



The Creative and Complicated World of ADP/ACP Nondiscrimination Testing

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Agenda

- Employees in the Test
- Correcting Failed Tests by Qualified Contributions
- Timeline for Testing and Corrections
- EPCRS Correction After 12 Months
- EPCRS 2013-12: New Issues Affecting Testing
- Correcting Failed Tests by Refunds and Other Scenarios
- Avoiding Testing Problems
- Merger and Acquisitions
- Compensation
- Post-severance Compensation

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Background

- Plan may not favor HCEs on contributions
 - HCEs can afford to defer larger %
- Congress developed 2 tests
 - Deferrals, ADP
 - Matching funds and After Tax, ACP
- Generally, plan covers only NHCEs – no testing
- Generally, plan covers only HCEs – no testing
 - Discrimination can only be between HCE and an NHCE
 - Sets up unusual patterns when there are only NHCEs
- Any test failures must be completed and corrected no later than 12 months after plan year end

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Employees in the Test

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Employees Included in the Test

- All employees who are able to defer at any point during the year are considered in the test
 - Example: Ann Jones is eligible. She defers in January, then terminates employment. She is in the test for the one month of deferrals and salary
- Employees who are eligible to defer and do not defer (zero ADR)
 - Automatically enrolled who take a permissible withdrawal

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401(k) Questionnaire Final Report Eligibility for Elective Deferrals

Age Requirement to Defer	
Age Plans	% of
None	20%
18 Years	13%
19-20	4%
21	64%

Age	Small	Medium	Large	Very Large
None	12%	20%	24%	57%
18 Years	3%	13%	20%	17%
19-20 Year	1%	4%	6%	2%
21 Years	84%	63%	50%	24%

Service Requirement to Defer	
Service of Plans	%
None	13%
One Month	4%
Six Months	14%
One Year	54%
Other	14%

Service Large	Service Requirement to Defer			
	Small	Medium	Large	Very
None	8%	13%	18%	44%
One Month	1%	3%	9%	8%
Six Months	10%	15%	16%	8%
One Year	77%	54%	29%	9%
Other	4%	14%	28%	31%

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Employees Included in the Test

- Hardship distribution suspension
 - Employees suspended from deferring due to having taken a hardship are to be included in the test
- Employee who changes jobs to an ineligible classification during plan year
 - Included for portion of year an eligible employee, compensation may be defined as period during which an eligible employee

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Employees Excluded from Test

- One-time irrevocable waiver *however, as of the EGTRRA prototype, no new waivers of participation are allowed*
- Employees who must wait a year to defer but who may make a rollover into the plan immediately and did RR 96-48

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ACP – Eligible Employees Based on Matching Contributions

- Anyone eligible to defer and eligible for a match is in the ACP test
- Employees who are eligible for the match, but who do not meet the allocation requirements for the match, i.e. last day or 1,000 hours, is excluded from the ACP test
- If there are separate allocation requirements for different portions of the year and the employee is eligible for any one period, the employee is eligible for the entire plan year

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Anti-abuse Provision 401(k) and (m) Final Regulations

- The 401(k) and (m) final regulations include language that indicates that repeated changes in elections or procedures used to inflate or improve testing results will cause the plan to fail nondiscrimination testing.
- The regulations do not include any examples of the types of changes that would constitute abusive practices.

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Anti-abuse Provision 401(k) and (m) Final Regulations

- *“The regulations are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures, or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.”*

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Correcting Failed Tests by Qualified Contributions

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Qualified Match or Qualified Nonelective “Booster Contributions”

- Employer contribution used in testing
 - Raises NHCE ADP or ACP so test passes
 - Qualified match (QMAC) or Qualified Nonelective (QNEC)
 - Must be fully vested and subject to in-service withdrawal restrictions
- Final 401(k) regulations limited the *targeted* contributions

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QMAC or QNEC “Booster Contributions” - Prior Year Testing

- *Prior year testing method, QNEC must be made by end of 12 months after prior year. i.e. before testing.*
- Example:
 - 2014 is testing year for HCEs
 - 2013 is prior year for NHCE data
 - Booster must be made by Dec. 31, 2014
 - Testing starts early 2015.
 - NOTE: All NHCEs participants on allocation date receive booster, even if subsequently terminate

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Abusive Use of Targeted Bottom-up QNECs and QMACs Ended

- Limitation (not elimination) of the “targeted” or “bottom-up” QNEC or QMAC
- IRS concerned about abuse and manipulation
 - Directed by Congress to limit
- What were they?

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QNEC/QMAC 5% QNEC/QMAC with No Restrictions

- ***Can use a QNEC or QMAC of 5% or less in ADP or ACP testing with no restrictions***
 - ***Note that this is 5% QNEC and 5% QMAC for any one individual***
 - ***Thus, one employee may get 10%!***
- **More than 5% QNEC or QMAC is limited by a test**
- Included in this method are “flat dollar” QNECs or QMACs

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Limitation on More Than 5% QNEC/QMAC

- **Test Formula:**
 - QNEC or QMAC allocation to any one individual may not be more than twice the *plan's representative rate*
- **The Plan's Representative Rate is defined as:**
 - *Lowest contribution rate (QNEC and QMAC divided by compensation) of any eligible NHCE among a group of NHCEs*
 - *Using Half of all NHCEs in test*
 - OR
 - *All of the NHCEs at PYE*

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Limitation on > 5% QNEC/QMAC Example 1

- *All NHCEs employed on last day of PY get a 15% QNEC*
 - OK
 - *Representative rate is 15%*

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**EXAMPLE**

**All NHCEs
employed on
last day of
Plan Year
receive
QNEC of
same %**

QNEC = \$37,100
(\$530,000 x 7%)

NHCE	Comp.	ADR	QNEC	Adj. ADR
Jimbob	\$90,000	10%	7%	17%
Michelle	80,000	8%	7%	15%
Josh	70,000	6%	7%	13%
Jana	60,000	6%	7%	13%
John-David	50,000	5%	7%	12%
Jill	40,000	5%	7%	12%
Jessa	35,000	5%	7%	12%
Jinger	30,000	3%	7%	10%
Joseph	25,000	0%	7%	7%
Josiah	20,000	0%	7%	7%
Joy-Anna	15,000	0%	7%	7%
Jedidiah	15,000	0%	7%	7%
ADP		4%		11%
		+2		x1.25
HCE		6%		13.75%

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Limitation on >5% QNEC/QMAC Example 2

- 24 nonhighly employees
- 12 don't get a QNEC
- 8 get 7%
- 4 get 14%

Okay because:

1. 50% of NHCEs got a QNEC
2. Highest QNEC rate of 14% was no more than twice the lowest rate of 7%

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**EXAMPLE**

**50% of NHCEs
get QNEC.**

**No one gets
more than twice
anyone else
gets.**

QNEC = \$10,200

NHCE	Comp.	ADR	QNEC	Adj. ADR
Jimbob	\$90,000	10%	0%	10%
Michelle	80,000	8%	0%	8%
Josh	70,000	6%	0%	6%
Jana	60,000	6%	0%	6%
John-David	50,000	5%	0%	5%
Jill	40,000	5%	0%	5%
Jessa	35,000	5%	6%	11%
Jinger	30,000	3%	6%	9%
Joseph	25,000	0%	6%	6%
Josiah	20,000	0%	6%	6%
Joy-Anna	15,000	0%	12%	12%
Jedidiah	15,000	0%	12%	12%
ADP		4%		8%
		+2		x 1.25
HCE		6%		10%

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**EXAMPLE**

**Targeted QNEC
of 5%**

QNEC = \$2,500

NHCE	Comp.	ADR	QNEC	Adj. ADR
Jimbob	\$90,000	10%	0%	10%
Michelle	80,000	8%	0%	8%
Josh	70,000	6%	0%	6%
Jana	60,000	6%	0%	6%
John-David	50,000	5%	0%	5%
Jill	40,000	5%	0%	5%
Jessa	35,000	5%	0%	5%
Jinger	30,000	3%	0%	3%
Joseph	25,000	0%	0%	0%
Josiah	20,000	0%	5%	5%
Joy-Anna	15,000	0%	5%	5%
Jedidiah	15,000	0%	5%	5%
ADP		4%		5.25%
		+2		+ 2
HCE		6%		7.25%

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**EXAMPLE**

**Flat Dollar
QNEC of \$500 to
each NHCE**

**Is OK because
no one receives
a QNEC of more
than 5%**

QNEC = \$6,000

NHCE	Comp.	ADR	QNEC as % of Comp	Adj. ADR
Jimbob	\$90,000	10%	0.56%	10.56%
Michelle	80,000	8%	0.63%	8.63%
Josh	70,000	6%	0.71%	6.71%
Jana	60,000	6%	0.83%	6.83%
John-David	50,000	5%	1.00%	6.00%
Jill	40,000	5%	1.25%	6.25%
Jessa	35,000	5%	1.43%	6.43%
Jinger	30,000	3%	1.67%	4.67%
Joseph	25,000	0%	2.00%	2.00%
Josiah	20,000	0%	2.50%	2.50%
Joy-Anna	15,000	0%	3.33%	3.33%
Jedidiah	15,000	0%	3.33%	3.33%
ADP		4%		5.60%
		+2		+ 2
HCE		6%		7.60%

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Limitation on > 5% QNEC/QMAC ACP Test

- For ACP test – similar rule
 - *Plan's representative contribution rate is defined as:*
 - *QNECs, QMACs and all matching contributions in ACP test*

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Limitation on > 5% QNEC/QMAC

- **Davis-Bacon exception**
 - *Since these plans make prevailing wage contributions to certain employees, may use up to 10% in testing (not 5%)*

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Timeline for Handling Testing Corrections

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Returning Excess Amounts Within 2½ Months After Plan Year End

- Testing **rush** to avoid 10% penalty to employer on refunds
- Refund taxable in year distributed
 - Earnings taxable in year distributed.
- Excess and excess aggregate cannot be refunded until after the plan year is over
 - even if you know the ADP and/or ACP test is going to fail.

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Returning Excess Amounts Within 2½ Months After Plan Year End

- No mandatory 20% withholding
- Subject to voluntary withholding (10%)
- No 10% penalties or spousal consent applies
- EACA covering all eligible EEs → 6 months to test and refund

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Returning Excess Amounts After 2½ Months, But Prior to 12 Months

- The same procedures as before 2½ months with the following changes.
 - ***Employer subject to a 10% excise tax on amount being refunded after 2½ months*** (or after 6 months for applicable EACA)
 - **Note: a QNEC may be made up until 12 months after the end of the year being tested without a 10% penalty to the employer.**

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Returning Excess Amounts After 12 Months After Plan Year End

- No correction available for after 12 months after plan year end (PYE)
- Plan is disqualified and must correct under IRS Employee Plans Compliance Resolution Systems (EPCRS)

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EPCRS Rev. Proc. 2013-12 Correction After 12 Months After Plan Year End Year

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Excess or Excess Aggregate Contribution After 12 Months After Plan Year End

- EPCRS → 2 self-correction procedures (SCP)
 - For use → within 2 years after end of testing period.
 - For example, if plan year being tested is 2012, the test is to be run and corrected by end of 2013, self correct may be made up until end of 2015.
- The two EPCRS methods are:
 - ***Provide a QNEC.***
 - ***The one-to-one correction method.***

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One-to-one Correction Overview

- One-to-One correction method requires:
 - Refund to HCEs excess, plus earnings, and, if applicable, gap period earnings, (Excess aggregate non-vested amounts would be forfeited.) **AND**
 - A contribution of the same amount refunded, which is allocated to the NHCEs.

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One-to-one Correction Form 1099-R Reporting

- Refunded excess → report on Form 1099-R for the year of distribution.
 - Taxable to HCE in year of distribution.
 - Code 8 → excess taxed in year distributed.

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One-to-one Correction, EPCRS Appendix B, Section 2.01 (b)

- Excess contribution determined and (adjusted for earnings) is either distributed to HCEs or forfeited from the HCE's' accounts
 - That same dollar amount is contributed to the plan and allocated to NHCEs as provided on next slide
- Under this correction, *a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees.*
 - Likewise, restructuring the plan into component plans is not permitted.

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One-to-one Correction Allocation Methods

- The contribution is allocated to the account balances of those individuals who were either:
 - (I) the eligible employees for the year of the failure who were NHCEs for that year, or
 - (II) the eligible employees for the year of the failure who were NHCEs for that year and who also are NHCEs for the year of correction.
- Alternatively, the contribution is allocated to account balances of eligible employees in (I) or (II), except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction.

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One-to-one Correction Allocation Methods

- For all the options, eligible employees must receive a uniform allocation (as a percentage of compensation) of the contribution.
- The amount allocated is treated as a section 415 annual addition for “the year of the failure” for the employee for whom it is allocated.
 - Plans using prior year testing method substitute "the year prior to the year of the failure" for "the year of the failure."

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One-to-one Correction Example

- On June 30, 2014, Employer A uses the one-to-one correction method to correct the 2012 ADP test.
- Employer A calculates the dollar amount of the excess contributions for the two HCEs.
 - Employee P Excess is \$4,000 (4% of \$100,000)
 - Employee Q Excess is \$2,375 (2% of \$118,750)
 - For a total of \$6,375.
- By leveling the excess contribution is assigned
 - Employee P = \$3,437.50 + \$687 earnings = \$4,124.50
 - Employee Q = \$2,937.50 + \$587 earnings = \$3,524.50

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One-to-one Correction Example

- On same date, Employer A makes a corrective contribution to the 401(k) plan equal to \$7,649
 - the sum of the \$4,124.50 distributed to Employee P and the \$3,524.50 distributed to Employee Q
- The corrective contribution is allocated to the account balances of eligible NHCEs for 2012, pro rata based on their compensation for 2012 (subject to section 415 limit for 2012).

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EPCRS Revenue Procedure 2013-12

**QNECs to Correct Failed ADP Test Must be 100%
Vested**

**Correction of Missed Deferral with Associated
Match Is Unchanged, However, Vesting of Match**

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EPCRS Rev. Proc. 2013-12 QNECs to Correct Failed ADP Test Must be 100% Vested

- **Rev. Proc. 2013-12 Section 6.02(4)(c)**
“(c) Corrective allocations should come only from employer nonelective contributions, including forfeitures if the plan permits their use to reduce employer contributions). For purpose of correcting a failed ADP, ACP, or multiple use test, any amounts used to fund QNECs must satisfy the definition of QNEC in § 1.401(k)-6.”
 - *§ 1.401(k)-6 requires the QNEC to be 100% vested when the employer contributes it to the plan.*

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EPCRS Rev. Proc. 2013-12 QNECs to Correct Failed ADP Test Must be 100% Vested

- PPA preapproved DC plan documents do not allow for the use of forfeitures to make “qualified” or “safe harbor” contributions to a 401(k) plan. *But*, this language may be in the EGTRRA pre-approved DC plan document.
- Employer will have reliance on the EGTRRA document provisions until they amend and restate. If employer wants to continue to use forfeitures for either purpose, and it is in the EGTRRA document, the employer may wish to delay restating onto the PPA plan until early in 2016, i.e. before April 30, 2016.

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EPCRS Rev. Proc. 2013-12 Correction of Missed Deferral with Associated Match Is Unchanged

- *Where an employer improperly excludes an employee from making deferrals in a non-safe harbor plan, and*
- *the employee did not receive the match on the missed deferrals*
- *The method of correction has not changed*
 - *Example on next slide*

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EPCRS Rev. Proc. 2013-12 Correction of Missed Deferral with Associated Match Is Unchanged

Missed Deferral Correction, With Associated Match

- John filed an elective deferral election for 10% of compensation that was not processed (less than 9 months of plan year left when discovered)
- Compensation that missed deferrals → \$10,000
- Missed deferrals: \$1,000
- Missed deferral opportunity → \$500, + earnings
- Missed match formula based on 100% of the missed deferrals (not the missed deferral opportunity) up to 6% → \$600, + earnings

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EPCRS Rev. Proc. 2013-12 Correction of Missed Deferral with Associated Match Is Unchanged

- The corrective employer matching contributions no longer has to be a QNEC
- If it is not a QNEC,
 - the corrective employer matching contribution may be subject to the plan's vesting schedule for its matching contributions

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Correcting Failed Tests by Refund and Other Scenarios

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Correcting Failed Tests Effect of Being Catch-up Eligible

- If HCE is to be refunded an excess contribution but is 50 or older.
- The refund is required to be recharacterized into a catch-up contribution (up to the catch-up limit) provided:
 - **Plan permits catch-up, and**
 - **Participant has not already used up the catch-up limit for the year.**
- Example
 - **Refund to an HCE is \$6,000 for plan year 2013.**
 - **\$5,500 recharacterized as catch-up. \$500 refunded**

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Correcting Failed Tests Effect of Being Catch-up Eligible

Catch-up limit to be used for refund

- Calendar year plans: Limit is based on year of test
- Off-calendar year plans: catch-up limit based on the limit in effect in the calendar year in which the plan year ends

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Correcting Failed Tests Effect of Being Catch-up Eligible

- Calendar plan year example
- HCE compensation \$250,000 and defers \$20,000 for 2013
- \$17,500 and \$2,500 of catch-up, leaving \$3,000 of unused catch-up
- This HCEs excess contribution is \$4,250
 - \$3,000 would be recharacterized to catch-up
 - \$1,250, adjusted for earnings would be refunded

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Correcting Failed Tests Effect of Being Catch-up Eligible

- Off-calendar plan year, plan year ends 06/30/09
- 2009 Deferral limit = \$16,500, Catch-up = \$5,500
- 2008 Deferral limit = \$15,500, Catch-up = \$5,000
- HCE defers \$14,000 for plan year ending 06/30/09
- \$6,800 from 7-1-08 to 12-31-08
- \$7,200 from 1-1-09 to 6-30-09
- ADP test fails as of 6/30/09
- Refund of \$1,500 recharacterized as catch-up
- \$1,500 counts toward 2009 catch-up limit

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Correcting Failed Tests Effect of Being Catch-up Eligible

- Off-calendar plan year, plan year ends 06/30/09
- 2009 Deferral limit = \$16,500, Catch-up = \$5,500
- 2008 Deferral limit = \$15,500, Catch-up = \$5,000
- Same HCE defers \$16,000 for calendar year 2008
- \$6,800 from 7-1-08 to 12-31-08, **but only \$6,300 brought into test as \$500 is catch-up for 2008**
- \$7,200 from 1-1-09 to 6-30-09
- ADP test fails as of 6/30/09
- Refund of only \$1,000 recharacterized as catch-up
- \$1,000 Counts toward 2009 catch-up limit

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Correcting Failed Tests Recharacterization as After-tax

- **If plan allows for after-tax contributions**
- **And catch-up does not apply to refund**
- **Pre-tax elective deferrals may be recharacterized as after-tax (left in plan)**
 - Earnings remain in the plan
- **Must include in ACP test as an after-tax amount**
- **Ex:HCE \$100,000 income, refund of \$1,000**

Elective deferrals	ACP test
\$9,000 9%	\$4,500 (match) 4.5%
<u>(1,000) recharact.</u>	<u>1,000</u> After-tax
\$8,000 8%	\$5,500 5.5%

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Correcting Failed Tests Roth Deferrals

- **Document can be written to give the participants the choice of which dollars (pre-tax or Roth) are returned**
 - This assumes both types of deferrals are contributed in the testing year
 - Document can be written to dictate which dollars are returned first
- **If Roth deferrals being returned, earnings must be included.**
 - For example, if excess contribution is \$3000 of Roth, pro rata earnings calculated, (e.g. \$287) included as part of \$3,000 and taxable.
 - If returned late, 10% employer penalty on the \$3,000.

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Refund of Deferrals with an Associated Match

- **Nondiscrimination Rules**
 - After deferrals are returned, the resulting rate of match for an HCE may not be greater than the rate of match for an NHCE
 - Match on refunded deferrals must be forfeited from HCE.

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Refund of Deferrals with an Associated Match

- 50 cents on a dollar match
- NHCE ADP Rate is 4% and test fails
- ACP Test still passes
- HCE 3 is going to get a refund of \$900
- After refund HCE 3 has a higher rate of match on the remaining deferrals
 - His rate of match exceeds 50 cents/dollar
- Nondiscrimination rules forbid HCEs from receiving a higher rate of match than NHCEs
- Forfeit the match on the amount of the deferrals being returned to the HCEs.
 - Match of \$450 forfeited

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Failing ADP or ACP After an HCE Takes a Total Distribution

- HCE takes a total distribution, then when testing is done the ADP test fails.
- Notify HCE of the change in the taxation treatment and send corrected 1099-R forms.
 - An example is on the next slide

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Failing ADP or ACP After a Total Distribution – Example

- *Nov. 11, 2013:* Total distribution of \$220,000 to HCE.
- *Feb. 28, 2014:* 1099-R filed with IRS for \$220,000.
- *Mar. 12, 2014:* Plan fails either ADP or ACP test for 2013, HCE to receive a refund of \$3,100 and \$120 of earnings.
- *Mar. 12, 2014:* Notify HCE of changes.
- Recharacterize the \$3,220 distribution as an excess contribution and reduce the total distribution.
- See next slide

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Failing ADP or ACP After a Total Distribution Example

- **File a CORRECTED Form 1099-R for 2013**
 - **Box 1** **\$216,780 (Less the excess and earnings)**
 - **Box 2a** **\$.00**
 - **Box 7** **G for direct rollover amount**
- **File a New Form 1099-R for 2013**
 - **Box 1** **\$3,220 Gross Distribution**
 - **Box 2a** **\$3,220 Taxable Amount**
 - **Box 7** **Code 8, Excess contributions**
- Amount directly rolled over must be reduced by the excess contribution plus earnings, as those amounts are not eligible for rollover
- Citation: 2013 Form 1099-R Instructions, Page 7 to 8

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Failing ADP or ACP After a Total Distribution

- To avoid a late filing penalty if the new Form 1099-R is filed after the due date, enter in the bottom margin of Form 1096, Annual Summary and Transmittal of U.S. Information Returns, the words “Filed To Correct Excess Contributions.”
- Citation: 2013 Form 1099-R Instructions, Page 8

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Coordination of Excess Deferral & Excess Contribution

- **An HCE with both excess deferrals and excess contributions may coordinate the amounts.**
- **Example:**

Employee	Excess Deferral	Excess Contrib.	Net Distribution
HCE 1	\$700	\$2,500	\$2,500
HCE 2	\$1,000	\$350	\$1,000
HCE 3	\$500	\$500	\$500

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Permissive Withdrawals

- **EACA's permissive withdrawals are not to be included in testing**
- **For those who are automatically enrolled late in the year, may wish to hold up testing until the 90 day period has expired**

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Stopping/Reducing Safe Harbor 401(k) Mid-year

- **Stopping/reducing safe harbor 401(k) mid-year**
 - **Amend the plan's safe harbor provision**
 - **Provide a supplemental notice 30 days before stopping the safe harbor contribution**
 - **Test ADP/ACP for the entire plan year**
 - **Use current year testing**
 - **Pro-rate 415 compensation**

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Stopping/Reducing Safe Harbor 401(k) Due to Plan Termination Mid-year

- **Mid-year safe harbor plan termination due to a merger, acquisition or a business hardship [as defined in section 412(d)], then provide safe harbor contribution through termination date and ADP/ACP testing not required**
- **Mid-year safe harbor plan termination for any other reason, provide safe harbor contribution through date of termination and run the ADP/ACP tests**

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Avoiding Testing Problems

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Avoiding Testing Problems Concepts and Design Based Ideas

- Pre-test – test early and often
 - Status of plan results
 - Chance to change definitions before yearend
 - HCE; top 20% election
 - Current year/ prior year
 - QNCE for prior year testing method
- Manage expectations
- Coverage test before ADP/ACP Testing

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Avoiding Testing Problems Concepts and Design Based Ideas

- Educate/set employer expectations to provide census data asap after year end.
 - *Avoids the employer 10% penalty*
- Some plan provision options
 - *Provide for QNECs to NHCEs*
 - *Provision for recharacterize to after-tax*
 - *Rarely, exclude HCEs from deferring*
 - *Eligibility of 1 year/age 21*

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Aggregation of Plans

- Two or more 401(k) plans sponsored by same employer
- Having same plan year ends
- Can be combined if helps pass testing for one big test
 - Unless prohibited (union group, etc.)

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Otherwise Excludable Testing Restructuring

- If plan has eligibility less than 1 year (i.e. less than the statutory Age 21 and 1 year of service) can test as two separate plans
 - Group 1 is all NHCE w/less than 21 and 1
 - Group 2 is all HCE plus NHCEs with more than 21 and 1
 - May help testing results (group 1 passes - group 2 eliminates short timers)
- **If selected, it must be used for all plan purposes, e.g. coverage and other testing**
- **Run test with and without restructuring to see if it benefits**

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Correcting a Failed Test Through Shifting

- If you pass ADP by a lot and fail ACP; you can shift amounts not needed in ADP to ACP
 - Testing method only – you do not actually move the funds
 - You must pass ADP both before and after shift
 - You cannot shift ACP to ADP (unless the ACP amounts are subject to the same withdrawal restrictions as deferrals)

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Correcting a Failed Test Through Shifting Example

	Before		After	
	ADP	ACP	ADP	ACP
HCE	6.40%	1.95%	5.40%	2.95%
NHCE	5.40%	.90%	4.40%	1.90%

- ADP passes before and after
- Shift of 1% helps ACP pass

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Top-paid 20% Election

- HCE is an individual who is either:
 - more than 5% owner in current year or prior year, directly or by family attribution, or
 - EE w/compensation in prior plan year > \$80,000, COLA adjusted, (2012 = \$115,000)
- The law provides an alternative that allows an employer to limit the number of HCEs as determined by compensation to the top 20% paid group.

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Top-paid 20% Example

Employee	Compensation	HCE	HCE under Top 20% Election
1	\$355,000	Yes	Yes
2	\$240,000	Yes	Yes
3	\$225,000	Yes	Yes
4	\$215,000	Yes	Yes
5	\$212,000	Yes	Yes
6	\$205,000	Yes	Yes
7	\$203,000	Yes	No
8	\$201,000	Yes	No
9	\$195,000	Yes	No
10	\$191,000	Yes	No
11-30	\$20,000 to \$95,000	No	No

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Current Year and Prior Year Testing Using Different Methods for ADP ACP

- Final Regs. permit ADP to be current and ACP to be prior or vice versa.
 - This is reflected on the EGTRRA prototype.
- If different methods are used, the plan cannot use
 - “Shifting ” of deferrals to ACP test
 - QMACs in ADP test
 - Recharacterize excess contributions as after-tax

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Prior Year, Plan Design Caveat

- **Discretionary matching formula and prior year testing.**
- **If no discretionary match made in prior year (and it is not the first year of the plan), then the HCEs may not receive a match.**
 - NHCE prior year = 0%, so HCEs can only put in $0\% \times 2$

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Changing Testing Methods The Five Year Rule

- Plan may shift from prior year method to current year method at any time.
- Once prior to current change must wait five years before going back to prior.
 - Plans in existence less than 5 years that always were on current may switch to prior.
 - For years that a plan is safe harbor from ADP test considered on current year
 - Plans aggregated for testing must all have been on current and satisfy 5 year rule

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Timing of Plan Amendments

- Timing of amendments
 - Current Year/Prior Year
 - HCE (top paid group)
- When must it be done?
 - Amendment by PYE
 - Rev. Proc. 2005-66, Updated as Rev. Proc. 2007-44 addressed amendment deadlines

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Current Year to Prior Year Testing Beware Double Counting QNECs

- Double Counting of QNECs is prohibited
- Cannot use same QNEC in two different years even if change methods
 - Plan made a QNEC to pass testing in 2013 under the current method
 - In 2014, changed to prior testing method,
 - may not count the QNEC used to pass the 2013 test to pass the prior year 2014 test

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USERRA Rehires and Testing

- Contributions made under USERRA are not considered in make-up year or year attributed to for:
 - Top heavy determination § 416
 - Nondiscrimination § 401(a)(4)
 - ADP/ACP testing § 401(k) and (m)
 - Coverage § 410
 - DB Participation § 401(a)(26)

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Controlled Groups and Testing

- Generally, all controlled group members to be tested together
- Based on coverage test
- If companies can pass coverage test separately, then the ADP/ACP test will be separately

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Controlled Group Passing Coverage Separately

- To pass coverage separately
 - Each firm must run the coverage test and pass coverage with the denominator containing all nonexcludable employees of the entire controlled group and the numerator containing just the one firm's employees.
 - If this is a 2 firm controlled group, both the firms must be tested this way and each firm must be able to pass. See next slide:

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2 Firm Controlled Group Passing Coverage Separately

Company A & Company B

Company A Test

- ✦ NHCE A Divided by NHCE A + B; divided by
- ✦ HCA A divided by HCE A + B

Company B Test

- ✦ NHCE B divided by NHCE A + B; divided by
- ✦ HCA B divided by HCE A + B

Both tests would have to pass.

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2 Firm Controlled Group One Company Excluded

	A	B	Total
1. Total Employees	256	100	356
2. HCEs	16	4	20
3. HCEs Benefiting	16	0	16
4. EEs Ineligible by Statute			
4a. Age	10	6	16
4b. Service	20	10	30
4c. Union	10	0	10
4d. Non-resident Aliens	0	0	0
5. Testing Total (Subtract 2 & 4 from 1)	200	80	280
6. Other NHCEs Not Benefiting	40	80	120
7. NHCEs Benefiting	160	0	160

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2 Firm Controlled Group One Company Excluded

RESULTS

NHCE = $160/280 = 57\%$

HCE = $16/20 = 80\%$

Result $57\%/80\% = 71\%$ passing

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Mergers and Acquisitions

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Transition Period for Certain Acquisitions or Dispositions

- Transition period rule of **Code Section 410(b)(6)(C)** permits a company that is acquiring a company with its own plan to operate the plans separately until the end of the year following the year of the transaction. There are two requirements:
 1. Both plans satisfy coverage on the day before the entity transaction; and
 2. There is no significant change in coverage, other than a change directly resulting from the acquisition or disposition.
 - An amendment to exclude a group of employees during the transition period would violate this rule.

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Transition Period Example

- Company J acquires 100% ownership of Company R on March 26, 2013.
- Company J has a 401(k) plan with a \$/\$ match up to 5% and Company R has a plan with a \$/\$ match up to 2%.
- Company J may operate the 2 plans separately until December 31, 2014.

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Acquisition of Company with a Safe Harbor 401(k)

- A call we often get is about an acquisition where one company has safe harbor 401(k) and the other does not.
- The transition rule [410(b)(6)(C)] permits them to operate the plans separately until the end of the year following the year of the transaction.
- By the end of the transition period the plans must be merged and either both must be safe harbor or neither may be safe harbored.
 - However, if the plans can pass coverage separately after the transition period, they may continue separately.

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Acquisition of Company with a SIMPLE IRA

- Another call we receive is about a company with a SIMPLE IRA being acquired by a parent company that has a 401(k).
 - A similar transition rule applies for SIMPLE IRAs. However, it provides until the end of the **second calendar year** after the year entity is acquired. Code section 408(p)(4)

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Acquisition of Company with a SIMPLE IRA – Example

- Max owns 100% of a hat Company H and has had a SIMPLE IRA and his 12 employees have participated for a number of years.
- Max sells his interest in March 2014 to Company Y that makes gloves and that has a 401(k).
- Company Y decides to continue the SIMPLE IRA as is until the end of the transition period which is December 31, 2016.
 - Only Max's employees may participate in the SIMPLE IRA during the transition time.

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Compensation

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Definitions Compensation Must Satisfy 414(s)

a. Code Section 3401(a) - W-2 Compensation subject to income tax withholding at the source, with all pre-tax contributions excluded.

b. Code Section 3401(a) - W-2 Compensation subject to income tax withholding at the source, with all pre-tax contributions included [Plan defaults to this election].

c. Code Section 6041/6051 - Income reportable on Form W-2, with all pre-tax contributions excluded.

d. Code Section 6041/6051 - Income reportable on Form W-2, with all pre-tax contributions included.

e. Code Section 415 - All income received for services performed for the Employer, with all pre-tax contributions excluded.

f. Code Section 415 - All income received for services performed for the Employer, with all pre-tax contributions included.

• The selection of any of the above definitions of Compensation meets the Code Section 414(s) definition of Compensation. The Code Section 415 definition shall always apply with respect to sole proprietors and partners.

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Definitions “Net Compensation” Example

- Participant has an annual salary of \$50,000
- Enters plan on January 1st
- Defers \$5,000
- “Net” Salary is \$45,000
- $ADR = \$5,000 / \$45,000 = 11.11\%$
- Gross would be $\$5,000 / \$50,000$ or 10%

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Definitions Net Compensation and 401(a)(17)

- Participant has an annual salary of \$267,500 in 2013
- Defers \$17,500
- “Net” Salary is \$250,000
- NOT \$250,000 less \$17,500

- Thus, for employees making above the total of the 401(a)(17) comp cap plus the 402(g) limit, gross and net are the same.
 - Participant makes \$300,000, net of deferrals is \$282,500, but is limited by 401(a)(17) to \$250,000

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Definitions Net vs. Gross Example 1

EE	Salary	Deferral	Gross %	Net %
HCE A	\$325,000	\$17,500	6.73%	6.73%
HCE B	\$277,500	\$17,500	6.73%	6.73%
			6.73%	6.73%
NHCE C	\$100,000	\$7,000	7%	7.53%
NHCE D	\$70,000	\$3,000	4.3%	4.5%
NHCE E	\$50,000	\$3,000	6.0%	6.4%
NHCE F	\$30,000	\$1,000	3.33%	3.5%
NHCE G	\$20,000	\$0	0%	0%
			4.13%	4.39%

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Definitions Net vs. Gross Example 2

EE	Salary	Deferral	Gross %	Net %
HCE A	\$325,000	\$17,500	6.73%	6.73%
HCE B	\$140,000	\$17,500	12.5%	14.29%
			9.62%	10.51%
NHCE C	\$100,000	\$7,000	7%	7.53%
NHCE D	\$70,000	\$3,000	4.3%	4.5%
NHCE E	\$50,000	\$3,000	6.0%	6.4%
NHCE F	\$30,000	\$1,000	3.33%	3.5%
NHCE G	\$20,000	\$0	0%	0%
			4.13%	4.39%

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Definitions – Compensation “While A Participant”

- Usually impacts first year employees who are NHCEs
- Example
 - Participant has an annual salary of \$60,000
- Enters plan on July 1st
- Defers \$3,000
- Eligible is $\$3,000/\$30,000 = 10\%$
- Full year is $\$3,000/\$60,000 = 5\%$

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Post-severance Compensation under the Final 415 Regulations

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Post-Severance Compensation

- Post-severance payments are to be included for qualified plan purposes, such as deferrals, matching, and employer contributions if the *compensation is paid by the later of*:
 - the end of the limitation year that contains the date of severance, or
 - 2½ months after severance
- **Post -severance compensation only includes compensation earned before the severance**

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Post-Severance Compensation

- Post-severance compensation does NOT include:
 - **Paychecks continuing after severance that are not for services rendered before the severance**
 - “go away” money
 - Example:
 - Here’s \$100,000 – agree not to sue me!!!

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Post-Severance Compensation

- Post severance for plan purposes includes payments that would have been received if the working relationship continued, including:
 - Bonuses
 - Overtime
 - Commissions
 - Shift Differential
 - Regular pay (of course)

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Post-Severance Compensation

- Optionally included are accrued and unused bona fide payments such as
 - Sick pay
 - Vacation pay
 - Other leave
- Note: Unlike regular pay – these amounts are excluded unless specifically included in the plan document.
- 415 amendment process

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Post-Severance Compensation Examples

Example 1: Calendar Year (plan year and limitation year)

- Termination Date – April 1, 2014
- Continue pay thru March 31, 2015
- *Pay until when is included???*
- *December 31, 2014 (end of limitation year)*
 - *provided the pay was earned before severance*

Example 2: Termination Date – December 1, 2014

- *Pay until when is included???*
- *February 15, 2015 (2 ½ months);*
 - *provided the pay was earned before severance*

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Post-Severance Compensation Crossing-over Plan Years

- If the final paycheck, or the first few weeks of the year's post severance compensation, crosses over into a different plan year (than the one in which the individual was terminated) and the individual is eligible to defer on the final paycheck because he or she is within 2½ months of severance
- *The compensation will be considered to be for the year in which it is paid, and the deferrals will be considered to be made in the year the compensation is paid*
 - Citation: Rev. Ruling 2009-32

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Post-Severance Compensation

- If the compensation meets the definition of post-severance compensation, does the plan document permit a terminated employee to defer against the final paycheck received after termination?
 - Plan document issue
 - If not allowed, than no deferral on final paycheck and compensation from final paycheck to be excluded from ADP/ACP testing
 - If allowed, follow deferral election on file, and include compensation in ADP/ACP test

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Regulatory References

- Final 401(k) and (m) Regulations 12/04
 - http://www.irs.gov/irb/2005-05_IRB/ar06.html
- Designated Roth Regulations 12/05; 04/07
 - http://www.irs.gov/irb/2006-06_IRB/ar07.html
 - http://www.irs.gov/irb/2007-22_IRB/ar07.html
- Rev. Rul. 2009-32
 - http://www.irs.gov/file_source/pub/irs-irbs/irb09-39.pdf
- EPCRS Rev. Proc. 2013-12
 - http://www.irs.gov/irb/2013-04_IRB/ar06.html

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Questions

- Questions or Comments
- E-mail questions to WCGrossman@dstrs.com
- Thanks for attending!!!

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