november/december 2012

Retirement PLAN news

Cross-tested 401(k) safe harbor plan design

A 401(k) plan design that combines a safe harbor nonelective contribution (NEC) with a cross-tested profit sharing allocation formula may permit certain plan sponsors to increase contributions to highly compensated employees (HCEs) while simultaneously satisfying compliance testing.

Maximizing contributions to HCEs is frequently a plan sponsor's goal. Following are the basic principles of a cross-tested safe harbor plan design and the advantages it offers.

Cross-testing benefits

A cross-tested allocation formula allows an employer to create separate participant groups and provide each group with a different allocation rate. For example, if certain nondiscrimination tests are passed, HCEs may receive a higher allocation of profit sharing contributions than nonhighly compensated employees (NHCEs). A cross-tested allocation formula must pass two tests: a gateway test and a nondiscrimination test.

The gateway test ensures that a minimum allocation is made to all NHCEs. To satisfy the gateway test, a contribution — either a 5% gateway allocation or a three times allocation — must be made to all NHCEs. The three times allocation method limits the highest allocation to any HCE to no more than three times the lowest allocation provided to any NHCE. For example, if the lowest rate to any NHCE is 3%, then the highest allocation rate to any HCE is limited to 9%. (Although not utilized as often, a cross-tested plan may pass the gateway test by using a broadly available allocation method.) The gateway test must be passed before the nondiscrimination test can be performed.

The nondiscrimination test is a complex test that permits allocations to be tested as if they were benefits provided under a defined benefit plan (i.e., the allocations are converted to an equivalent benefit accrual rate). Then each HCE's rate is tested to see if the plan passes the nondiscrimination test on a benefits basis. In general, for a cross-tested plan to pass the nondiscrimination test, the covered NHCEs should be younger than the HCEs, since younger NHCEs will have a longer time horizon until normal retirement age for their benefits to accrue relative to the older HCEs.

Safe harbor 401(k) plan

A safe harbor 401(k) matching or nonelective contribution permits the plan to satisfy the actual deferral percentage (ADP) test applicable to employee deferrals while allowing HCEs to maximize their elective deferrals. (HCEs over age 50 or who reach age 50 during the plan year may make additional elective catch-up contributions.) However, there are some strings attached to these advantages:

- All safe harbor contributions are immediately 100% vested (unless the plan is a qualified automatic contribution arrangement safe harbor 401(k)), and

(Continued on page 2)

Pension Benefits Unlimited
Actuaries & Consultants

17748 Sky Park Circle, Suite 240
Irvine, California 92614
(949) 260-1880 • (949) 261-2985 (FAX)

Deferrals and the compensation limit

Section 401(a)(17) of the Internal Revenue Code establishes the annual compensation limit for pension plans. The limit is $250,000 for 2012. It is critical for plan administrators to understand how the annual compensation limit is applied.

Although $250,000 is the compensation cap for the year, a key question sometimes arises: Must deferrals cease at the point during the year when the employee has received $250,000 in pay? Or is the $250,000 annual limit checked after the end of the year? Consider the following hypothetical situations involving employees whose compensation exceeds $250,000 during 2012:

- An employee earning $600,000 per year ($50,000 per month) wants to begin making contributions after August 1. However, her compensation has already exceeded the $250,000 limit. May she begin making deferrals at this point in the plan year?
- A second employee who has already received compensation exceeding $250,000 wants to defer on a year-end bonus. Is that permitted?
- A third person earning $50,000 per month defers 3% of payroll beginning in January. May he contribute elective deferrals in excess of $7,500 (5 months at $50,000 × 3%) in 2012?

The answer to all three questions is, "Yes." The IRS examined this topic and addressed how elective deferrals should be treated in its newsletter (*Employee Plans News*, Fall 2009). The IRS expressed the opinion that (1) the compensation limit is applied after the year is completed and (2) the plan is not required to determine a participant's Section 401(a)(17) compensation based on the earliest point at which his or her paid compensation reaches the $250,000 limit.

Some plans may impose additional restrictions, such as a percentage of compensation limit on deferrals by highly compensated employees (HCEs). Here's an example: If a plan limits HCE deferrals to 5% of compensation and an HCE earns more than $250,000 in compensation, the annual limit of 5% of $250,000 would limit the HCE to a maximum deferral of $12,500 ($250,000 × 5%). Of course, if the HCE were age 50 or older and the plan permits catch-up contributions, the HCE could make additional contributions of up to $5,500 (in 2012) if eligible (i.e., he or she had reached the plan's percentage of compensation limit on deferrals).

Cross-tested 401(k) safe harbor plan design

(Continued from page 1)

- All eligible participants must receive a safe harbor contribution, even if they do not meet service requirements (i.e., work 1,000 hours during the plan year and/or be employed on the last day of the plan year).

In addition, many safe harbor 401(k) nonelective contribution plans are designed to be exempt from top-heavy rules. The safe harbor rules require that a nonelective contribution of at least 3% be made to all eligible nonkey employees. To be exempt from the top-heavy rules, no other nonelective contributions may be made. Generally, a plan should have the same service requirements for both elective deferrals and safe harbor contributions; it will not be exempt if it permits a shorter period of service for eligibility for elective deferrals than for safe harbor contributions.

Combining safe harbor and cross-testing

There are several advantages to combining the nonelective safe harbor contribution with a cross-tested profit sharing formula. The safe harbor nonelective contribution (typically 3%) can offer relief from ADP and ACP (actual contribution percentage) testing. It may also be used to satisfy both the minimum gateway allocation and the top-heavy minimum contribution requirement and is included in nondiscrimination testing. **Note:** A safe harbor matching contribution cannot be used to satisfy the gateway minimum nor is it included in rate group testing.

Pitfalls

In many cases, adding a younger HCE to a cross-tested calculation will cause it to fail. For that reason, employers interested in this type of design should consider excluding their children from the plan.

There also may be an issue if a participant receives a safe harbor NEC or a top-heavy contribution but is ineligible to receive a cross-tested allocation due to a last-day or hours-of-service requirement. For example, if a participant separated from service and received a 3% safe harbor contribution but was not eligible for the cross-tested allocation, that participant still must be included in the cross-tested gateway test. If a 5% gateway allocation design is used, this may cause the plan to include that participant in the entire gateway allocation in order to pass the gateway test.

Participant loan disclosures

Many 401(k) plans permit participants to borrow from their accounts. To prevent a plan loan from becoming a taxable distribution, it must meet a number of rules under IRC Section 72(p).

One of the requirements is that the loan must be based on a legally enforceable written agreement. This agreement, which may be either a paper or an electronic document, requires the participant to make amortized repayments at least quarterly, based on a repayment schedule.

This article is an overview of the various loan-related disclosures that plan sponsors should be familiar with if their plan allows participant loans.

Participant loan program

If not already described in its Summary Plan Description, a plan must adopt and distribute a "loan policy." This document outlines the plan's administrative procedures for granting and maintaining participant loans. It includes eligibility requirements, limitations on loan amounts, repayment requirements, default rules, and a description of loan initiation and/or maintenance fees (if applicable). Additional points to be covered include, but are not limited to, the effect a leave of absence or active military service has on a participant's outstanding loan, how outstanding loans are handled for a terminated participant, the number of loans permitted, whether refinancing is available, whether a designated Roth is a loan source, and prioritization (if any) of sources or investments to be used for the loan.

Loan application

The loan application should include the amount being requested, the duration of the loan, the participant's signature, and the date. Accounts subject to spousal consent will require married participants to obtain their spouse's signature consenting to the use of a portion of the account balance as security for the loan. Spousal consent must be witnessed by either a plan representative or notary public. Loan applications may be provided in either paper or electronic format (provided the IRS and DOL electronic communication guidance is followed).

Promissory note

Plan sponsors should document every loan in the form of a promissory note signed by the participant. The promissory note will specify the amount of the loan and a commercially reasonable rate of interest. (The plan administrator will be responsible for determining the interest rate.)

Amortization schedule

The loan amortization schedule reflects what portion of each loan repayment is applied to principal and what portion is applied to interest. If a designated Roth source is part of the loan, then each repayment must include an amortized repayment to the designated Roth account.

Irrevocable pledge

A participant typically will secure a loan with up to 50% of his or her vested account balance (as of the date the loan is granted). The irrevocable pledge and assignment of that portion of his or her accrued benefit is used as collateral for the loan.

If the loan is made from a plan in which earnings are allocated to individual participant accounts and is backed by the participant's vested interest, the security is required to cover the loan principal only. Security for loan interest is not required since a failure to repay the loan would only reduce the participant's own account. In plans with pooled assets, the security must be adequate to cover the loan principal and interest in the event the participant defaults on the loan.

Truth-in-lending disclosure

Prior to July 1, 2010, retirement plans that had made a certain number of participant loans in the prior calendar year were required to provide participants

who were taking loans with disclosures under the Truth in Lending Act (TILA, also known as Regulation Z). TILA requires creditors to disclose certain financial terms of lending agreements to consumers. These disclosures include the amount financed, finance charge, interest rate (expressed as the annual percentage rate, or APR, which includes the effect of interest compounding), timing of payments, and total amount to be paid.

Effective July 1, 2010, TILA disclosures are generally no longer required for participant loans. However, there are some exceptions: Qualified plans that do not comply with the participant loan requirements of Section 72(p), disregard the 50% of vested account balance rule, or fail to meet the Section 401(a) requirements are still required to comply with the disclosure requirements of Regulation Z.

Note: Some plans still provide the TILA disclosure because it is simple to use and is an excellent disclosure of a loan's financial information.

RECENT developments

Revised participant disclosure guidance

On July 30, 2012, the Employee Benefits Security Administration (EBSA) issued FAB 2012-02R revising prior guidance with respect to participant disclosure requirements for plan sponsors that provide participants and beneficiaries with brokerage windows as an investment option. The revision rescinds FAQ 30 of FAB 2012-02, which required brokerage windows to be treated as designated investment alternatives under certain situations and subjected certain brokerage windows to participant disclosure requirements. There was an immediate outcry from the retirement plan industry regarding the operational impossibility of complying with this type of participant disclosure for brokerage windows. As a result, the EBSA ceased its attempt to apply the participant-level disclosure requirements to brokerage windows, self-directed brokerage accounts, and similar arrangements.

Although the Department of Labor (DOL) stated in its new FAQ 39 that brokerage-type accounts are not designated investment alternatives (and are not, therefore, subject to participant fee disclosure regulations), it reiterated that brokerage-type investments remain subject to the fiduciary standards of prudence and loyalty to the participants and beneficiaries who utilize those investments.

Certain 403(b) plans may lose ERISA exemption

Under Advisory Opinion 2012-02A, the DOL issued an opinion that a deferral-only "non-ERISA" 403(b) plan sponsored by a Section 501(c)(3) tax-exempt organization will lose its exemption from being an ERISA plan if the employer also maintains a qualified plan subject to ERISA that receives matching contributions based on employee deferrals to the 403(b) plan. It is not uncommon for non-profit organizations to sponsor two plans: a 403(b) plan consisting solely of employee deferrals that satisfies the criteria for exemption from ERISA and a separate Section 401(a) qualified plan that is funded with matching contributions based on the deferrals made to its 403(b) plan. Under this advisory opinion, such an arrangement would subject the non-ERISA 403(b) plan to ERISA and *both* plans would have to comply with ERISA's reporting and disclosure requirements.

p|b|u

Pension Benefits Unlimited

Actuaries & Consultants

17748 Sky Park Circle, Suite 240

Irvine, California 92614