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Questions

Answers to Self Assessment ~~Problems~~ for Chapter Four

1. True

2. d. *See* Treas. Regs. §1.410(b)-4(c)(3).

3. a. TG = 2750 - 50 = 2700, of which 2500 are NHCEs, 200 are HCEs
Benefiting under Lawrenceville = 250, of which 186 are NHCEs, 64 are HCEs
RP for Lawrenceville: 186/2500 vs. 64/200 =7.4%/32% = 23%, failing the 70% test

Whether Lawrenceville's Plan could be aggregated with any of the others depends on whether its plan falls within the list of mandatory disaggregation plans. The Princeton plan is a 401(k) plan, and thus cannot be aggregated with a non-401(k) plan, such as Lawrenceville.

Under ABT test, lst prong = is the use of Lawrenceville geography a nondiscriminatory classification? It may be, unless the other two subsidiaries are nearby boarding schools. Also the eligibility criteria of "senior status" appears to be suspect if it's trying to impose a waiting period more than the statutorily required one-year wait. 2nd prong= new RP test based on NHCE concentration % = 2500/2700=93%, so a very low corridor, of 25.25 to 20. As the actual RP is 23%, we pass the 2nd prong only if facts and circumstances can justify the criterion.

b. Since the plan is a DB plan, the 401(a)(26) rule requires a minimum of 50 ees or 40% of the TG, which would be 50. Hence we satisfy this requirement.

✓ 4. a. If the determination is for the ~~2006~~ 2011 plan year, the HCE definition asks (1) who was a 5% owner in the prior or current plan year and (2) who had compensation in excess of the $80,000 (indexed) amount in the prior plan year. Certainly, Father and Daughters are HCEs due to their ownership interests of 75% and 25% in the current plan year. Using the prior year's IRC §414(q) compensation limit (*e.g.*, ~~$95,000 in 2005~~ $110,000 in 2010), none of the other employees qualify as an HCE on the basis of compensation.

b. The permitted exclusions are the 5 union employees, the 2 employees who are under age 21, and the 5 employees who are part-time (verifying that they all work less than 1,000 hours). Hence, the test group = 32 employees – 12 exclusions = 20 employees. Of the 20 employees, 2 are HCEs and therefore 18 are NHCEs.

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Review of IRC §§401(a)(3) and 401(a)(4):

1. Eligibility = age 21 + one-year wait + third component: IRC §401(a)(3) asks whether the "third component" results in discriminatory coverage – more HCEs covered under the plan relative to NHCEs covered under the plan. Or another way of characterizing the test: are there sufficient NHCEs covered under the plan relative to the number of HCEs covered under the plan.

   Test Group = All employees – Permissible Exclusions (e.g., age 21, less than one-year, union employees, airline pilots) – then split into two categories – whether the ee is a NHCE or an HCE

   Question: Plan's Ratio Percentage = [NHCE covered ÷ NHCE Test Group] / [HCE covered ÷ HCE Test Group]

   a. Ratio Percentage Test doesn't require a minimum number of NHCEs or HCEs to be covered – the test is a relative test – if coverage of the HCE group is high (100% of the potential pool of HCEs to be covered), then is coverage of the NHCE group likewise high (70% of the potential pool of NHCEs to be covered).

      - to the extent coverage of the HCE group is not exceptionally high (e.g., 50% of the potential pool of HCEs to be covered), then coverage of the NHCE group can be correspondingly less (e.g., 70% of the 50% or 35% of the potential pool of NHCEs to be covered).
      - could the plan be aggregated with another plan and then rerun the coverage numbers? Answer depends on whether one of the plans is on the mandatory disaggregation list.

   b. If the Ratio Percentage test fails to meet the 70% threshold, then there is a second test – the Average Benefits Percentage test – with three components:

      - is the "third component" a reasonable classification? Treas. Reg. §1.401(b)-4(b) states reasonable classifications include specified job categories, nature of compensation, geographic location.
      - using the NHCE concentration % ratio (NHCEs ÷ Test Group), the chart in Treas. Regs. §1.401(b)-4(b) provides a new ratio percentage – a range of percentages – if the plan's ratio percentage is at or above the safe harbor, the second part of the test is met. If the plan's ratio percentage is between the safe and unsafe harbor, facts and circumstances can be provided to the IRS. If the plan's ratio percentage is at or below the unsafe harbor, the plan fails.
      - under the third test, the average benefit accrual/allocation rates for all NHCEs under all plans maintained by the employer must be at least 70% of the average benefit accrual/allocation rates for all HCEs under all plans

maintained by the employer. This test suddenly takes a look at what the actual accrual/allocation rates that the NHCEs achieve versus HCEs achieve.

2. Once there is a sufficient number of NHCEs covered relative to HCEs covered to satisfy IRC §401(a)(3), IRC §401(a)(4) then asks whether the actual accruals/allocations that the NHCEs are receiving is nondiscriminatory relative to the HCEs.

- The regulations go beyond the text of the statute and impose three different tests:
  Test 1: the actual accrual/allocation rates that the NHCEs are receiving are nondiscriminatory when compared to the accrual/allocation rates that the HCEs are receiving.
  Test 2: benefits, rights and features (listed in Treas. Regs. 1.401(a)(4)-4(e)(3)(iii)) are currently available to a nondiscriminatory group of participants and are effectively available to a nondiscriminatory group of participants.
  Test 3: benefits payable upon "special circumstances" must be provided on a nondiscriminatory basis.
- For Test 1, the regulations provide certain safe harbors (*i.e.,* ways to design the allocation formula or the AB formula such that they meet this test). The safe harbors have certain uniformity requirements that must first be satisfied (see page 160 of textbook).
- Once the uniformity requirements have been satisfied: safe harbors include:

a. For DC plans:

   - Allocation formula that provides all NHCEs covered and all HCEs covered with the same % of total compensation (capped for IRC §§401(a)(17) and 415) meets the safe harbor.
   - Allocation formula that uses points to all allocate on the basis of total compensation and/or service or age, provided that the average of all the NHCEs rates is at least the same (but not lower) than the average of all the HCEs rates.
   - Integrated formula (or permitted disparity) permits a given x% on total compensation + y% on total compensation in excess of the Social Security maximum taxable wage base, provided y% ≤ two times x% and the difference between y% and x% ≤ 6.2%.

b. For DB plans:

   - Unit credit AB formula that provides all NHCEs covered and all NHCE covered with the same % of total compensation (capped for

IRC §§401(a)(17) and 415) meets the safe harbor. The plan's AB formula must also satisfy the 133⅓ Rule of IRC §411(b).

- Unit credit NRB formula with a fractional rule AB formula; however, no employee may accrue at a rate more than 133⅓% of the rate of any other employee.
- Fixed benefit NRB formula with a fractional rule AB formula (with a 25 year minimum floor).
- Fixed benefit NRB formula with a fractional rule AB formula, provided the average of all the NHCEs rates is at least 70% (but not lower) than the average of all the HCEs rates.
- Integrated formula (or permitted disparity) permits a given unit credit AB formula of x% on total compensation + y% on total compensation in excess of the Social Security maximum taxable wage base, provided y% ≤ two times x% and the difference between y% and x% ≤ 0.75% and the number of years of credit is capped at 35 years.

c. General Test: If the highest HCE allocation/accrual rate > lowest NHCE allocation/accrual rate, the general test fails. However, the plan can be "restructured" into a number of different allocation/accrual rate groups (based on the different number of HCE allocation/accrual rates).

For example: Allocation rate = 3% x base pay (not total pay), conditioned upon attaining 1,000 hours during the plan year + still being employed on the last day of the plan year

Test Group = 100 – 90 NHCEs and 10 HCEs
Eligibility under DC plan = age 21 + one-year wait + salaries – resulting in coverage of only 10 employees – 6 NHCEs and 4 HCEs

EE's Status	Base Pay	Total Pay	Allocation	Allocation/Total Pay
NHCE #1 - #4	$20,000	$25,000	$6,000	2.4%
HCE #1 - #2	80,000	100,000	24,000	2.4%
NHCE #5	30,000	40,000	9,000	2.25%
HCE #3 - #4	100,000	100,000	30,000	3%
NHCE #6	25,000	0		0%

General Test: Does highest HCE allocation rate > lowest NHCE allocation rate? Yes, 3% > 0%; however, the plan can be restructured into two different rate groups – based on the two different HCE rates of 2.4% and 3%.

Rate Group #1 is all participants (NHCEs and HCEs) with an allocation rate of 2.4% or more:

NHCE #1 - #4	$20,000	$25,000	$6,000	2.4%
HCE #1 - #2	80,000	100,000	24,000	2.4%

NHCE #5	30,000	40,000	9,000	2.25%
HCE #3 - #4	100,000	100,000	30,000	3%

Redo the IRC §410(b) coverage test for this rate group:
[NHCEs covered ÷ NHCE test group] / [HCEs covered ÷ HCE test group]
= [5 ÷ 90] / [4 ÷ 10] = 5.6%/4% ≥ 70% ratio percentage test

Rate Group #2 is all participants (NHCEs and HCEs) with an allocation rate of 3% or more:

HCE #3 - #4	100,000	100,000	30,000	3%

Redo the IRC §410(b) coverage test for this rate group:
[NHCEs covered ÷ NHCE test group] / [HCEs covered ÷ HCE test group]
= [0 ÷ 90] / 2 ÷ 10] = 0%/2% = 0% -- fails the ratio percentage test and the average benefits test