2015 NIPA Annual Forum & Expo (2015NAFE)

nipa National Institute of Pension Administrators

# New Comparability – The Basics and Beyond

*Karen Smith, FSA, EA, J.D., President, Nova 401(k) Associates*

New Relationships. New Ideas. New Look. A New Way to Look at NIPA

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## Karen Smith, FSA, EA, J.D., President, Nova 401(k) Associates

Karen Smith is the President of Nova 401(k) Associates in Houston. She has more than 20 years of experience working on 401(k) and defined benefit plans. She is both an actuary and an attorney. She is the chairperson of ASPPA's Defined Benefit Sub-Committee and chairperson of the American Academies Committee on Qualifications.

## Suggested Prerequisites

- Determining HCEs
- Coverage testing including ABPT
- Traditional and integrated profit sharing allocations



## Agenda

- Flexibility in defining participant contributions
- 401(a)(4) testing
- Plan document
- Operation

## Flexibility in Defining Participants Contributions

- Traditional profit sharing
  - Eligible participants all receive the same profit sharing amount or the same percentage of compensation
- Integrated profit sharing
  - Eligible participants receive a contribution amount based upon their base compensation and excess compensation
- But, what if an employer wants to target certain employees or pay people specific amounts?



## Flexibility in Defining Participants Contributions

New comparability plans can allow the following options:

- Owners receive 15% of pay while staff receives 5%
- Non-owner HCEs targeted to receive more or less.
- Division A receives a different profit sharing contribution than Division B.
- HCEs receive $0, but each NHCEs receive an amount specified by the employer.

## Flexibility in Defining Participants Contributions

- Example 1 – 2 new comp groups

| | Age | Comp. | Traditional PS | New Comp PS |
|---|---|---|---|---|
| Owner | 55 | $50,000 | $11,250 | $28,750 |
| Employee 1 | 25 | $50,000 | $11,250 | $2,500 |
| Employee 2 | 25 | $50,000 | $11,250 | $2,500 |
| **Total** | | **$150,000** | **$33,750** | **$33,750** |



## Flexibility in Defining Participants Contributions

- Example 2 – individual allocation groups

| | Age | Comp. | Traditional PS | New Comp PS |
|---|---|---|---|---|
| Owner | 55 | $50,000 | $12,417 | $32,000 |
| Employee 1 | 25 | $50,000 | $12,417 | $2,750 |
| Employee 2 | 25 | $50,000 | $12,417 | $2,500 |
| **Total** | | **$150,000** | **$37,251** | **$37,250** |

## Flexibility in Defining Participants Contributions

Sometimes people think about new comparability only in terms of targeting additional contributions for owners and HCEs, but new comparability can be used to solve a variety of other plan sponsor issues.

- Targeted bonuses
- Avoid writing really complicated language for a plan
- Contributing just enough not to be top heavy
- Making a top heavy contribution palatable



## 401(a)(4) testing

- New comparability allocations are typically tested using rate group testing. Four basic flavors of testing:
  - Contribution basis based upon benefit
  - Contribution basis based upon percent of pay
  - Accrual basis based upon benefit
  - **Accrual basis based upon benefit as a percentage of pay**
- Last method is most common – takes advantage of pay and age disparity that is often present

## 401(a)(4) testing

- To test on an accrual basis as a percentage of pay, the employer contribution is accumulated with interest to the testing age, then converted to an annuity and then divided by pay.
  - Testing age is usually normal retirement age
  - Standard interest rate and mortality rate
  - Compensation is a 414(s) definition of compensation limited by 401(a)(17) limit
- Very roughly speaking you are converting the contribution to a defined benefit accrual



## 401(a)(4) testing

Example 3 – convert contribution to an accrual rate

Age 45

Contribution of $5,000

Compensation $50,000

Normal retirement age 65

Annuity factor – 95.38

## 401(a)(4) testing

Example 3 – Convert contribution to an accrual rate

$$\text{Accrual rate} = \frac{5000*1.085^{(65-45)}}{50000*95.38}$$

=.536%



## 401(a)(4) testing

Example 4 – convert contribution to an accrual rate

Age 65
Contribution of $25,000
Compensation $50,000
Normal retirement age 65
Annuity factor – 95.38

## 401(a)(4) testing

Example 4 – Convert contribution to an accrual rate

Accrual rate = $\dfrac{25000*1.085^{(65-65)}}{50000*95.38}$

=.524%



## 401(a)(4) testing

Note the power of compound interest!

$1.085^{20} = 5.112$

## 401(a)(4) testing

- What is rate group testing?
  - A rate group is an HCE and all other participants who have the same or higher EBAR
  - If each rate group passes modified coverage testing, then you pass 401(a)(4) testing.
    - Can pass ratio percentage test OR
    - Average Benefit Test



## 401(a)(4) testing

- If a plan has 10 HCEs and 200 NHCEs, what is the maximum number of rate groups there could be?

## 401(a)(4) testing

- If a plan has 10 HCEs and 200 NHCEs, what is the maximum number of rate groups there could be?
- 10 – there can never be more rate groups than the number of HCEs.



## 401(a)(4) testing

- If a plan has 10 HCEs and 200 NHCEs, what is the minimum number of rate groups there could be?

## 401(a)(4) testing

- If a plan has 10 HCEs and 200 NHCEs, what is the minimum number of rate groups there could be?
- 1 – this could happen if all of the HCEs have the same accrual rate



## 401(a)(4) testing

- Can all of the rate groups pass testing and the plan still fail coverage testing?

## 401(a)(4) testing

Can all of the rate groups pass testing and the plan still fail coverage testing? Yes

- Rate group testing – must be above mid-point of the safe harbor and non-safe harbor percentage
- Coverage testing – must be above safe harbor percentage



## 401(a)(4) testing - gateway

If a dc plan tests on an accrual basis (cross-tests), then the plan must satisfy a gateway requirement for each NHCE who receives a non-elective contribution.

- 5% of compensation
- 1/3 of the highest contribution rate of HCEs

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## 401(a)(4) testing - gateway

Gateway contribution not required:

- If testing on a contribution basis even if ABPT is done on an accrual basis
- For individuals who do not receive a non-elective allocation



## 401(a)(4) testing - gateway

What counts as a non-elective contribution:

- A profit sharing allocation
- An allocation of profit sharing forfeitures
- Top heavy minimum
- Safe harbor non-election contribution

## Document

If you have a plan with traditional profit sharing allocation, by when must you amend it if you want to change it to new comparability?

- Safe harbor 401(k) – Before the beginning of the year to conform to IRS safe harbor guidance.
- Non-safe harbor 401(k) –Before anyone satisfies the allocation conditions for a profit sharing contribution



## Document

A non-safe harbor 401(k) plan has a traditional profit sharing allocation formula. To be eligible for a profit sharing allocation a participant must earn 1000 hours or be employed on the last day of the plan year. You take-over the plan in August 2015. Can you amend it to a new comparability plan for 2015?

## Document

A non-safe harbor 401(k) plan has a traditional profit sharing allocation formula.  To be eligible for a profit sharing allocation a participant must earn 1000 hours or be employed on the last day of the plan year.  You take-over the plan in August 2015.  Can you amend it to a new comparability plan for 2015?

- Probably not

- By August 2015, it is likely that most participants have already earned 1000 hours.



## Plan Document

- Eligibility

- Allocation conditions

## Plan Document

- Normal retirement age
  - Avoid young normal retirement age because it makes accumulation period shorter – less time to compound interest
  - Younger early retirement age okay



## Plan Document

- Safe Harbor Non-Elective
  - Potentially exclude HCEs
  - Use entire year pay

## Plan Document

- New comparability groups
  - Precise wording
  - Enough group to get troublesome HCE into their own groups
  - Owners

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## Plan Document

- Volume Submitter
- Prototype

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## Plan Document

- Failsafe language
  - Hardcoded language in the plan document that fixes testing failures
  - May wish to remove from new comparability plans



## Operation

Checking software

- Data
  - Dates of birth
  - Hours
  - Compensation
  - Deferrals
  - HCEs

## Operation

Checking software

- Specifications
  - Interest rate
  - Mortality
  - Plan specifications



## Operation

Checking software

- Coordination
  - Gateway
  - Top Heavy
  - Is it what the client wants?

## Operation

- Options when a plan fails 401(a)(4) testing?
  - Don't make the contribution – or change it
  - Keep testing using different methods or assumptions
  - 11g amendment



## Operation

- Is choosing how much each class receives in profit sharing allocation a fiduciary function?

## Operation

- Is choosing how much each class receives in profit sharing allocation a fiduciary function?
- No – It is a settlor function.



## Operation

- Can each partner choose their own profit sharing contribution?

## Operation

- Can each partner choose their own profit sharing contribution?
- Beware of busted CODA!