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Proposed Regulations Affect Cross-Tested Plans

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On January 29, 2016, the Treasury proposed several changes to its nondiscrimination regulations. For the most part, the proposals address issues associated with closed defined benefit plans. However, the regulations also make a significant change affecting the general nondiscrimination test as used for cross-tested defined contribution plans. This ASPPA *asap* discusses the cross-tested rules. A future ASPPA *asap* will analyze the defined benefit rules.

It is important to realize at the outset that this is simply a proposal. It is not currently effective. The proposal would apply to plan years beginning after the year the regulations are finalized. However, this proposal is extremely important because it has the potential to increase the employee costs of some of the most popular defined contribution plan designs being used today, and could lead some employers to restructure their allocation methods.

Cross-tested plans demonstrate that the nonelective contributions are nondiscriminatory in amount by passing the general nondiscrimination test. (Sometimes this is called rate group testing). Contributions are converted to equivalent benefit accrual rates (EBARs) and participants are classified into rate groups based on their respective EBARs. Each rate group must either pass the ratio percentage test or the average benefit test.

The proposed regulations add a new requirement. A rate group cannot pass the average benefit test unless "The formula that is used to determine the allocation for the HCE with respect to whom the rate group is established applies to a group of employees that satisfies the reasonable classification requirement of §1.410(b)-4(b)."

Many plans, as currently structured, will not be able to satisfy this requirement.

The reasonable classification requirement of Treas. Reg. §1.410(b)-4(b) states:

> A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

For example, a plan that places each employee in a separate allocation classification or group cannot satisfy the requirement, nor could classifications that have the same effect as naming individuals. The proposed regulations would force these plans to pass the ratio percentage test for each rate group, which will often require additional contributions for rank and file employees. A rate group cannot pass the ratio percentage test unless the coverage fraction (or ratio percentage) of the group is at least 70%. The threshold for the nondiscriminatory classification test, which is part of the average benefit test, is much lower, ranging from 20% to 45%.

Right now, the reasonable classification requirement of Treas. Reg. §1.410(b)-4(b) is part of the average benefit test as it applies to *coverage*. Currently the reasonable classification requirement is *not* part of the average benefit test when applied to *nondiscrimination testing*. The proposed regulations seek to change this.

Under the proposal, a rate group cannot use the average benefit test unless the allocation formula applied to the HCE or HCEs at the heart of the group applies to a group of employees that is reasonable and that satisfies objective business criteria, such as job classification or location. Grouping employees by name cannot satisfy the test.

Besides the problems this will cause for many individual plan sponsors, there are many serious concerns about the proposal:

- The proposal introduces a "facts and circumstances" test, with related uncertainty, into a nondiscrimination system that has been purely numerical for over 20 years. Is a classification that describes just one employee equivalent to enumeration by name? What about two employees? There is no way to know before the plan is under audit.
- The proposal unfairly burdens small employers, who face added uncertainty because of the likelihood of having very small groups. The smaller the groups, the more likely an IRS challenge that a job classification is the equivalent of enumeration by name.
- To the extent an employer is forced to use the ratio percentage test, rather than the average benefit test, this could raise costs to cover employees. For over a decade cross-tested plans have provided minimum gateway contributions, a systematic approach which over time can give an employee generous retirement benefits.

The proposal gives the example of an HCE and two (out of four) NHCEs all of whom have the same allocation formula. The NHCEs were selected by name. The proposal concludes that is not a reasonable classification. This is why a plan placing each employee in a separate group cannot satisfy the proposal.

For example, suppose a cross-tested plan classifies employees into two groups: doctors and staff members, and has different allocation formulas for each group. Job classification is a reasonable formula which meets the reasonable classification test, but we are uncertain whether the group is so small it is equivalent to enumeration by name. Suppose the following situation exists for 2016:

Column1	Age	Comp.	Allocation	Alloc. Rate	EBAR
Dr. 1	50	$265,000	$53,000	20.00%	8.55%
Dr. 2	45	$265,000	$53,000	20.00%	12.86%
Staff 1	40	$80,000	$4,000	5.00%	4.84%
Staff 2	32	$60,000	$3,000	5.00%	9.29%
Staff 3	29	$40,000	$2,000	5.00%	11.85%
Staff 4	25	$30,000	$1,250	5.00%	16.45%
Total		$740,000	$116,250		

There are two rate groups, 8.55% and 12.86%. The 8.55% group satisfies the ratio percentage test. It benefits both HCEs and 3 of the 4 NHCEs, for a coverage fraction of 75%. However, the 12.86% rate group covers 50% of the HCEs and 25% of the NHCEs, for a coverage fraction of 50%. That will satisfy the nondiscriminatory classification portion of the average benefit test, but it will not satisfy the ratio percentage test. The plan easily passes the average benefit percentage test at 99.05%. This plan is nondiscriminatory, both under existing rules and under the proposed regulations, assuming (and this is a big assumption) that the IRS would find this is a reasonable business classification.

However, suppose the plan document places each employee in a separate allocation group. The employer nonetheless wishes to make the same allocations described above. Under the proposed regulations, the employer would not be able to use the average benefit test for the 12.86% rate group. In order to pass the ratio percentage test, the employer would need to have another staff member in the 12.86% rate group. The employer could accomplish this by allocating an additional $170 to Staff 3. For many existing plans, the increased contribution cost associated with this proposal, whether expressed as dollars or as a percentage of compensation could be quite significant.

That cost would not necessarily benefit all NHCEs, as do minimum gateway contributions, but only employees the employer selects.

The proposed regulations, if finalized, would mean most cross-tested plans would need to be analyzed, and many would need to be amended. It is regrettable that an extensive amendment process would have to be again undertaken and so soon following the completed deadline to restate preapproved defined contribution plans for PPA.

Naturally, the ASPPA Government Affairs Committee is already closely reviewing the proposed regulations, with an eye to making formal comments to the Treasury. As part of ASPPA's response, it may well be calling on member input or asking for members to assist in a lobbying and educational effort.