 year of service

Bifurcated Eligibility

- This arrangement works as long as plan is not top heavy.
- If plan is top heavy, then employees eligible to make 401(k) deferrals must also receive top heavy minimum allocations.
- If the top heavy plan employs cross-testing, less than 1 year service employees must also receive gateway minimums

Bifurcated Eligibility

- Possible strategy with a top heavy plan
  - Set up a separate 401(k) plan for non-key only
  - 401(k) has immediate eligibility
  - Separate profit sharing plan with 1-2 years eligibility requirement
  - Both plans taken together are top heavy
  - Profit sharing alone is top heavy
  - And 401(k) alone is NOT top heavy
  - Works well if key employees are able receive maximum allocation with Profit Sharing only
  - Regulation 1.416-1 Q&A T-3.

Bifurcated Eligibility

- Strategy with a top heavy plan
  - The trick is to remove the 401(k) plan from the required aggregation group
    - NO Key employees participate in the 401(k)
    - 401(k) does not enable profit sharing to pass coverage and non-discrimination testing
      - If the plan uses cross-testing that requires use of ABP test (not all rate groups have a 70% ratio percentage)
      - Then run ABP test 2 ways: both with salary deferrals and profit sharing (usual way), and just with profit sharing (proves 401(k) not needed to pass).

Bifurcated Eligibility

- Consider the following safe harbor match plan
  - Immediate eligibility for 401(k)
  - 1 year service for Safe Harbor Match
  - If plan is not top heavy, this arrangement works
  - If plan is top heavy, then top heavy minimum allocation is due for all participants

Forgone 401(k)

- Variant of previous strategy
  - Cross-tested profit sharing with 401(k)
  - Small group of senior principals
  - Significant # of other HCE’s
  - Senior principals receive $51K profit sharing
  - Senior principals make 401(k) catch-up only
  - Others receive varying levels of profit sharing, but no less than gateway minimum
  - Serves as relief valve for ADP/ACP test since group of senior principals are Zero’s

Who is a Highly Compensated Employee?

- Default definition:
  - Employees with compensation in excess of $115,000 in 2012 (prior year) for determining HCE’s in 2013.
  - More than 5% owners (using §318 attribution) in current (2013) or prior year (2012)

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - Employees with compensation in excess of $115,000 (threshold for 2012/2013) in the prior year **AND** ranked in the top 20% of all employees by compensation
  - More than 5% owners (using attribution) in current or prior year
  - Must be applied to all plans of the ER

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - How to count all employees in order to determine top paid 20%:
    - Use determination year
    - Start with all employees, then remove those
    - With less than 6 months service at plan year end
    - Who are younger than 21 at plan year end
    - Who typically work less than 17 ½ hours per week
    - If over 90% of employees are union employees, then subtract collectively bargained
    - Exclude those who did not provide services in the year
  - Then apply 20% to the resulting number

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - Then rank all prior year employees in descending order by compensation, even counting those excluded in determining the 20% number
  - Count off from the top the 20% number determined above, however, stopping at $115,000 compensation threshold (2013)
  - Rounding conventions are permitted
  - See Reg 1.414(s)-1T.

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - Why do it?
    - Must have over 20% of the workforce with compensation above HCE threshold
    - Helps ADP/ACP testing where those with compensation above the HCE threshold, but NOT in the top 20% have high ADR's
    - However, it may hurt other non-discrimination testing and increase gateway costs in CT plans
    - Look at this in medical groups, law firms, and ER's with large group of collectively bargained

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - Interesting example
    - 25 office workers
    - Up to 1000 union tradesmen
    - 10 EE's among 25 office workers with compensation above $115K
    - Deferrals of HCE's mostly at §402(g) limit
    - Solution:
      - Can exclude union if over 90% of countable employees are union

Who is a Highly Compensated Employee?

- Example of Top Paid Group Continued:
- Can reduce service, hour, and age thresholds to ZERO
- This allows us to count all union tradesmen
- Therefore, over 90% of employees are union and union can be excluded
- Top 20% equals 20% of 25 office employees
- Therefore we reduce HCE count from 10 to 5

Who is a Highly Compensated Employee?

- Example of Top Paid Group Continued:

HCE	Comp	Deferral	Def %
1-5	255,000	17500	6.86%
6	120,000	12000	10.00%
7	110,100	11010	10.00%
8	110,000	11000	10.00%
9	130,000	13000	10.00%
10	120,000	12000	10.00%

HCE ADP Before Top Paid Group Election: 8.43%
HCE ADP After Top Paid Group Election: 6.86%

Top Paid Group Election cont.

- This can Backfire!
  - Cross-tested profit sharing or DB/DC general test plan
  - Newly formed NHCE's must receive Gateway Minimum Allocation
  - Employer restricted in discriminating against this group
- Solution:
- Unelect Top Paid Group
- Add 401(k) Safe Harbor Non-Elective to deal with ADP Test

Top Paid Group Election cont.

- Top Paid Group Election must be stated in the Plan document
- Election can be made or rescinded year to year by plan amendment
- Amendment needs to be made before year end
- If prior year testing election for ADP/ACP in 2013 then
  - Determine who is an HCE by compensation based on 2012 census data
  - Determine who is an NHCE by compensation based on 2011 census data
  - Possible for someone to end up in both groups

Calendar Year Data Election

- Purpose
  - For determining HCE's
    - Relevant only if plan has a fiscal year
    - Lookback year is calendar year starting during previous plan year (lookback year)
    - Must apply to all plans of the employer
    - Might be helpful where multiple plans exist with differing years
    - Must be stated in plan
    - Notice 97-45

Calendar Year Data Election

- Example
  - Company maintains a 401(k) plan with a fiscal year 7/1/2012-6/30/2013
    - Lookback year is 7/1/2011-6/30/2012
  - Company maintains a pension plan with a fiscal year 10/1/2012-9/30/2013
    - Lookback year is 10/1/2011-9/30/2012
  - Calendar year for lookback is 2012.

Current or Prior Year Testing

- 2 methods of calculating data for ADP/ACP
  - Current year test uses data entirely from the current testing year
  - Prior year testing uses NHCE ADP/ACP from the prior year and current year ADP/ACP for the HCE’s
  - Plan document must state which one will apply
  - See Notice 98-1

Current or Prior Year Testing

- Advantage of current year testing
  - Participation may be improving over time, thus favoring current year data
  - Only method in which QNEC's and QMAC's can be used (as a practical matter)
  - Simpler
  - By matter of law if safe harbor applies
- Advantage of prior year testing
  - Ability to see in advance how HCE ADP may be limited

Current or Prior Year Testing

- Prior year testing
  - If multiple HCE's exist, then an advance look may be of little value
  - If testing completed late in the following year, then little time to react to test results
  - Can be used in conjunction with split testing
  - Could be complicated where plan coverage changes in the current year due to a business transaction, plan amendment, change in testing procedure, etc.

Current or Prior Year Testing

- Prior year testing
  - Special rule for new plans (first plan year)
    - ADP/ ACP deemed to be 3% for NHCE's, OR
    - ADP/ ACP for NHCE's based on actual first year data
      - Allows double counting of QNEC's
    - Reg 1.401(k)-2(c)(3)

Current or Prior Year Testing

- Prior year testing Strategy:
  - If plan is adopted too late (past October 1st for a calendar year plan) for a safe harbor, then substantial leverage can be obtained using prior year testing and the deemed 3% ADP/ ACP
    - This permits HCE ADP/ ACP of 5%
    - May want to change back to current year testing and adopt a safe harbor for the 2nd plan year

Current or Prior Year Testing

- Prior Year Testing
  - Change from current year to prior year testing after 5 years of current year testing
    - Special rule for plan less than 5 years old
    - Regulation 1.401(k)-2(c)(1)
  - Always able to change to current year testing
  - Can use 1 method for ADP and other for ACP
    - Regulation 1.401(k)-2(c)(3)
- Must use same method for ADP/ACP in plans that are permissively aggregated. Reg §1.401(m)-1(b)(4)(iii)(B).
  - §410(b)(6)(C) transaction occurs and prior year election made within transition period
  - QNEC's cannot be double counted in year of switch
    - Same rule applies to use of shifting

Compensation Issues

- Plan operation must match plan definition
- Are non-cash items such as moving expenses, taxable welfare benefits and car allowance included?
- Does employee salary deferral election relate to cash compensation only?
- If a matching contribution is calculated periodically, then are a portion of non-cash amounts considered?
- May wish to remove non-cash compensation

Compensation for Testing

- Any Section 414(s) definition is acceptable
  - Unless W2, §3401, or total compensation under §415(c)(3) is used, testing of the compensation may be needed
  - Compensation may be tested using individual averages or using aggregate compensation of HCE's and NHCE's as groups. Reg 1.414(s)-1(d)(3)
  - Can always be excluded without testing:
    - Compensation earned prior to participation
    - Pre-Tax Salary Deferrals
    - Section 125 Deferrals
    - Reg 1.401(k)-6; Section 414(s)(2)

Testing Compensation

- Special Definition of Compensation
- In the example below, plan does not pass ADP using "gross" compensation
- It does pass ADP using "net" compensation
- Definition of Testing Compensation need not be stated in the plan document.

Name	Gross Comp	401(k)	§125	Net Comp	Gross Comp Deferral %	Net Comp Deferral %
Laura	275,000	17,500	0	255,000	6.86%	6.86%
Dan	45,000	2,500	1,500	41,000	5.56%	6.10%
Jon	50,000	1,600	1,200	47,200	3.20%	3.39%
NHCE Avg:						4.74%

Special Definition of Compensation

- Can exclude pre-participation compensation
  - For testing- does not require a plan amendment
  - For calculation of Safe Harbor contributions and minimum gateway contributions. This must be stated in plan
  - Cannot exclude for top heavy minimum to non-keys
- Beneficial for mid-year entrants who are NHCE's
- Can exclude other types of compensation if definition passes non-discrimination testing under 414(s)
- Essentially 414(s) requires overall impact on NHCE's is less than impact on HCE's
- Besides testing, definition of compensation applies to income that may be deferred

Compensation in Year of Termination

- What compensation to use for ADP/ACP testing?
- Use compensation to date of termination
  - Applies for safe harbors
  - Applies for matching contributions
- Date of termination
  - Complete stoppage of deferrals, match and any safe harbor contributions
  - Different from plan year end which is the date all assets have left the plan- used to determine application of excise tax for refunds
  - If match ends but deferrals continue

Mergers/ Acquisitions

- If §410(b)(6)(C) relief then both plans tested separately if no change in coverage during transition period (end of year following year of transaction)
  - Applies to asset or stock sale. Reg §1.410(b)-2(f). Rev Rul 2004-11
  - Relief may end if match is changed (at least for ACP)
  - Must continue to pass ADP/ACP testing with original plan
  - Some situations may be unclear

Mergers/ Acquisitions

- If plans merged then 3 possible methods of ADP/ACP testing:
  - 3 tests: each plan to date of merger and combined plans from merger to PYE
  - 2 tests: surviving plan for full year and merged plan to date of merger
  - 1 test: all deferrals and compensation

Order for Testing

- Return 402(g) excess
- Forfeit or distribute match related to 402(g) excess
  - These still count under Sections 404 and 415
- Perform ADP test
  - Correct failure
  - Forfeit/distribute match related to excess contributions
- Perform ACP test
  - Correct failure
  - BRF test of match structure

Performing the Tests

- ADP Test
  - Counting deferrals
    - Exclude deferrals of NHCE's in excess of Section 402(g) under a single plan, even if distributed
    - Include deferrals of NHCE's in excess of Section 402(g) if the excess is attributed to another plan
    - Reg 1.401(k)-2(a)(5)(ii)
    - Exclude deferrals refunded as 415 excess. Rev Proc 2013-12 Section 6.06.

Performing the Tests

- ADP Test
  - Counting deferrals
    - Catch-up contributions under Section 414(v) are not included to the extent they represent excess over Section 415, 402(g), or a plan limit
    - Reg 1.401(k)-2(a)(5)(iii)
    - Exclude deferrals made under Section 414(u) (attributable to active duty in military)
    - Reg 1.401(k)-2(a)(5)(v)

Performing the Tests

- ADP Test
  - Counting deferrals
    - Deferrals in excess of Section 415 limits are distributed along with gains and associated match is placed in forfeiture account.
    - Deferrals in excess of 415 limits are not counted in testing.
    - See Rev Proc 2013-12, section 6.06

Example of ADP Test

STEP 1 ADP Test				
	Status	Comp	401(k)	ADR
Belinda	HCE	150,000	13,000	8.67%
Tracy	HCE	230,000	15,500	6.74%
Richmond	NHCE	52,000	2,500	4.81%
Dany	NHCE	20,000	1,000	5.00%
John	NHCE	17,000	500	2.94%
NHCE ADP		4.25%		
Allowable HCE ADP		6.25%		
Actual HCE ADP		7.70%		
ADP Test Fails!				

Example of ADP Test

STEP 2 Determine Total Refund				
	Status	Comp	401(k)	ADR
Belinda	HCE	150,000	9,375	6.25%
Tracy	HCE	230,000	14,375	6.25%
Richmond	NHCE	52,000	2,500	4.81%
Dany	NHCE	20,000	1,000	5.00%
John	NHCE	17,000	500	2.94%
Total HCE Actual Deferrals			28,500	
Total HCE Allowable Deferrals			23,750	
Refunded Deferrals			4,750	

Example of ADP Test

STEP 3 Allocate Refunds				
	Status	Comp	401(k)	ADR
Belinda	HCE	150,000	11,875	7.92%
Tracy	HCE	230,000	11,875	5.16%
Richmond	NHCE	52,000	2,500	4.81%
Dany	NHCE	20,000	1,000	5.00%
John	NHCE	17,000	500	2.94%

Performing the Tests

- Calculating plan year gains
  - Any reasonable method
  - Allowable Method:
    - – Gain or loss on the account for the plan year multiplied by
    - – Excess Contributions, divided by
    - – Beginning of year account balance, plus plan year contributions

Performing the Tests

- Special Roth 401(k) Rules
  - Plan may designate whether Roth, pre-tax, or some combination is distributed
  - Plan may give Participant the choice
  - Income on Roth excess contributions is taxable
  - Reg 1.401(k)-2(b)(1)(ii)

Performing the Tests

- Collectively Bargained Employees
    - Tested separately from other employees
    - May be tested along with EE's from another collectively bargained unit, or each unit tested separately
    - Reg 1.401(k)-1(b)(4)(v)(B)

Matching Contributions

- Three pronged approach to testing:
  - Which matching contributions to count in ACP test
    - Elimination of matching contributions disproportionate to the amount of deferrals (overly bottom weighted)
  - ACP Test
    - Tests whether the amount of matching contributions is discriminatory
  - Benefits, Rights, Features
    - Prohibits use of discriminatory structures that would otherwise pass ACP testing
    - Reg 1.401(a)(4)-4(e)(3)(iii)(G)

Performing the Tests

- ACP Test
  - What is a matching contribution for an NHCE
    - Idea is to eliminate bottom weighting of match to avoid distortion of test result
    - Matching contributions which exceed the greatest of the following amounts are not included in the ACP test for NHCE's:

Performing the Tests

- ACP Test- What is a match?
  - Greatest of:
  - Match which does not exceed 5% of compensation
  - Match which does not exceed employee's deferral
  - 2 times the product of the representative matching rate and the employee's deferrals
    - Representative matching rate = match/deferrals

Matching Contributions

- Match used for NHCEs in ACP cannot exceed greater of:
  - 100% of deferrals
  - 5% of compensation
  - 2 X representative match rate (calculation is similar to representative contribution rate using: match/deferrals)
  - Reg 1.401(m)-2(a)(5)(ii)
  - If match is not level, then assume employee deferred 6% of compensation

Matching Contributions (cont.)

- Targeted Match Example:

Name	Comp	Deferral	Match	Rate
Tom	50,000	1,000	500	50%
Dick	40,000	1,000	500	50%
Harry	25,000	1,000	1,500	150%

Representative match rate = 50%, thus match included in ACP test for Harry is $1,250 which represents greater of:

Level of deferrals- $1,000

2X representative match rate- $1,000 (2X50%X1000)

5% of compensation- $1,250

Performing the Tests

- ACP Test
  - Include after tax employee contributions as well as matching contributions related to those amounts
  - Exclude forfeited/distributed match that relates to excess contribution or excess deferral
  - Reg 1.401(m)-2(a)(3); Reg 1.401(m)-2(a)(5)(v)

Performing the Tests

- ACP Test
  - Same as ADP test except the ratio consists of matching contributions divided by compensation. Reg 1.401(m)-2
  - Each rate of match must pass Benefits, Rights and Features (BRF) non-discrimination testing. Reg 1.401(a)(4)-4(e)(3)(iii)(G)
    - Regardless of whether ACP testing passes

Matching Contributions

- Varying Matching Contribution Structures:
- Each separate structure must meet basic coverage test for “current and effective availability” under §1.410(b)-4.
- Reg. §1.401(a)(4)-4(e)(iii)(G)
- For example: HCE’s receive 100% up to 4% of pay and NHCE’s receive 100% match up to 2% of pay, would violate this rule
- Determination of a separate benefit structure is made after refunds from ADP/ACP tests

Example of ACP Test

STEP 1 ACP Test			Gross	Gross	Initial
	Status	Comp	401(k)	Match	ACR
Belinda	HCE	150,000	13,000	13,000	8.67%
Tracy	HCE	230,000	15,500	15,500	6.74%
Richmond	NHCE	52,000	2,500	2,500	4.81%
Dany	NHCE	20,000	1,000	1,000	5.00%
John	NHCE	17,000	500	500	2.94%
NHCE ACP		4.25%			
Allowable HCE ACP		6.25%			
Actual HCE ACP		7.70%			

Example of ACP Test

STEP 2 Forfeit Match Related to Excess Contribution							
			Net	Total	Retained	Forfeited	Revised
	Status	Comp	401(k)	Match	Match	Match	ACR
Belinda	HCE	150,000	11,875	13,000	11,875	1,125	7.92%
Tracy	HCE	230,000	11,875	15,500	11,875	3,625	5.16%
Richmond	NHCE	52,000	2,500	2,500	2,500	0	4.81%
Dany	NHCE	20,000	1,000	1,000	1,000	0	5.00%
John	NHCE	17,000	500	500	500	0	2.94%
NHCE ACP		4.25%					
Allowable HCE ACP		6.25%					
Actual HCE ACP		6.54%					
ACP Test Fails!							

Example of ACP Test

STEP 3 Determine Total Refunded Match					
			Net	Adjusted	Adjusted
	Status	Comp	401(k)	Match	ACR
Belinda	HCE	150,000	11,875	11,004	7.34%
Tracy	HCE	230,000	11,875	11,875	5.16%
Richmond	NHCE	52,000	2,500	2,500	4.81%
Dany	NHCE	20,000	1,000	1,000	5.00%
John	NHCE	17,000	500	500	2.94%
Total Non-Forfeited HCE Match			23,750		
Total Allowed HCE Match			22,879		
Refunded HCE Match			871		

Example of ACP Test

STEP 4 Allocate Refunded Match					
			Net	Adjusted	Final
	Status	Comp	401(k)	Match	ACR
Belinda	HCE	150,000	11,875	11,440	7.63%
Tracy	HCE	230,000	11,875	11,440	4.97%
Richmond	NHCE	52,000	2,500	2,500	4.81%
Dany	NHCE	20,000	1,000	1,000	5.00%
John	NHCE	17,000	500	500	2.94%

Performing the Tests

- ACP Test
  - Safe harbor for ADP, but not ACP
    - Able to either
      - Perform normal ACP test, or
      - Perform ACP test counting only match in excess of 4% of each employee's compensation. Reg. 1.401(m)-2(a)(5)(iv)

Performing the Tests

- ACP Test Failure- Distribution
  - Excess aggregate contributions may be distributed
  - Alternatively, vested excess aggregate contributions may be distributed and non-vested amounts forfeited
  - Follow plan document
  - Reg 1.401(m)-2(b)(2)(v); 1.401(k)-2(b)(4)(ii)

Who is Included

- Actual employees who meet eligibility requirements
- In most cases, employees who are on the payroll of a "leasing company" but provide services like an employee to the adopting company
- HCE participates in more than 1 plan
  - All deferrals and compensation are aggregated in all ADP/ACP tests. Reg 1.401(k)-2(a)(3)(ii)
  - Each plan can have a separate definition of compensation
- Collectively bargained employees are tested separately. Reg 1.401(k)-1(a)(4)(v)

Who is Included

- Special rules for ACP test
  - Last day of year rule for match
    - Terminees excluded from ACP test
    - However, separate coverage test under Section 410(b) is performed for matching contribution structure
  - Multiple matching contribution structures must pass BRF testing under Reg 1.401(a)(4)-4(e)(iii)(G) and Reg 1.401(m)-2(b)(3)(v)(B)

Taxation of Corrective Distributions

- Subject to ordinary income tax, cannot be rolled over
- Distribution of Roth contributions are not taxable, but earnings are taxable
- No consent required
- Does not reduce RMD's
- Reg 1.401(m)-2(b)(2)(vi); 1.401(k)-2(b)(2)(vi)

Taxation of Corrective Distributions

- Timing:
  - Taxed in year received
  - More than 2 ½ months after plan year end, subject to 10% excess tax under Section 4979
  - Excise tax free deadline extended to 6 months for eligible automatic contribution arrangements under Section 414(w)(3)

Taxation of Corrective Distributions

- Section 402(g) Excess
  - Taxed in year contributed and also distributed, unless distributed within 3.5 months of year end. Rev Proc 2013-12 Appendix A .04
  - Included in ADP for HCE, not for NHCE
  - Regulation 1.401(k)-1(a)(4)(iii) and (v)(ii)

Coordination of Refunds

- Reg 1.401(k)-2(b)(4)(i) and (ii)
- Essentially protects against double distribution for both excess deferrals and excess contributions regardless of which test was performed first
- Allows forfeiture of match associated with excess deferrals and contributions in order to meet Section 401(a)(4) testing

Other Methods of Correction

- QNEC's and QMAC's
  - Can take either into account under ADP or ACP test
  - Provide only to NHCE's
    - QNEC can satisfy top heavy minimums
    - Non-elective contributions, excluding QNEC's must meet the requirements of Section 401(a)(4) Reg 1.401(k)-2(a)(6)(ii)

Other Methods of Correction

- QNEC's and QMAC's
  - QNEC's must be fully and immediately vested
  - QNEC's must be subject to same distribution restrictions as salary deferrals
  - QMAC's used in ADP test must meet above requirements too
  - Reg 1.401(k)-1(b)(5)

QNECs and QMACs

- Cannot be double counted (except in 1st year where deemed 3% rule not elected)
- Counts towards top heavy minimum

QNECs and QMACs (cont.)

- Issues the Plan Document Needs to Address
  - Who gets QNEC?
    - All NHCEs or Subset
    - Terminees
  - How is QNEC allocated?
    - Flat percent of pay
    - Modified flat dollar
    - Class based allocation
  - Can Plan be amended after plan year end?

QNEC's and QMAC's

- QNEC's and QMAC's cannot be overly bottom weighted
- Reg 1.401(k)-2(a)(6)(iv); 1.401(m)-2(a)(5)(ii)
- QNEC counted in ADP testing for any NHCE cannot exceed greater of:
  - 5% of compensation
  - 2 X representative contribution rate
- In general see, Reg 1.401(k)-2(a)(6)

QNEC's and QMAC's

- 2 X representative contribution rate
  - Contribution rate is QNEC plus QMAC used in ADP, the total divided by compensation
  - Rank eligible NHCE's by contribution rate in descending order
  - Consider the smallest group that includes half of eligible NHCE's
  - Representative contribution rate is the lowest contribution rate in this group

QNEC’s and QMAC’s

- 2 X representative contribution rate
  - Alternatively, representative contribution rate is lowest contribution rate of all participants who have not terminated employment

QNEC's and QMAC's

- QNEC's and QMAC's
  - ACP Test
  - Use QMAC
    - Must be valid match
  - Use QNEC
    - Must meet requirements for QNEC use in ADP test
  - Reg 1.401(m)-2(a)(6)

QNEC's and QMAC's

- Corollaries
  - 5% of comp QNEC is always valid, even if given to only 1 participant
  - Can use selective 5% of comp QNEC in ADP and also in ACP tests
  - Can use QMAC in addition to QNEC
  - Use QNEC/ QMAC only once. Reg 1.401(k)-2(a)(6)(vi)
  - If any participant receives QNEC >5% of comp, then at least half of participants must receive QNEC

QNEC Example

Name	Comp	QNEC	Rate
Joe	20,000	1,500	7.500%
Esther	25,000	1,500	6.000%
Arne	35,000	1,200	3.429%
Suzette	30,000	1,000	3.333%
Dani	30,000	1,000	3.333%
Jon	35,000	500	1.429%
Glenda	40,000	0	0%
Tracy	45,000	0	0%
Rick	50,000	0	0%

QNEC Example (cont.)

- 9 eligibles
- Pick the 5 with the highest applicable contribution rate
- Pick the lowest rate in this group: 3.333%
- 2 X Representative contribution rate = 6.666%
- QNEC considered for Joe in ADP test:
  - 20,000 X 6.666% = 1,333
  - Therefore (1,500-1,333) $167 of QNEC is disregarded in ADP test

Another QNEC Example

Name	Comp	QNEC	Rate
Dani	30,000	1,000	3.333%
Jon	35,000	500	1.429%
Glenda	40,000	0	0%

Let's assume Jon and Glenda terminate before year end.

Other Methods of Correction

- Shifting (Reg 1.401(k)-2(a)(6) and 1.401(m)-2(a)(6))
- Imagine deferrals, QNEC's, and QMAC's in a single pool
  - Apportion these amounts between deferrals and match
  - The amount apportioned to deferrals is subject to the ADP test
  - The amount apportioned to match is subject to ACP test

Other Methods of Correction

- Shifting
- Works best where there is a relatively low dollar cap on the match and the ADP test is failing
  - Match must look like deferral in order to shift it to the deferral pot
  - Potentially shifting beneficial where ADP test passes and match rate exceeds 100%
  - Must be stated in plan

–Example of Shifting-- BEFORE

Name	Compensation	Deferral $	Match $	Deferral %	Contrib %	HCE
Moe	205,000	13,000	1,000	6.34%	0.49%	Yes
Larry	120,000	13,000	1,000	10.83%	0.83%	Yes
Curly	190,000	10,000	1,000	5.26%	0.53%	Yes
				7.47%	0.617%	
George	45,000	1,500	1,000	3.33%	2.22%	No
John	40,000	1,200	1,000	3.00%	2.5%	No
Tom	50,000	1,300	1,000	2.60%	2.0%	No
				2.98%	2.24%	

- # Example of Shifting-- AFTER

Name	Compensation	Deferral $	Match $	Deferral %	Contrib %	HCE
Moe	205,000	13,000	1,000	6.34%	0.49%	Yes
Larry	120,000	13,000	1,000	10.83%	0.83%	Yes
Curly	190,000	10,000	1,000	5.26%	0.53%	Yes
				7.47%	0.617 %	
George	45,000	2,361	139	5.25%	0.31%	No
John	40,000	2,076	124	5.19%	0.31%	No
Tom	50,000	2,145	155	4.29%	0.31%	No
				4.91%	0.31%	

EPCRS Issues

- Late discovery of failed test
  - Correct by QNEC
  - Must include all eligibles (no split test, etc.)
  - Must be flat percentage of compensation (no targeted QNEC)
  - Rev Proc 2013-12 Appendix A .03
  - Other fixes available in VCP??

EPCRS Issues

- No opportunity to defer
  - Generally, ER must contribute 50% of missed deferral opportunity
    - Based on ADP of HCE or NHCE group times compensation
    - For safe harbor plan use 3% for non-elective and highest rate of 100% match for match safe harbor
    - Corrective match equals match owed based on 100% missed deferral opportunity
    - Corrective safe harbor ER amounts are based on 3% of compensation for a non-elective safe harbor and for match safe harbor it is the SHM owed based on correction for missed deferrals
  - ADP/ACP failure is corrected first
  - For non-safe harbor plans the ADP/ACP test may exclude those improperly excluded
  - Rev Proc 2013-12 Appendix A .05(2)

Catch-Up Contributions

- $5,500 for 2013
- Must turn 50 by December 31
- Indexed in $500 increments
- Section 414(v) and Reg 1.414(v)-1(c)(2); 1.414(v)-1(g)(3)

Catch-Up Contributions

- Excluded from all testing:
  - Section 415 limits
  - Section 402(g) limits
  - ADP testing
  - Section 401(a)(4) non-discrimination testing
  - However, deferrals in excess of compensation cannot be catch-up contributions
  - Reg 1.414(v)-1(b)(1); 1.414(v)-1(d)(3)

Catch-Up Contributions

- Priority of application:
  - First, amounts above statutory limits, e.g. Section 415(c) limits and Section 402(g) limits
  - Second, to amounts in excess plan limits
  - Third, reduce excess contributions resulting from ADP test
  - Reg 1.414(v)-1(d)

Catch-Up Contributions

- Universal Availability
  - If any plan of the employer allows catch-up contributions, then all 401(k) plans of the employer must allow them
  - If permitted, each participant must have ability to make full amount of catch-up above statutory or plan limits

Catch-Up Contributions

- Universal Availability
  - Collectively bargained plans excluded
  - Transition relief for mergers and acquisitions
  - 2 methods
    - Allow deferrals of up to 75% or more of compensation
    - Pro-rata deduction each pay period of catch-up, above any plan limit
  - Plan limits that apply to only HCE's are OK

Catch-Up Contributions

- Timing rules. Reg 1.414(v)-1(c)(3)
- Relevant for non-calendar year plans
  - 402(g) limits: apply catch-up as paid
  - Plan limits: generally apply at end of plan year
  - ADP testing: apply remaining amounts against refunds

Catch-Up Contributions

- Matching Contributions
  - Catch-up contributions are matched
  - Match related to excess contributions can be forfeited, even if catch-ups are applied to the excess contribution
  - When performing BRF testing of a rate of matching contributions, catch-ups are considered deferrals
  - Reg 1.414(v)-1(d)(2)(iii)

Safe Harbors

- Type of Safe Harbors:
  - Matching Contributions
    - Basic
    - Automatic Contribution (QACA)
    - Enhanced
  - Non-Elective
    - Basic
    - Automatic Contribution
  - DB-K Plan (§414(x)- no guidance or pre-approved documents)

Safe Harbors

- Matching Contribution- Basic:
  - $1 for $1 match, for deferrals up to 3% of compensation, Plus
  - $0.50 match, for deferrals between 3%-5% of compensation
  - Total Match of 4% of compensation
  - Full Vesting
  - No last day of year rule

Safe Harbors

- Matching Contribution- Qualified Automatic Contribution (QACA) §401(k)(13):
  - $1 for $1 match, for deferrals up to 1% of compensation, Plus
  - $0.50 match, for deferrals between 1%-6% of compensation
  - Total Match up to 3 ½% of compensation
  - 2 Year Cliff Vesting
    - This provision has little effect on plans with 1 year eligibility service
  - No last day of year rule
  - Special notice QACA notice

Safe Harbors

- Qualified Automatic Contribution Arrangement (QACA) §401(k)(13):
  - QACA withholding schedule:

	% of comp withheld
– Year 1-2	3%
– Year 3	4%
– Year 4	5%
– Year 5+	6%

  - Maximum is 10% of comp in any year
  - Strategy: Use a flat 6% for simplicity

Safe Harbors

- Automatic Contribution (QACA)
- Who Gets Automatically Withheld?
  - All participants after the effective date of arrangement who do not have a new deferral election
  - New participants after the effective date of the arrangement, plus old participants with no prior election
  - Affirmative deferral elections can expire (no minimum life?)
  - Mid year increases are permitted if consistent
  - No need to have QDIA
  - Automatic Contributions may be restricted due to §§415, 402(g), and hardship distributions
  - Best strategy in small ER is to avoid auto enrolling anyone. Make participants elect to defer or not defer

Safe Harbors

- Matching Contribution-Enhanced
  - Match deferrals up to 6% of compensation
  - Applies to both basic and QACA types
- Pay as you go Match
  - Can calculate match by pay period, month, or quarter
  - Company must pay match by end of quarter following the quarter in which the calculation period occurs

Safe Harbors

- Non-Elective
  - – 3% of compensation to all eligible NHCE's
  - – Full and Immediate Vesting
  - – No Last Day of Year Rule
- Non-Elective with (QACA)
  - – Same as regular non-elective except 2 year cliff vesting permitted
  - – QACA rules apply as previously described

Safe Harbors

- Non-Elective- Contingent
  - Notice to employees by December 1st of preceding year
  - Decision whether to employ safe harbor by December 1st of plan year
    - Subsequent notice needed only if safe harbor will apply
    - Plan amendment needed
  - Allows safe harbor decision to be deferred to 30 days from plan year end
  - When to employ contingent versus standard non-elective?

Strategic Use of Safe Harbors

- Threshold issue is whether to use a safe harbor
  - Small S Corps where owners have moderate salary but will defer 402(g) maximum
  - Spouse of owner of small business drawing low salary and wishing to defer 402(g) max
  - Weak NHCE participation (auto enroll?)
  - Non-owner HCE's would be forced to restrict deferrals
  - Cross-tested profit sharing plans- would contribute at least the same amount anyways

Example of High HCE ADP

	Comp	Deferral	ADR
SAUL	200,000	17,500	8.75%
MIRIAM	25,000	17,500	70%

HCE ADP = 39.38%

Strategic Use of Safe Harbors

- For larger groups some ADP refunds may be tolerable.
  - Cost of full vesting
  - Cost of Safe Harbor Contribution to Terminees

Strategic Use of Safe Harbors

- Compensation for Safe Harbor
  - Any 414(s) definition
  - Compensation earned as a participant
    - Minimizes fully vested contributions
- Who Receives Safe Harbor
  - Provide safe harbor to NHCE's only
  - Some HCE's may receive equivalent 3% of comp profit sharing contribution
  - Non-Key HCE's have top heavy minimum allocation satisfied with contributions subject to vesting
  - Be sure this is consistent with plan document

Strategic Use of Safe Harbors

- Plans which provide only for deferrals and safe harbor contributions are deemed not top heavy
- Therefore, allocation of forfeitures removes top heavy exemption
  - Use forfeitures for plan expenses
  - Potential issue using for SH contributions
- Non-elective safe harbor does not equate to Top Heavy minimum allocation
  - E.g. 5% of comp equivalent to DB minimum
  - T/H Minimum based on total comp for the year

Strategic Use of Safe Harbors

- If objective of owner is to defer $25,000-$30,000, then Safe Harbor Match often works best
- If plan will be cross-tested, then Safe Harbor Non-elective almost always works best
- If plan uses safe harbor match and expects weak participation, then carefully document distribution of notices
- Plan with immediate eligibility wishing to use basic safe harbor match can use QACA to take advantage of 2 year cliff vesting to avoid benefit cost for short service employees

Strategic Use of Safe Harbors

With Non-Elective Safe Harbor, starting point is to make it Contingent

- Will plan always be top heavy so that safe harbor will always be paid?
- Is plan cross-tested and does company have predictable income stream so that determining whether to use the safe harbor a year in advance is adequate?

Strategic Use of Safe Harbors

- Safe Harbors always eliminate ADP testing
- Elimination of ACP testing is requires the following requirements be met:
  - Discretionary match cannot exceed 4% of compensation
  - Rate of match cannot increase as deferrals increase
  - Rate of match for HCE's at any given level of deferrals cannot exceed the rate at that level of match for any NHCE
    - Match with last day of year rule voids ACP Pass
  - Deferrals above 6% of comp cannot be matched

Strategic Use of Safe Harbors

- Considerations to Qualified Automatic Contribution Safe Harbor
  - Client prefers short waiting period for eligibility
  - Client does not want to vest short service employees
  - Company wants a lower cost match than basic safe harbor
  - In small companies, incentive to obtain affirmative elections from eligibles
  - Cost may increase with QACA's relative to basic safe harbor match due to increased participation

Things to Know About Safe Harbors

- Generally, the plan year must be a full year
- Exceptions:
  - 1st year of a 401(k) arrangement (new plan or existing PSP adding 401(k) feature)
    - Must be in effect for 3 months (Oct 1st for a calendar year)
  - Last year of a plan that terminates
    - 30 day notice
    - Regulation 1.401(k)-3(e)(4)
  - Last year of a plan due to merger
  - Sandwich year where short year associated with plan year change

Things to Know About Safe Harbors

- Safe Harbor Match can be ended mid year with 30 day prospective notice
- Safe harbor non-elective can be ended mid year due to substantial business hardship
- Safe Harbor Contribution must be paid by EOY following year for which it is due
- Compensation applied to date of plan termination in the last active plan year
- Many amendments are precluded.

Things to Know About Safe Harbors

- Many amendments are precluded
  - Add Roth 401(k)
  - Add Hardship distributions
  - Expand eligibility
  - Change trustees
  - Change plan year
  - Retroactive coverage amendment
  - Other items not addressed in the participant notice??

Coordination of Contributions

- Cross-Tested Plans with SH Non-Elective
- All NHCE's receive SH Non-elective Contrib
- If greater, all NHCE's must receive Gateway minimum allocation
- If greater, all non-key employed at year end, must receive Top Heavy minimum allocation, based on full year compensation

Coordination of Contributions

- Gateway minimum
  - DC only
    - 5% of compensation is always acceptable
    - 4.38% of compensation is acceptable as follows:
      - Principal receives allocation of $51K
      - Of this amount $17,500 is 401(k)
      - $33,500 is profit sharing
      - Compensation is $255,000

Automatic Contributions

- Viewed favorably by policy makers as a way to increase retirement savings
- Presumes participants want to save for retirement, but often fail to take the initiative
- Use to improve ADP testing results
- Some design flexibility
- Use along with special safe harbors
- Deadline for §4979(f) 10% excise tax on refunded excess contributions extended to 6 months for EACA's that apply to **all** participants

Automatic Contributions

- Definitions:
- Eligible Automatic Contribution Arrangement (EACA) §414(w)
  - Permits withdrawal of automatically withheld contributions within 90 days of first contribution
  - Contributions need not be invested in QDIA
  - Annual notice 30-90 days before plan year beginning, or up to date of eligibility for new entrants
  - Cannot start mid year except for a new plan
  - Can be limited to new employees (lose 6 month refund extension)

Automatic Contributions

- EACA withdrawal not counted as salary deferral
- EACA withdrawals restricted to amounts withheld under a default election
- EACA withdrawal does not mandate cessation of salary deferrals
- Match associated with EACA withdrawal is forfeited
- Partial EACA withdrawals prohibited
- If an arrangement is a QACA it is also an EACA

Automatic Contributions

- Qualified Default Investment Alternative (QDIA) ERISA §404(c)(5)
  - Default investment in the absence of an election
  - 4 Choices
    - Managed account intended to meet the needs of the entire plan population- Single Strategy. E.g. Balanced Account
    - Lifecycle or Target Date Fund using age sensitive allocation and automatic adjustments over time
    - Separate managed accounts based on age
    - During 1st 120 days, a money market or stable value fund

Automatic Contributions

- Qualified Default Investment Alternative (QDIA) ERISA §404(c)(5)
  - 30 day notice, waived for EACA's
  - Various requirements relating to content of notice and ability to move and select other investments
  - Fiduciary responsibility for selection and monitoring of QDIA

Issues in Roth 401(k)

- Treated as another money type
- Strict separate accounting standards to avoid diversion of income to Roth K account
- Contributions are after tax and constitute basis
- No income restrictions on making Roth K contributions

Issues in Roth 401(k) (cont.)

- Growth is also tax free if:
  - 5 years since initial contribution AND
    - Age 59 ½,
    - Death, or
    - Disability
  - 5 years starts the first day of the calendar year for which a contribution is made and ends the last day of the 5th calendar year from that date
    - Participant enter plan and contributes 7-1-2009. Five years is satisfied 12-31-2013

Issues in Roth 401(k) (cont.)

  - Proprietor makes 2010 deferral contribution on 4-15-2011. Five years is satisfied on 12-31-2014
- No Tacking of years from Roth K account to Roth IRA
  - Separate 5 years for Roth IRA
  - If Roth K distribution “qualified” when rolled over, then entire amount is basis
  - Only growth on this amount could be taxable within 5 years
  - Roth IRA treats withdrawals as basis first – Contributions, then Conversions, then earnings
  - Unlikely that any amount will be taxable

Issues in Roth 401(k) (cont.)

- Example: Jon, age 60, having made his first Roth K contribution in 2008, makes a direct rollover of his Roth K account of $75,000 to a new Roth IRA on 7-1-2012. Jon begins taking $1,000 per month from the Roth IRA. It is not likely there will be taxable income.
- If a Roth 401(k) account is rolled to a pre-existing Roth IRA, the 5 year period for the entire amount starts with the date of the first contribution/rollover for the Roth IRA.

– Non-qualified distributions from Roth K acct taxed under Section 72 based on income proportionate to basis (not the same as Roth IRA's)

Issues in Roth 401(k) (cont.)

- Roth K accounts are included in determining MRD's.
- Roth IRA's are not subject to MRD's
  - Roll Roth K account to Roth IRA prior to Required Beginning Date
- Roth 401(k) likely be advantageous (or at worst neutral) for workers that pay little or no federal income tax.
  - Taxation under state laws?

Issues in Roth 401(k) (cont.)

- Hardship Distributions
  - Amount of available hardship determined with reference to both Roth K and pre-tax deferrals
  - Hardship distribution may be taken entirely from either Roth K or pre-tax deferrals
  - Amount of available hardship reduced by total amount of distribution
  - Roth K hardship distribution may be partially taxable
- Rollover of Roth K to another plan only if recipient plan permits Roth K contributions

Issues in Roth 401(k)

- Plan Design Issues
  - Will plan permit participants to select Roth K or pre-tax deferral for
    - Loans
    - Hardship distributions
    - Returns of excess contribution and excess deferrals (may apply default assumption initially or after lapse of fixed period)
- Roth K and pre-tax deferrals are counted separately in determining $1,000/ $5,000 cash-out threshold

Roth Conversions

– Able to directly roll over from pre-tax account (401(k), match, PS) to Roth IRA or Roth account in a QP
  - Section 72(t) tax does not apply (unless subsequent distribution within 5 years from rollover – referred to as a "recapture tax")
  - No mandatory withholding on pre-tax plan account to Roth IRA/QP conversion
  - Participant can recharacterize external conversion back to a traditional IRA if she changes her mind.
  - Recharacterization does not apply to internal conversions
  - External Roth conversions require a distributable event

Roth Conversions

Plan can limit the purpose of an in service distribution to an external Roth conversion

- Timing of retroactive amendment for internal Roth conversion
- Amendment to accept Roth conversions as compared to Roth K rollovers
- Series of conversions can achieve income spreading. Is there a tax benefit?
- Economics of a conversion depend on ability to pay taxes with after tax personal assets

Roth Conversions

- New ATRA rules: internal conversion without distributable event
- Will IRS permit post year end discretionary amendment?
- Will IRS allow amendment to be limited to the vested balance, or fully vested accounts?
- Will spouses and other beneficiaries be permitted to complete an IRR?

Roth Conversions

- Distributable events:
  - Age 59 ½
  - Attainment of normal retirement age (62+)
  - 5 years participation for PS/Match
  - Money invested in plan for at least 2 years (PS/Match)
  - Termination of employment issues
    - Severance of employment sufficient for 401(k)
    - For pension (such as money purchase) standard is person is employed by a new employer, new employer does not maintain the plan, there is no transfer of liabilities or assets, and new employer is unrelated through 414(b), (c), or (m)

Selective Safe Harbor Match

- Example:

Name	Base Comp	Commis sion	Total Comp	SH Match	Savings
Owner	255,000	0	255,000	10,200	0
Sales 1	50,000	100,000	150,000	2,000	4,000
Sales 2	50,000	100,000	150,000	2,000	4,000
Sales 3	50,000	100,000	150,000	2,000	4,000
Office 1	35,000	0	35,000	1,400	0
Office 2	45,000	0	45,000	1,800	0

You Know You're in Trouble When…

10. You neglect to add your TPA fees to the 404(a)(5) notice and the DOL punishes you for Indecent Disclosure
9. You applied the remaining $1 in your forfeiture account to your safe harbor match
8. You add a comma to the document of a Safe Harbor Match plan in the Middle of the Year.

You Know You're in Trouble When…

7. You flunk the new DOL Fiduciary Lie Detector

6. You think the new DOL electronic disclosure rules require the Employer purchase an IPAD for each participant

5. You hire an ERPA to lead you on your next Himalayan expedition

You Know You're in Trouble When…

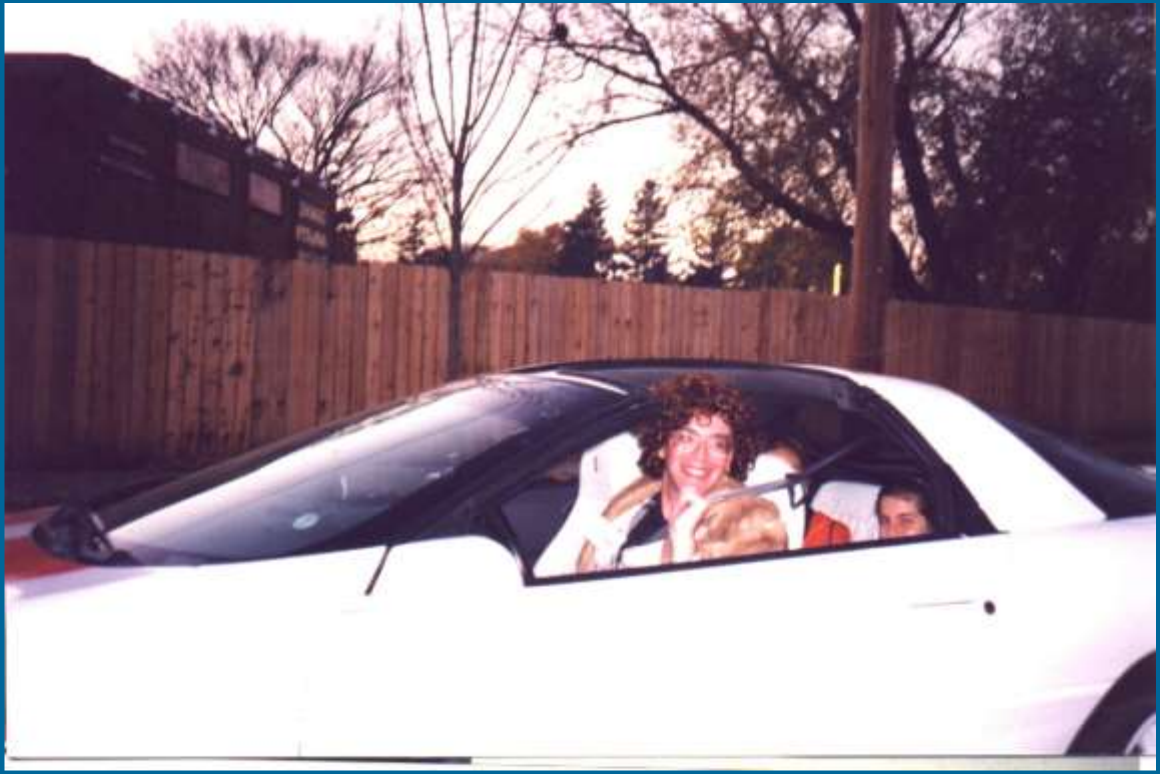
4. You think an Unaffiliated MEP is one that has not yet aligned itself with a Religious Order.

3. The number of ASPPA Designations has finally exceeded the number of Fidelity Funds

2. You think an Open Architecture Arrangement is based on the Linux system

1. You celebrate your 30th Wedding Anniversary at an ASPPA Conference

Cross Testing is Fun!



THE END