401(k) Plan Design-
A Comprehensive Look

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Topics

- Testing Elections and Corrections
- Keeping Afloat in Safe Harbors
- Automatic Contributions- Glass is ½ Full
- Matching Contributions-
- Roth Conversions
- Defining Compensation
- Distributions
- Cross-Testing and 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
  - Otherwise there is a choice
- HCE's deferrals, match, and compensation combined in each plan in which they are tested

Determining the Employer

- All members of a controlled group are treated as 1 employer
  - This is usually pretty easy to determine
- All members of an affiliated service group are treated as 1 employer
  - Often murky
  - Is there a single or multiple ASG's
  - Obtain determination letter for better clarity

Determining the Employer

- Trend with medical groups to consolidate into larger hospital based practices
  - Movement away from traditional private practice
  - Plain vanilla qualified plans
  - Latest trend is to treat physicians as IC’s
    - Back to smaller/richer qualified plans
    - Less efficient than original arrangements

Testing Elections

- Plan document includes only those testing elections required to be stated in plan
  - Split testing
  - Top Paid Group
  - Prior Year/Current Year
- 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
  - 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
- However, the plan does not have to specifically authorize these methods

Split Testing Example for 2011

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

- 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

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, and just with profit sharing.

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 $49K 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 $110,000 in 2010 (prior year) for determining HCE's in 2011.
  - More than 5% owners (using §318 attribution) in current (2011) or prior year (2010)

Who is a Highly Compensated Employee?

- Top Paid Group Election:
  - Employees with compensation in excess of $110,000 (threshold for 2010/2011) 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%:
    - 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
    - Who are union employees, but only if over 90% of employees are union employees
  - 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 $110,000 compensation threshold (2011)
  - Rounding conventions are permitted

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 HCE's among 25 office workers
    - 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	245,000	16500	6.73%
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: 8.37%
HCE ADP After Top Paid Group Election: 6.73%

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 2010 then
  - Determine who is an HCE by compensation based on 2009 census data
  - Determine who is an NHCE by compensation based on 2008 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 7/1/2010-6/30/2011
    - Lookback year is 7/1/2009-6/30/2010
  - Company maintains a pension plan with a fiscal year 10/1/2010-9/30/2011
    - Lookback year is 10/1/2009-9/30/2010
  - Calendar year for lookback is 2010.

Current or Prior Year Testing

- 2 methods of calculating data for ADP/ACP
  - Current year test uses data 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

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
  - Simpler
- 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 to current year testing after 5 years
    - Special rule for plan less than 5 years old
  - Always able to change to current year testing
  - Can use 1 method for ADP and other for ACP
  - §410(b)(6)(C) transaction occurs and prior year election made within transition period

Mergers/ Acquisitions

- No specific guidance on testing method
- 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)
- If plans merged then 3 possible methods
  - 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

Safe Harbors

- Type of Safe Harbors:
  - Matching Contributions
    - Basic
    - Automatic Contribution (QACA)
    - Enhanced
  - Non-Elective
    - Basic
    - Automatic Contribution
  - DB-K Plan (§414(x))

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

- Matching Contribution- Qualified Automatic Contribution (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

Safe Harbors

- Matching Contribution- 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

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
  - 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

Example of High HCE ADP

	Comp	Deferral	ADR
SAUL	200,000	16,500	8.25%
MIRIAM	25,000	16,500	66%

HCE ADP = 37.13%

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 or SH contributions (potential issue with latter)
- 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 line with common match formula
  - 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)
    - Must be in effect for 3 months (Oct 1st for a calendar year)
  - Last year of a plan that terminates
  - 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 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 may be precluded if issue addressed in safe harbor 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
    - 4.422% of compensation is acceptable as follows:
      - Principal receives allocation of $49K
      - Of this amount $16,500 is 401(k)
      - $32,500 is profit sharing
      - Compensation is $245,000

Coordination of Contributions

- Gateway minimum
  - DB/DC Combination
    - 7.5% of compensation is acceptable
    - Lower amount may work
      - » Based on disparity in equivalent allocation
      - » Allocation equivalent of DB accrual counts towards this

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 testing results if no safe harbor applies
- 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 may not be tied to temporary 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 2006, makes a direct rollover of his Roth K account of $75,000 to a new Roth IRA on 7-1-2011. Jon begins taking $1,000 per month from the Roth IRA. It is not likely there will be taxable income.
- Non-qualified distributions from Roth K acct taxed under Section 72 based on income proportionate to basis (not the same as Roth IRA's)
- 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

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 starting 1-1-2010 regardless of participant's MAGI.
  - 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 Roth QP account
  - Both internal and external Roth conversions require a distributable event

Roth Conversions

- Conversions in 2010 subject to special income spreading rule over 2011 and 2012.
  - Based on tax rates in effect in 2011 and 2012
- Series of conversions can achieve income spreading but without the deferral of taxation
- In-service distributable event can be limited to a Roth conversion
- Timing of retroactive amendment for internal/external Roth conversion
- Amendment to accept Roth conversions as compared to Roth K rollovers

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)

Compensation Earned After Severance

- The Following Compensation is Counted
  - Commissions, bonuses, regular pay that would have been paid, for services already provided, if the individual had not terminated employment.
    - To qualify must be paid no later than the later of:
      - The end of the limitation year
      - 2 ½ months after severance from employment
    - This compensation MUST be counted and subject to any 401(k) deferral election in place at the time the compensation was paid

Compensation Earned After Severance

- The Following Compensation May Be Counted
  - Payments for unused sick pay, unused vacation pay, or other leave MAY (at employer's election) be counted as compensation if paid no later than the later of:
    - The end of the limitation year, or
    - 2 ½ months after severance from employment
- Severance Payments are never counted (request on census?)

Compensation Earned After Severance

- Non-Qualified Deferred Compensation payments May Be Counted
  - Must be received no later than:
    - End of the limitation year
    - 2 ½ months after severance from employment
- Pay received on Military Leave- MAY be counted
  - Must not be greater than what the employee would have earned during the period of active duty

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

Testing Compensation

- Use a different definition of testing compensation than that prescribed in the plan
- Exclude tax exempt §125 deferrals and tax deferred §401(k) deferrals (not Roth K)
- Objective is to lower compensation of NHCEs while leaving compensation of HCEs relatively unchanged

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	16,500	0	245,000	6.73%	6.73%
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

Selective Safe Harbor Match

- Example:

Name	Base Comp	Commission	Total Comp	SH Match	Savings
Owner	250,000	0	250,000	9,800	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

Combining Defined Benefit and 401(k)

- Some interesting planning observations…
  - Since 401(k) deferrals do not count towards deduction limits, it can be advantageous to "shift" allocations from employer contributions to deferrals
    - This creates more room for defined benefit contributions
  - For self-employed persons, gross compensation is netted against employer contributions, but not against salary deferrals
    - This allows a larger testing compensation in situations where the participant does not have compensation in excess of §401(a)(17) limits

Example of CB/ 401(k) Plan

EE	Comp	Age	401(k)	SH	PS	CB	Total
Owner 1	245K	51	22,000	7,350	0	122,500	151,850
Owner 2	245K	51	22,000	7,350	0	122,500	151,850
Owner 3	245K	51	22,000	7,350	0	122,500	151,850
HCE 1	150K	45		4,500	3,000	0	7,500
HCE 2	150K	50		4,500	3,000	0	7,500
HCE 3	150K	55		4,500	3,000	0	7,500
NHCE 1	50K	35		1,500	2,250	1,500	5,250
NHCE 2	40K	40		1,200	1,800	1,200	4,200
NHCE 3	30K	45		900	1,350	900	3,150

Explanation of Example

- Cash Balance plan with 401(k), safe harbor non-elective and profit sharing
- All employees receive SH non-elective contribution of 3% of compensation
- Owners receive cash balance pay credit of 50% of compensation
- Other HCE's are excluded from Cash Balance
- NHCE's receive profit sharing and CB pay credits sufficient to obtain top heavy minimum, gateway, and pass 401(a)(4) testing
- HCE's receive sufficient PS for TH minimum

Summary of Example

- Total Compensation: $1,305,000
- 6% of comp DC deduction limit: $78,300
- Actual DC contribution (excl 401(k)): $44,550
- Total Contributions Both Plans: $490,650
- % of total contribution to 3 owners: 92.8%

Other Observations

Other Testing Observations

- Adding 401(k) feature allows “conversion” of some allocations from employer contributions to 401(k) deferral with respect to principals
- For example, a participant can have $49,000 in profit sharing allocations, or $32,500 in profit sharing allocations and $16,500 in salary deferrals
- Adding a 401(k) often helps to reduce rank and file employee contribution costs for principals who want to maximize contributions at the §415(c) level

Other Testing Observations

- This principle holds true except where age disparities are so large that the plan passes cross-testing with the gateway minimum allocation
- 401(k) also allows the use of catch-up contributions where the principals are at least age 50

Other Testing Observations (cont.)

- Adding a 401(k) feature may, in some circumstances, assist testing…
  - By reducing employer contributions to principals, it may eliminate the need to perform ABP testing by reducing accrual rates for HCE's to the point where each rate group has a 70% ratio percentage
  - An HCE can have the highest accrual rate for ABP testing purposes and still pass this test.
  - However, an HCE cannot have the highest accrual for purposes of the rate group test.

Other Testing Observations (cont.)

- This may, in some circumstances, assist testing…
  - Thus, splitting the maximum allocation between 401(k) and profit sharing may enable passing by reducing the HCE’s accrual rate for the rate grouping test
  - This may be necessary with relatively younger HCEs in a multiple HCE group

Illustration With No 401(k)

Name	Age	Comp	Allocation	HCE Acc Rate	NHCE Acc Rate
Euclid	50	200K	30,000	13.812%	
Archimedes	31	40K	2,000		12.922%
Ptolemy	26	45K	2,250		9.002%
Moe	58	200K	30,000	5.223%	
Eudoxus	39	52K	2,600		5.167%
Larry	55	35K	1,750		1.967%
Curly	60	40K	2,000		1.546%

Plan fails rate group test since Euclid has highest accrual rate

Illustration With 401(k)

Name	Comp	401(k)	PS Allocation	HCE Acc Rate	NHCE Acc Rate
Archimedes	40K		2,000		12.922%
Ptolemy	45K		2,250		9.002%
Euclid	200K	15,000	15,000	7.044%	
Eudoxus	52K		2,600		5.167%
Moe	200K	15,000	15,000	2.612%	
Larry	35K		1,750		1.967%
Curly	40K		2,000		1.546%

Plan passes rate group test. Still needs some NHCE 401(k) to pass ABP test

Illustration

- Dr. Diane has Schedule C income of $200,000
- Her maximum profit sharing deduction is $38,140
- There is room for $6,987 to go to a DB
- Now add 401(k) to profit sharing
- She has deferrals of $16,500
- She can have profit sharing of $32,500 for a total defined contribution allocation of $49,000
- She can have a defined benefit of deduction of $12,627

Other Observations

- Maximize allocations to those earning less than 401(a)(17) limits (for 2011)
  - If profit sharing only, need $196,000 in wages for $49,000 allocation
  - If profit sharing only, need $255,036 of net self employment income for $49,000 allocation
  - If profit sharing and 401(k) need $130,000 in wages for $49,000 allocation
  - If profit sharing and 401(k) need $171,416 in net self employment income for $49,000 allocation

Other Observations (cont.)

- Maximum allocation with safe harbor match: $26,300 ($31,800 with catch-up)
- Maximum allocation with non-elective safe harbor: $23,850 ($29,350 with catch-up)
- Minimum compensation in order to make $16,500 401(k) deferral
  - $17,867 in wages assuming full FICA + Medicare
  - $16,743 in wages assuming Medicare only

Other Observations (cont.)

- 402(g) limit of $16,500 ($22,000 with catch-up) is based on individual over a calendar year. Includes 401(k) plans and 403(b) plans
- Exception for Section 457 government deferral plans which stand on their own and don’t share limitations

QNECs and QMACs

- Provide only to NHCEs
- Total non-elective contributions must be non-discriminatory excluding QNECs
- QNEC can each be used for ADP or ACP test
- QMAC with QNEC characteristics can be used in ACP test
- Cannot be double counted (except in 1^{st} year where deemed 3% rule not elected)
- Counts towards top heavy minimum
- Limited ability to bottom weight or use selectively

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?

QNECs and QMACs (cont.)

- Can select any subgroup, in any amount if no one receives more than a 5% of comp QNEC
- Otherwise representative contribution rate rule applies
- If over half of NHCE’s terminate then special relief
- QNEC’s often more expensive than safe harbors so explore safe harbor if repeated use of substantial QNEC’s

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%

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

QNECs and QMACs

- Employer able to count 5% QNEC for ADP test and 5% QMAC for ACP test for an employee
- QMAC's used in ACP must be eligible matching contributions
- At least half of employees must receive a QNEC if the QNEC for any employee exceeds 5% of compensation

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

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)
  - 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

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
- Consider “springing” matching contribution

Interim Valuations

- Applies to pooled, trustee invested, profit sharing account and remaining quarterly valued 401(k) participant directed accounts.
- Plan should probably be amended before any affected employee terminated employment to avoid potential cut-back and BRF issues
- Trustee must act in the interests of all plan participants
- Interim valuations used to avoid distortion of accounts to participants remaining after distributions

You Know You're in Trouble When…

10. DOL 408(b)(2) regulations authorize civil penalties for Indecent Disclosure

9. Your broker apparently thinks QDIA stands for Questionably Determined Investment Advice

8. ASPPA lobbies Congress to pass the Annual Stimulus for Pension Professional Act (ASPPA), requiring costly interim amendments each year

You Know You're in Trouble When…

7. You think a PTIN is something you find in an outhouse

6. Influenced by the new Weight Loss Shows, your client adopts a stringent diet when you scold him for using Bottom Weighted QNEC's

5. It figures that a Congressman from Texas would spend so much time thinking about cross-testing

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

You Know You're in Trouble When…

3. You think an AFTAP is something a professional athlete does to a reporter, then gets in trouble

2. You obligingly recruit the services of a clergyman every time a client asks for a Roth Conversion

1. You've blown up more safe harbors this year than the US Navy SEALS

THE END