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 plans)
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
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-subsidiary 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
A and B are related employers. Each has a 401(k) plan covering its own employees. The nonexcludable employees are shown.

<table>
<thead>
<tr>
<th></th>
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<tbody>
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<td>A</td>
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<td>6</td>
</tr>
<tr>
<td>B</td>
<td>6</td>
<td>14</td>
</tr>
<tr>
<td>Total</td>
<td>10</td>
<td>20</td>
</tr>
</tbody>
</table>

Does the A plan pass ratio percentage?
\[
\frac{6}{20} \div \frac{4}{10} = \frac{30\%}{40\%} = 75\%
\]

Does the B plan pass ratio percentage?
\[
\frac{14}{20} \div \frac{6}{10} = \frac{70\%}{60\%} = 116.67\%
\]
### Coverage testing with separate plans

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<td>C</td>
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<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>12</td>
<td>30</td>
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</tbody>
</table>

- 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?  
  \[
  \frac{6}{30} \div \frac{4}{12} = 20\% / 33\% = 60\%
  \]
- What can A do?  
  - Bring in some C employees  
  - Pass average benefit test  
  - Permissively aggregate the A and B plans  
  \[
  \frac{20}{30} \div \frac{10}{12} = 67\%/83\% = 80\%
  \]
# Average benefit test for coverage

## 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)

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</thead>
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</tr>
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<td>6%</td>
<td>6</td>
<td>14</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
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<td>10</td>
</tr>
<tr>
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<td>30</td>
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- NHCE% = (6 × 10% + 14 × 6%) / 30 = 4.80%
- HCE% = (4 × 10% + 6 × 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 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
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 with 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

<table>
<thead>
<tr>
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<th>Comp</th>
<th>Deferral</th>
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<tr>
<td>A</td>
<td>$100,000</td>
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<tr>
<td>B</td>
<td>$50,000</td>
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</tr>
<tr>
<td>Total</td>
<td>$150,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

- 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

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<td>C</td>
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<td>0</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
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</tbody>
</table>

- 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

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</table>

- 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
- \( AB\%T = \frac{5}{7.6} = 65.79\% \) 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

<table>
<thead>
<tr>
<th>Name</th>
<th>Allocation</th>
<th>EBAR</th>
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<tbody>
<tr>
<td>Hilda</td>
<td>20%</td>
<td>3.78%</td>
</tr>
<tr>
<td>Nick</td>
<td>5%</td>
<td>2.14%</td>
</tr>
<tr>
<td>Nancy</td>
<td>5%</td>
<td>7.27%</td>
</tr>
<tr>
<td>Norman</td>
<td>5%</td>
<td>3.22%</td>
</tr>
<tr>
<td>Nadia</td>
<td>5%</td>
<td>16.45%</td>
</tr>
</tbody>
</table>

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

### A and B together

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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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• Who’s the Employer is available at:
  • www.employerbook.com
  • www.erisapedia.com