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Getting Together and Getting It Right: Testing Related Employer Plans



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Your Co-Hosts

- Joanne Pecina
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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

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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

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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



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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?



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PLAN CONSIDERATIONS AND STRATEGIES

Alternative approaches
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Common misconceptions

- Many practitioners think:
 - All related employers must cosponsor a plan
 - Employees of all related employers must participate in the plan
 - If employees of a related employer don't participate, you need to file under VCP
- None of these is necessarily true!



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These plans must cover all related employers

- SEP
 - If it doesn't, can't use model SEP
- SIMPLE IRA treats all related employers as single employer
 - 100 employee maximum
 - No other plan
 - Participation
- Standardized plan
 - After coverage transition period



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Nonstandardized and individually designed plans don't have to cover all related employers

- They do have to pass coverage, however, taking into account all related employers
 - That's why it can be simpler to cover all the employees in a single plan
 - Easier testing
 - Lower cost



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What happens if related employers don't cosponsor nonstandardized plan?

- Check plan document:
 - Standard clause: Employees of related employer that doesn't cosponsor plan are ineligible to participate
 - No operational failure for excluding the employers
 - But it may be a coverage failure
 - Some documents say employees of all related employers automatically are participants
 - Creates operational failure
 - Typical for solo(k)



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COMPENSATION

Total
Nondiscriminatory
Allocation

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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 \$80,000 in 2022

- Result: Jack has \$160,000 compensation for purposes of
 - 415 limit
 - Top heavy minimum
 - Key employee determination
 - HCE determination
 - Deduction limit
 - 5%/7.5% minimum gateway

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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


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Compensation ratio test

- X and Y are controlled group
- Each sponsors a plan for its employees considering its own comp

Name	X Comp	Y Comp	Total Comp	X %
Henry	\$200,000		\$200,000	100%
Hope		\$220,000	\$220,000	
Nick	\$60,000		\$60,000	100%
Norma		\$50,000	\$50,000	
Neville	\$30,000	\$30,000	\$60,000	50%



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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
 - X contributes 10% of compensation allocated to X employees
 - Y contributes 5% of compensation allocated to Y employees
- But you must use nondiscriminatory definition to test

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Coverage and minimum participation



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HCE Status

- An HCE of any related employer is an HCE of all group members
- Comp with all related employers counts
- Top Paid Group rule
 - Top 20% based on all employees of all group members
 - All plans sponsored by any group member must make the top paid group election or it isn't valid for any of them
 - Count comp from all group members to determine top 20%



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Coverage testing with separate plans

	HCE	NHCE
A	4	6
B	6	14
Total	10	20

- 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?
 $14/20 \div 6/10 = 70\%/60\% = 116.67\%$

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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
 $20/30 \div 10/12 = 67\%/83\% = 80\%$

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Average benefit test for coverage

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	14
C	0%	2	10
Total		12	30

- 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% = $4.80\% / 6.33\% = 75.83\%$

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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

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Try it again with a larger company

	HCE	NHCE
A	4	6
B	20	194
Total	24	200

- A covers 6/200 NHCEs = 3%
- A covers 4/24 HCEs = 16.67%
- Coverage fraction for A = 18% FAIL
- Options:
 - Permissively aggregate plans
 - Include some B employees in A plan
 - Concentration % is 89%
 - 28.25% safe harbor percentage
 - Just 4 more employees needed!
 - Must pass AB%T

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Actual case from this month

- We have a plan that was deemed to be part of an affiliated service group for 2021
 - Plan A: 2 HCEs (husband/wife), no NHCEs, and does not have safe harbor contributions.
 - Plan B: 1 HCE, 7 NHCEs, and has a safe harbor match.
- The plans were combined for coverage and are passing the ABPT with deferrals, match, and profit sharing contributions.
- Can the plans be tested separately for ADP/ACP testing?



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Reply

- You can't aggregate ADP-tested with safe harbor
- So you can't test the two plans together
 - So Plan A runs ADP test and Plan B uses safe harbor
- But Plan A fails coverage
 - Cover 2/3 HCEs and 0/7 NHCEs: Coverage fraction is 0%
 - It fails ratio percentage and nondiscriminatory classification



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Correction Calculations

- To pass ratio percentage test, Plan A must benefit at least 4 NHCEs
 - Given that plan covers 2/3 of HCEs
- To pass nondiscriminatory classification test, Plan A must benefit at least 2 NHCEs
 - Concentration percentage is 70% (7 of 10 employees are NHCEs)
 - Safe harbor percentage is 42.5%
 - Must also pass average benefit % test

NHCEs Covered	NHCE Ratio	Coverage Fraction
0	0.0%	0.0%
1	14.3%	21.4%
2	28.6%	42.9%
3	42.9%	64.3%
4	57.1%	85.7%
5	71.4%	107.1%
6	85.7%	128.6%
7	100.0%	150.0%



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Correction

- 1.401(a)(4)-11(g) amendment to add 4 NHCEs to Plan A
 - Doesn't matter that they are eligible to defer to Plan B
- Must make QNEC for them
 - 100% of NHCE ADP in Plan A
 - Problem: There are no NHCEs in Plan A
 - Recommendation: Use ADP that allows Plan A to pass ADP test
 - If HCEs deferred 6.5%, use 4.5% QNEC
 - Can't count QNEC in average benefit percentage test



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Minimum participation under 401(a)(26)

- Only applies to DB plans
- Requires lesser of 50 employees or 40% of nonexcludable employees benefit
 - Minimum of 2 if there are at least 2 employees
- Count all nonexcludable employees of all related employers
- Permissive aggregation not available
- Clinic has 6 NHCEs and is in ASG 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

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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



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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



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SEPS and SIMPLE IRAs

- No coverage transition rule for SEPs
- SIMPLE IRAs:
 - Rule protects
 - 1 plan requirement
 - 100 employee maximum
 - Don't have to expand coverage
 - Coverage transition rule lasts extra year
 - BigCo buys LittleCo today
 - LittleCo sponsors SIMPLE IRA; BigCo sponsors 401(k)
 - LittleCo can continue with SIMPLE IRA through 2024
 - BigCo has to take LittleCo employees into account in testing after 2023



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ADP/ACP TESTING



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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 the 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/ACP 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

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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 |
| Total | \$150,000 | \$15,000 |
- » 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

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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



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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



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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.



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Nondiscrimination under 401(a)(4)

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Principles for 401(a)(4)

- If the plan is a 401(a)(4) 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



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Average benefit test in nondiscrimination

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	15
C	0%	0	9
Total		10	30

- 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

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Average benefit test in nondiscrimination

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	15
C	0%	0	9
Total		10	30

- 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**

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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

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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 59% 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

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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



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Cross-testing related employers					
Company A only			A and B together		
Name	Allocation	EBAR	Name	Allocation	EBAR
Hilda	20%	3.78%	Hilda	20%	3.78%
Nick	5%	2.14%	Harry	0%	0%
Nancy	5%	7.27%	Nick	5%	2.14%
Norman	5%	3.22%	Nancy	5%	7.27%
Nadia	5%	16.45%	Norman	5%	3.22%
3.78% rate group covers 50% of NHCEs (30% midpoint)			Nadia	5%	16.45%
AB%T = 192.07%			6 other NHCEs	0%	0%
Plan passes			3.78% rate group covers 50% of HCEs and 20% of NHCEs = 40% (27.75% midpoint)		
			AB%T = 153.66%		
			Plan passes		

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