



# Coverage and Nondiscrimination Testing with Related Employers

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# What we'll cover



- Basic principles
- Plan considerations and strategies
- Compensation
- HCE status
- Coverage and minimum participation
- ADP/ACP testing
- Nondiscrimination under 401(a)(4)
  - Allocations/Benefits
  - Benefits, Rights, and Features

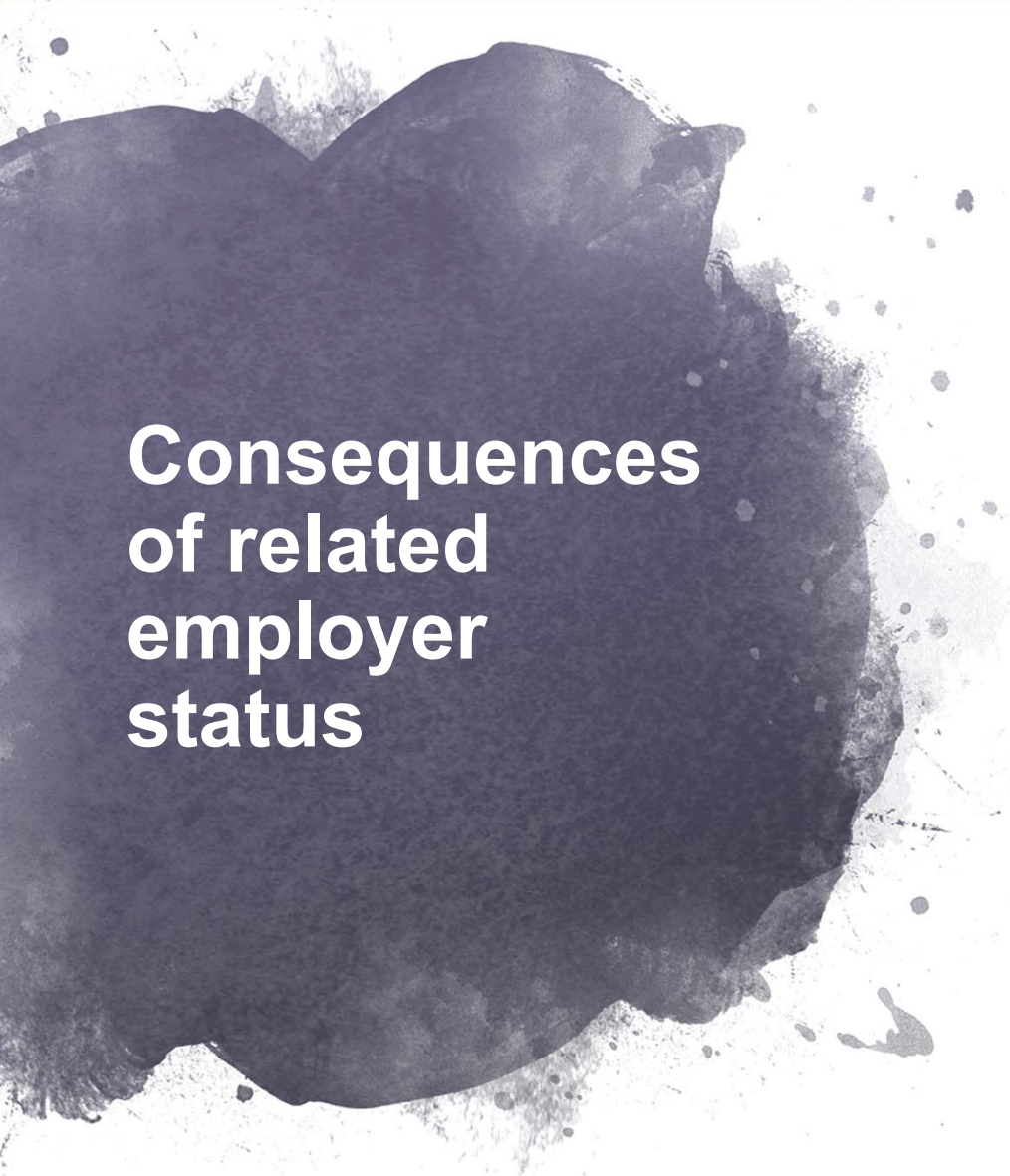


**Basic  
principles**

# Ways to have related employers

- Controlled group
  - Parent-subsidiary
  - Brother-sister
  - Combined
- Common control
  - Special tax-exempt rules
- Traditional affiliated service groups
  - A-Org
  - B-Org
- Management function groups





## Consequences of related employer status

- All employees of all related employers are deemed to be employed by a single employer for most retirement plan purposes
  - Exclusive benefit rule
  - Crediting service for eligibility, vesting and benefit accrual
  - Coverage
  - Nondiscrimination
  - 415 limits
  - Top-heavy

# What does that really mean?



- Who are the employees of this employer?
  - Count all employees of any related employer
- Who is the employer of this employee?
  - Count the employee's employer and any business related to that employer
- Moving from one related employer to another isn't a separation/severance
- All related employers count all service with any related employer

# Ask the right question



- The related employer rules don't directly answer the question:  
What employees need to be included in the plan?
- Instead, the related employer rules answer these questions:
  - **Who are the employees of this employer?**
  - **Who is the employer of this employee?**
- Easiest way to resolved related employer consequences questions
  - ask yourself:
    - **If this was one corporation with two different offices, what would the Code tell me?**

# Typical related employer question

- Scenario:
  - A and B are in a controlled group
  - A sponsors a plan
  - Does the plan need to cover the employees of B?
- The related employer rules don't answer that question
  - Instead, they tell you all employees of A and B are deemed to have a single employer
- So what's the answer?
  - SEPs, SIMPLEs, standardized plans: cover them
  - Other plans: you don't have to cover B if you can pass coverage and nondiscrimination (and minimum participation for defined benefit)



# Standardized Plan



- A and B are related employers (throughout this program)
- A has sponsored a SIMPLE 401(k) on a standardized prototype since 2005
  - B does not cosponsor the prototype
- The document nonetheless covers the B employees
  - This is not an exclusive benefit rule violation
- If the B employees haven't been allowed to participate:
  - Operational failure
  - Likely significant
  - File under VCP



**Plan considerations and  
strategies**

Alternative  
approaches

# Working together



- A and B jointly adopt a single plan covering all eligible employees of both A and B
- One plan document
  - Separate adoption agreements
- One Form 5500
- Easy testing
- Recommendation: Each employer contributes for its own employees
  - Could have deductibility issues otherwise

# One employer carries the load



- A adopts a plan covering the employees of A and B
  - B does not cosponsor the plan
- Issues:
  - Deduction limit just based on A's employees
  - A may have difficulties deducting contributions for B even if it is within the limit
  - As a practical matter, B needs to be involved if you have elective deferrals

# Separate plans



- A adopts a plan for its eligible employees
- B adopts a plan for its eligible employees
- Two plans to maintain
- Two Forms 5500
- Allows different approaches for the two employers
- Either:
  - Each plan must separately pass coverage and nondiscrimination
  - Permissively aggregate the plans to test as a single plan



# Permissive aggregation



- Valuable option: Can facilitate passing coverage or nondiscrimination
- Requirements:
  - Same plan year end
  - Same testing method
    - Safe harbor contribution method
    - Current or prior year testing
- Helpful features:
  - Similar benefits, rights, and features
    - Since you'll be testing the plans as a single plan for all elements of 401(a)(4)
    - Different vesting schedules OK
  - Same eligibility requirements
    - Otherwise excludable employee rule can help

# Leave 'em out



- A adopts a plan covering its employees (only)
- B doesn't have a plan
- Can work if the plan passes coverage and nondiscrimination

**KEEP  
OUT**



# Compensation

Total  
Nondiscriminatory  
Allocation



# Total (415) Compensation



- Compensation for 415 purposes includes all compensation from all related employers
- A and B are related employers
  - Each has a separate plan
- Jack works for both A and B
  - Each pays Jack \$40,000 in 2012
- Result: Jack has \$80,000 compensation for purposes of
  - 415 limit
  - Top heavy minimum
  - Key employee determination
  - HCE determination
  - Deduction limit
  - 5%/7.5% minimum gateway

# Nondiscriminatory (414(s)) compensation



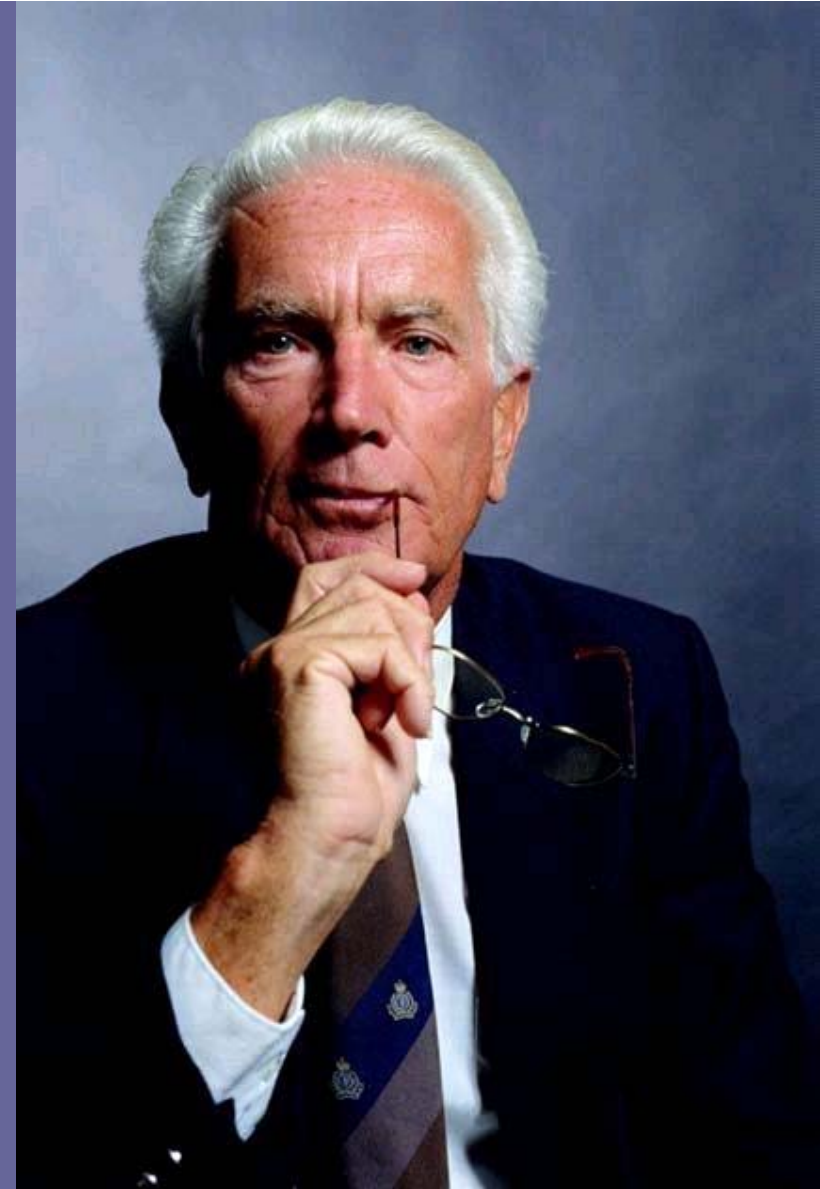
- Plan must use nondiscriminatory definition of compensation for:
  - Coverage testing
  - ADP/ACP testing and safe harbor
  - Other nondiscrimination testing
- Safe harbor nondiscriminatory definitions include all compensation from all related employers
- Alternative definition: Just count compensation from one of the related employers
  - Must pass compensation ratio test each year



# Allocation definitions

- Need not use nondiscriminatory definition for purposes of:
  - Determining deferrals
  - Limitations on matching contributions
    - Although if the definition is discriminatory it could create a discriminatory right or feature; must test
  - Allocating employer nonelective contribution
- So you can consider compensation from only one related employer even if that is discriminatory
  - Example
    - A and B are related employers and jointly sponsor a plan
    - A contributes 10% of compensation allocated to A employees
    - B contributes 5% of compensation allocated to B employees

# HCE status



# 5% owner status



- If you are a more than 5% owner of an employer, you are an HCE of that employer and any related employer
- Example:
  - Corporation A owns 90% of Corporation B
    - Parent-subsidary controlled group
  - Mary owns the remaining 10% of B
    - Mary is an employee of A or B
  - Mary is an HCE of B and an HCE of A

# HCE by compensation



- Add all compensation from all related employers to determine an employee's compensation
  - Chris works for A and B and each pays her \$70,000 in 2017
  - A sponsors a plan covering A employees
  - Chris is an HCE for 2018 with 2017 compensation of \$150,000
- Top 20% rule
  - Count all employees from all related employers
  - Count all compensation from all related employers
  - All plans of all related employers must make same choice regarding top 20% rule

**Coverage  
and  
minimum  
participation**





# Coverage testing with separate plans



|              | HCE       | NHCE      |
|--------------|-----------|-----------|
| A            | 4         | 6         |
| B            | 6         | 14        |
| <b>Total</b> | <b>10</b> | <b>20</b> |

- A and B are related employers. Each has a 401(k) plan covering its own employees. The nonexcludable employees are shown.
- Does the A plan pass ratio percentage?  
 $6/20 \div 4/10 = 30\% / 40\% = 75\%$
- Does the B plan pass ratio percentage?  
 $14/20 \div 6/10 = 70\%/60\% = 116.67\%$

# Coverage testing with separate plans



|       | HCE | NHCE |
|-------|-----|------|
| A     | 4   | 6    |
| B     | 6   | 14   |
| C     | 2   | 10   |
| Total | 12  | 30   |

- C is now part of the group and doesn't have a plan or participate in the A or B plan
- Does the A plan pass ratio percentage?  
 $6/30 \div 4/12 = 20\% / 33\% = 60\%$
- What can A do?
  - Bring in some C employees
  - Pass average benefit test
  - Permissively aggregate the A and B plans  
 $20/30 \div 10/12 = 67\%/83\% = 80\%$

# Average benefit test for coverage



|              | Alloc. | HCE       | NHCE      |
|--------------|--------|-----------|-----------|
| A            | 10%    | 4         | 6         |
| B            | 6%     | 6         | 14        |
| C            | 0%     | 2         | 10        |
| <b>Total</b> |        | <b>12</b> | <b>30</b> |

- Nondiscriminatory classification
  - Covering employees of only one employer is reasonable, objective classification
  - A's coverage fraction of 60% exceeds safe harbor % (41.75%)
- Average benefit % test (AB%T)
  - NHCE% =  $(6 \times 10\% + 14 \times 6\%) / 30 = 4.80\%$
  - HCE% =  $(4 \times 10\% + 6 \times 6\%) / 12 = 6.33\%$
  - AB% =  $4.80\% / 6.33\% = 75.83\%$

**Minimum  
participation under  
401(a)(26)**

- Only applies to DB plans
  - Requires lesser of 50 employees or 40% of nonexcludable employees benefit
  - Count all nonexcludable employees of all related employers
- 
- Clinic has 6 NHCEs and is in affiliated with 3 doctors (each of which is sole employee of a PC)
  - Dr. X wants to set up a defined benefit plan
  - The plan must benefit at least 4 employees

# 410(b)(6)(C) coverage transition rule



- Sometimes called “free pass”
- Applies to ownership transactions:
  - Formation of controlled group/ASG, etc.
  - Change in controlled group/ASG, etc.
  - Asset or stock acquisition
  - Merger
- Plan must be in existence prior to transaction
  - Must satisfy coverage and minimum participation immediately prior to transaction

# Result of free pass



- If free pass applies, then plan passes 410(b) and 401(a)(26) throughout coverage transition period
  - Transition period:
    - Begins on date of transaction
    - Ends at earlier of:
      - End of following plan year
      - Change in coverage or benefits



# Free pass example



- Solo maintains a defined benefit pension plan
  - The plan specifies that only employees of Solo participate.
  - Solo has 5 HCE, 5 NHCEs; all participate
  - Plan passes 410(b) and 401(a)(26)
  - Calendar year plan
- 2/16/2017, BossCo buys 80% of Solo Stock
  - Controlled group formed 2/16/2017
  - BossCo has 500 NHCEs, 20HCEs
  - Solo doesn't amend plan
  - Solo's plan passes 401(a)(26) and 410(b) for 2017 and 2018

# Free pass example: 3 tweaks



1. Solo decides to amend plan 1/1/2018 to increase benefits
  - Free pass ends immediately
  - Solo fails 401(a)(26) for 2018
2. Solo's plan terms cover all controlled group members
  - Free pass does no good
  - So check the terms before the transaction
3. HugeCo buys BossCo 1/15/2018
  - Coverage transition rule doesn't apply
    - Plan didn't satisfy minimum participation/coverage on date of transaction without regard to the free pass

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# ADP/ACP testing



# ADP and ACP tests

- ADP test considers only employees eligible to defer to the plan
- ACP test considers only employees eligible to receive a match (if they defer to the plan)
- A sponsors a 401(k) plan covering to 30 A employees and not the 20 B employees
  - The ADP test only considers the A employees eligible to defer
- One plan means one ADP test
- A and B jointly sponsor a 401(k) plan
  - A provides a match of 50% of deferrals up to 6% of comp
  - B provides a match of 100% of deferrals up to 4% of comp
  - There is a single ACP test
  - Check benefits, rights, and features because of different match rates

# HCE in multiple plans



- A and B sponsor separate plans
  - A is a safe harbor plan a 3% nonelective contribution
  - B is an ADP-tested plan
- Harry, an HCE, is eligible to defer to both plans
  - But only defers to the A plan
- The B plan counts Harry's deferrals to both plans in the ADP test (ADR = 10%)
- Same applies to ACP

|              | Comp             | Deferral        |
|--------------|------------------|-----------------|
| A            | \$100,000        | \$15,000        |
| B            | \$50,000         | \$0             |
| <b>Total</b> | <b>\$150,000</b> | <b>\$15,000</b> |

- » Use the comp definition and plan year of the plan being tested
- » This rule is for HCEs only
- » If the B plan fails the ADP test, Harry's excess deferrals returned to him can't exceed his B deferrals

# Problem for ACP safe harbor



- ACP safe harbor condition: Rate of match of any HCE at any level of deferrals cannot exceed rate of match of any NHCE at same level of deferrals
  - HCE aggregation rules (adding match from all plans) apply to determine if this limit is satisfied
  - This could easily blow ACP safe harbor
  - Escape hatch:
    - HCE didn't participate in both plans simultaneously (e.g., employee moved from A to B and switched plans at same time)
    - Period used to determine match for each plan limited to period HCE participated in the plan



# Can't combine safe harbor/ADP tested



- A and B jointly maintain a 401(k) plan
  - A wants a 3% safe harbor nonelective plan for its employees
  - B wants an ADP-tested plan
- Can't do it in a single document
  - All NHCE participants of the employer (A and B) would have to receive the safe harbor contribution
  - Can't restructure or split a single employer in a single plan for ADP/ACP
    - Exceptions: Otherwise excludable employee rule, union/nonunion, QSLOBs, and ESOP/non-ESOP

# Coverage transition and safe harbor termination



- If a safe harbor plan has an event that qualifies for the coverage transition rule, then the employer can terminate the plan midyear
  - Without giving 30 days advance notice
  - Keeping the ADP/ACP safe harbor and top-heavy exemption (if applicable)
  - But has to fund up to date of termination
- The termination must be “in connection with” the merger, acquisition, controlled group change, etc.

# Change of testing method



- General rule: If plan is on current year testing (and previously used prior year testing) it can convert to prior year testing only if it has been current-year tested for 5 years
- Exception: If:
  - A merger, acquisition, change in related employers, or other event giving rise to the coverage transition rule of Code §410(b)(6)(C) takes place, and
  - The employer (related employers) maintain both a prior year tested plan and a current year tested plan as a result of the change, then
  - The employer can switch to prior year testing any time within the coverage transition period

# Effect of coverage transition rule on ADP/ACP



- Coverage transition rule applies to 401(k) coverage requirement
- No free pass of ADP/ACP
- Warning: Plan coverage change complicates prior year testing
  - Plan establishment or amendment,
  - Plan merger or spinoff,
  - A change in permissive aggregation,
  - A reclassification of a substantial group of employees that has the same effect as a plan amendment, or

# Other plans



- SIMPLE IRA and 401(k)
  - Free pass lasts one year longer
- SEPs
  - No free pass!!!
- 403(b)
  - Should be able to use free pass for 410(b) testing
  - Doesn't need free pass for deferrals



## **Nondiscrimination under 401(a)(4)**



# Principles for 401(a)(4)



- If the plan is a safe harbor design plan, then it satisfies 401(a)(4), regardless of whether all employees are participants
  - The key is to pass coverage
    - Or have the benefit of the coverage transition rule
- If the plan is not a safe harbor design, and must perform the general nondiscrimination test then:
  - You must take into consideration all nonexcludable employees of all related employers (regardless of whether they benefit from the plan being tested)
  - If you must run the average benefit % test (AB%T) then you must take all plan maintained by any related employer into consideration

# Average benefit test in nondiscrimination



|              | Alloc. | HCE       | NHCE      |
|--------------|--------|-----------|-----------|
| A            | 10%    | 4         | 6         |
| B            | 6%     | 6         | 15        |
| C            | 0%     | 0         | 9         |
| <b>Total</b> |        | <b>10</b> | <b>30</b> |

- A, B and C are related employers
- A and B jointly sponsor a plan for their employees; C employees have no plan
- A contributions go to A employees and B contributions go to B employees
- Plan as a whole passes ratio percentage test for coverage (70%)
- Not a safe harbor plan; general test required for nondiscrimination

# Average benefit test in nondiscrimination



|              | Alloc. | HCE       | NHCE      |
|--------------|--------|-----------|-----------|
| A            | 10%    | 4         | 6         |
| B            | 6%     | 6         | 15        |
| C            | 0%     | 0         | 9         |
| <b>Total</b> |        | <b>10</b> | <b>30</b> |

- Divide employees into rate groups based on allocation rate
- Two rate groups: 10%, 6%
- 10% rate group includes 6/30 NHCEs and 4/10 HCEs
  - Coverage fraction = 50%, passes nondiscriminatory classification test
- 6% rate group includes 21/30 NHCEs and all HCEs
  - Coverage fraction = 70% passes ratio percentage test
- $AB\%T = 5\%/7.6\% = 65.79\%$  **FAIL**

# Alternative approach: restructuring

- No special plan provisions needed
- Allows you to divide plans into component plans, each consisting of the benefits provided to a group of employees
  - You pick who is in what group
- If each component passes coverage and nondiscrimination alone, plan as a whole passes nondiscrimination
- Plan as a whole must pass coverage
- Can use different testing methods for different parts:
  - Example: One part is cross-tested, another is safe harbor
- Can't use restructuring to:
  - Satisfy minimum gateway
  - Pass ADP
  - Pass ACP

# Beware of benefits, rights, and features issues



- Particularly a problem if you are permissively aggregating two plans maintained by different related employers
- Need to make sure that all benefits, rights, and features benefit nondiscriminatory classification of employees
  - Coverage fraction should equal safe harbor %
  - No need to perform AB%T
- A plan has 59½ distributions; B does not
- A plan has different investment options than B plan
- A plan allows participant investment direction; B plan is trustee directed
- A plan has different match rate than B plan
- A plan allows deferral from bonus; B plan does not

# Coverage transition rule and 401(a)(4)



- Can use coverage transition rule to pass coverage for component plans if restructuring
- Can't use coverage transition rule to pass general nondiscrimination test
- Uncertain what approach IRS would take:
  - Take into account all employees of newly related employer
  - Perform nondiscrimination testing as though merger/acquisition/change had not occurred
  - Argue that the coverage transition rule somehow applies





# Cross-testing related employers

## Company A only

| Name   | Allocation | EBAR   |
|--------|------------|--------|
| Hilda  | 20%        | 3.78%  |
| Nick   | 5%         | 2.14%  |
| Nancy  | 5%         | 7.27%  |
| Norman | 5%         | 3.22%  |
| Nadia  | 5%         | 16.45% |

**3.78% rate group covers 50% of NHCEs  
(30% midpoint)  
AB%T = 192.07%  
Plan passes**

## A and B together

| Name             | Allocation | EBAR   |
|------------------|------------|--------|
| Hilda            | 20%        | 3.78%  |
| Harry            | 0%         | 0%     |
| Nick             | 5%         | 2.14%  |
| Nancy            | 5%         | 7.27%  |
| Norman           | 5%         | 3.22%  |
| Nadia            | 5%         | 16.45% |
| 6 other<br>NHCEs | 0%         | 0%     |

**3.78% rate group covers 50% of HCEs and  
20% of NHCEs = 40% (27.75% midpoint)  
AB%T = 153.66%  
Plan passes**



# Thank you!

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