

STRATEGIC PLAN DESIGN:

SMART SOLUTIONS FOR OVERCOMING FAILED ADP/ACP TESTING

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Agenda

Testing Failures and Corrections

**Testing Failures and Plan Design:
Helping Find Opportunities**

Advantages of Adding Non-Qualified Plans

Questions



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TESTING FAILURES AND CORRECTIONS

Testing Requirements

Coverage Test

Plan must cover a minimum number of employees

Identify non-excludible employees as highly Compensated Employees (HCE) and Non-Highly Compensated Employees (NHCE)

Determine which non-excludible employees are benefiting under the plan

- Consider document provisions
- Include all employees in determination (part time, seasonal)
- Controlled group and affiliated service group considerations

Non-Discrimination Test

IRC 401(k) – Actual Deferral Percentage (ADP) Test

IRC 401(m) - Average Contribution Percentage (ACP) Test

Actual Deferral Percentage (ADP) Test

The ADP test compares the average deferral rate (ADR) of non-highly compensated employees (NHCEs) to the average deferral rate of highly compensated employees (HCEs) in the Plan

The deferral rate equals the total annual deferral (excluding catch-up contributions) divided by the annual compensation

Must use the compensation as defined in the Plan document for testing purposes

The NHCE average deferral percentage (ADP) is the total of all the deferral rates for NHCEs divided by the number of NHCEs who could have deferred for the plan year

The HCE average deferral percentage (ADP) is the total of all the deferral rates for HCEs divided by the number of HCEs who could have deferred for the plan year

Document will dictate whether to use current year or prior year testing

To pass the ADP Test requires that either

- The HCE rate be no more than the lessor of 2 times the NHCE ADP or the NHCE ADP plus 2 OR
- The HCE ADP be no more than 1.25 times the NHCE ADP for the plan year

Actual Contribution Percentage (ACP) Test

The ACP test compares the average contribution rate (ACR) of non-highly compensated employees (NHCEs) to the average contribution rate of highly compensated employees (HCEs) in the Plan

The contribution rate equals the total annual match and voluntary employee after-tax contributions divided by the annual compensation

Must use the compensation as defined in the Plan document for testing purposes

The NHCE average contribution percentage (ACP) is the total of all the contribution rates for NHCEs divided by the number of NHCEs who could have made an after-tax contribution or could have received a match for the plan year if a deferral election had been made

The HCE average contribution percentage (ADP) is the total of all the contribution rates for HCEs divided by the number of HCEs who could have made an after-tax contribution election or could have received a match for the plan year if a deferral election had been made

Document will dictate whether to use Current year or Prior year testing

To pass the ACP Test requires that either

- The HCE rate be no more than the lessor of 2 times the NHCE ACP or the NHCE ACP plus 2 **OR**
- The HCE ACP be no more than 1.25 times the NHCE ACP for the plan year

ADP/ACP Testing

NHCE ADP/ACP	PASSING HCE ADP/ACP
Less Than 2.0%	$\leq 2 \times \text{NHCE ADP/ACP}$
2.0% - 8.0%	$\leq 2 + \text{NHCE ADP/ACP}$
Above 8.0%	$\leq 1.25 \times \text{NHCE ADP/ACP}$

Examples:

NHCE ADP/ACP = 1.50%, HCE ADP/ACP \leq 3.00% (using 2 times test)

NHCE ADP/ACP = 2.50%, HCE ADP/ACP \leq 4.50% (using 2 plus test)

NHCE ADP/ACP = 8.00%, HCE ADP/ACP \leq 10.00% (using 2 plus test)

NHCE ADP/ACP = 9.00%, HCE ADP/ACP \leq 11.25% (using 1.25 times test)

Testing Failures

All failures create an opportunity to help improve the plan design!

Failed ADP or ACP Test – Alternative Testing Methods

Statutory exclusion of otherwise excludible employees

Use net compensation for testing

Re-characterize excess contributions

Plan imposed deferral limit

Testing Failures

All failures create an opportunity to help improve the plan design!

Failed ADP or ACP Test

If this test fails, there are some options for passing:

- » Qualified non-elective employer contribution (QNEC) to non-highly compensated to increase ADP
- » Refund to HCE

Must be corrected no later than the end of the plan year following the plan year the test is for

Corrective distributions create 10% excise tax payable by the employer if not distributed within 2 ½ months after the end of the plan year the test is for (Form 5330 required)

Self-correction permitted within the two plan years following the end of the initial testing period

Avoiding Testing Failures

Automatic Contribution Arrangements (ACA)

Traditional

- Eligible Automatic Contribution Arrangement (EACA) – Has more regulatory governance
- Qualified Automatic Contribution Arrangement (QACA) – Requires an escalation feature or a 6% automatic deferral AND a modified safe harbor contribution

Eligible Automatic Contribution Arrangement (EACA)

- Has more regulatory governance
- Requires initial notice and annual notice at least 30 days before year end
- Permits withdrawal of defaulted amounts within 90 days of initial withholding
- Permits up to 6 months for corrective distributions to cure ADP/ACP failure

Qualified Automatic Contribution Arrangement (QACA)

- Combination of a Safe Harbor and ACA (deemed to pass ADP/ACP)
- Requires an escalation feature or a 6% automatic deferral AND a modified safe harbor contribution

Avoiding Testing Failures

Safe Harbor Plan Design

Basic Safe Harbor Match

- 100% of the first 3% of compensation deferred PLUS 50% of the next 2% of Compensation deferred
- Contributions must go to all employees who defer with NO allocation conditions
- SH match must be 100% vested so no forfeitures available to reduce other contributions
- For plans with low participation this may be significantly less costly than the SH non-elective contribution

Enhanced Safe Harbor Match

- 100% of the first 4% (or more) of compensation deferred
- Same restrictions as Basic SH match

Safe Harbor Non-Elective (SHNE)

- Contribution must be at least 3% of compensation for any eligible to defer whether or not deferring – No Allocation conditions
- Also must be 100% vested so no forfeitures to reduce other contributions
- Works well with a cross tested / group allocation profit sharing contribution
- May be more cost effective in a plan that has high levels of employees deferring into the plan

Comparison

	401(k) w/ACA	401(k) w/EACA	401(k) w/QACA
Automatic Deferral	Must be in plan document	Requires special amendment	Requires special amendment
Escalation	Not required but must be in document if will be done	Optional – must be uniform	Mandatory until default reached 6%
Other Employee Contributions	Optional	Optional	Mandatory – Safe Harbor (see below)
90 Day Distribution	N/A	Optional but must be in document if will be used	Optional if also an EACA
Uniform Deferral Rate	N/A	Mandatory to satisfy uniformity rule	N/A unless intending to be EACA also
Qualified Default Investment	Optional	Optional	Optional
Participants to be Covered	<ol style="list-style-type: none"> 1) Newly eligible participants only and if desired 2) Subgroup of current participants 	<p>Same as QAC if 6 month testing period is desired</p> <p>Same as ACA if 6 month testing period not an issue</p>	<ol style="list-style-type: none"> 1) Ppt w/no affirmative election 2) Ppt w/election under default % 3) All Employees regardless of past election
Top Heavy	Could increase any required contribution until becomes non-TH	Could increase any required contribution until becomes non-TH	Any required TH deemed satisfied if only safe harbor contributions allocated
ADP/ACP Testing	Standard rules apply	6 mo. testing period MAY apply	Safe Harbor plan
Added to Existing Plan	Any time	Beginning of plan year	Beginning of plan year
Notice	Mandatory (on or before entry and 30-90 days before beginning of each plan year thereafter)	Mandatory (on or before entry and 30-90 days before beginning of each plan year thereafter)	Mandatory (on or before entry and 30-90 days before beginning of each plan year thereafter)

Comparison

	Safe Harbor Non-elective	Safe Harbor Basic Match	Safe Harbor Enhanced Match	QACA Non-Elective	QACA Basic Match	QACA Enhanced Match
Plan Year	<p>Must be a full 12 months. If plan is a new 401(k), deferral period can't be shorter than 3 months in first plan year.</p> <p>*If you are adding a Safe Harbor to an existing 401(k) plan, the effective date would need to be the first day of the plan year with the amendment/restatement executed prior to that date. Notice must be distributed 30-90 prior to the effective date.</p>					
Eligibility	<p>Same as deferral or can use statutory eligible (age 21/1 year with entry no later than semi-annual) *If statutory is used, plan will have to test for those who do not meet this requirement but in most cases all will be NHCE (watch out for any new owners or family members of owners).</p> <p>If the plan is top heavy and the safe harbor does not cover all those eligible to defer, a top heavy contribution may be required for those who did not meet the 1 year/age 21 requirements.</p>					
Automatic Deferral Contribution	<ul style="list-style-type: none"> Optional (does not have to be Qualified if added to the plan) 			<ul style="list-style-type: none"> Mandatory, must be Qualified Automatic Contribution Arrangement Must be uniform Cannot exceed 10% Minimum must be 3% and increases to 4%, 5% & 6% at the beginning of the next plan year after initial period ends (initial period ends on the last day of the plan year following initial enrollment) Could use a minimum of 6% to avoid the escalation feature 		
Catch-up Deferrals	Must be considered when calculating a safe harbor match (Basic, Enhanced and QACA)					
Contributions to satisfy the ADP Test	3% (or higher)	100% on the 1 st 3% of Comp deferred + 50% on next 2% of Comp deferred (max safe harbor match is 4% of Comp)	Minimum can't be less than Basic – EXAMPLE: 100% on first 4% of Comp deferred. Match on deferrals over 6% of Comp will trigger an ACP test	3% (or higher)	100% on 1 st 1% of Comp deferred plus 50% on next 5% of Comp deferred (maximum QACA match is 3-5% of Comp)	Minimum can't be less than Basic – EXAMPLE: 100% on the first 3-5% of Comp deferred. Match on deferrals over 6% of Comp will trigger an ACP test

Comparison

	Safe Harbor Non-elective	Safe Harbor Basic Match	Safe Harbor Enhanced Match	QACA Non-Elective	QACA Basic Match	QACA Enhanced Match
ACP Test Deemed Satisfied for additional match above safe harbor contribution			<ul style="list-style-type: none"> Discretionary match on first 6% of Comp deferred (or less) <ul style="list-style-type: none"> Discretionary Match capped at 4% of Comp <ul style="list-style-type: none"> No allocation conditions Vesting schedule can apply <ul style="list-style-type: none"> Current Year Method 			
Vesting		100% immediate vesting			Must 100% vest no later than 2 Years of Service	
Notice Requirement			<ul style="list-style-type: none"> 30 days before the beginning of the plan year for all eligible employees <ul style="list-style-type: none"> Before entry into the plan for eligible employees 			
Reduce or Suspend Mid-Year	Prerequisite: Either economic loss exception or "Maybe Not" notice furnished (normally language is included in the annual safe harbor notice advising participants that the employer may suspend or eliminate the Safe Harbor)					
Reduce or Suspend Mid-Year			<ul style="list-style-type: none"> Current Year ADP/ACP Testing Method applies <ul style="list-style-type: none"> Top Heavy requirements must be met if plan is top heavy Must contribute the safe harbor contribution through effective date of change Supplemental Notice – 30 days prior to change (allowing deferral changes) <ul style="list-style-type: none"> Amendment required prior to the effective date of the change 			
Miscellaneous	<ul style="list-style-type: none"> Safe harbor contribution can be deposited into other plan of employer (including ESOP) – must have same plan year Match calculated on a payroll period must be deposited by end of the plan qtr following the qtr containing contribution calc pd No allocation conditions – must contribute safe harbor to all participants who were active at any time during the plan year <ul style="list-style-type: none"> Top Heavy minimum requirements are satisfied if the only employer contribution meets the safe harbor – a forfeiture allocation will remove this "deemed not top heavy" status <ul style="list-style-type: none"> Cannot distribute safe harbor contributions under Hardship Provision Deferrals distributed for hardship under a safe harbor plan must suspend deferral for 6 months (cannot use 12 month suspension or falls out of safe harbor) <ul style="list-style-type: none"> Can only be distributed after age 59 ½ if still employed Amending a 401(k) Safe Harbor during the plan year is available under certain condition – Discuss with a Newport ERISA Consultant as some provisions could be amended if they do not directly or indirectly affect the deferral election decisions or the participant's right to receive the safe harbor contribution 					

The Power of Plan Design

Utilize ACA and/or SH plan features to help maximize HCE deferral contributions:

- Traditional 401(k) plans can limit HCE contributions.
- Refunds cause HCE to not meet retirement contribution objectives.
- Cost vs benefit

Exclude HCE from the 401(k) Plan

- Avoid the ADP/ACP test completely
- Add a Non Qualified Plan help to meet HCE's retirement plan objectives

ADDING NON-QUALIFIED PLANS

What is a Non-Qualified Deferred Compensation Plan (NQDCP)?

A “qualified” plan meets the requirements of Code Section 401(a)

- Covers broad, nondiscriminatory group of employees
- Employer receives tax deductions for plan contributions, but employees don’t include balances as income until payments are made
- Subject to substantive provisions of ERISA including fiduciary rules and requirements that all assets be held in trust

A “non-qualified” plan does not meet the requirements of Code Section 401(a)

- Covers corporate executives or highly compensated employees
- No employer deduction until employees recognize income at distribution
- Must satisfy Code Section 409A rules
- Generally exempt from most provisions of ERISA
- Assets may not be held in trust unless trust assets remain subject to company’s creditors (so-called “rabbi trust”)
- May be established for one individual (e.g., under an employment agreement), or for a group of highly compensated executives

Differences Between Qualified 401(k) Plan and Non-Qualified DCP

NQDCP

- Employee deferrals are limited only by plan design (can be up to 100% of compensation)
- Company contributions are optional and can discriminate by employees
 - 401(k) make-up match
 - Independent match
 - Discretionary (non-matching) contribution

401(k)

- Employee deferrals are limited to \$18,500 for 2018 (\$24,500 if catch-up eligible) and may be further reduced due to discrimination testing
- Company contributions must be nondiscriminatory and cannot be based on compensation above \$275,000

Differences Between Qualified 401(k) Plan and Non-Qualified DCP

NQDCP

Trust

Rabbi Trust assets can be claimed by creditors of the company in bankruptcy

Rollover

Not permitted – this is a non-qualified plan

In-Service Distributions

Permitted

- Without penalty if scheduled at the time of initial enrollment or re-deferral
- Without penalty for unforeseeable financial hardship

Loans are not permitted

401(k)

Trust

Qualified Trust assets are protected from participant and company creditors

Rollover

Permitted within 60 days of receipt of account balance

In-Service Distributions

Permitted for hardship and following attainment of age 59-½

Withdrawals prior to age 59-½ are generally subject to early withdrawal penalties

Loans are permitted

Why Deferred Compensation?

Employee Perspective

- Supplement 401(k) retirement savings/wealth accumulation
- Reduce current taxable income
- Tax deferred capital accumulation
- In service distributions for planned or unplanned events without penalty
 - Child college expenses (planned)
 - Medical emergency (unplanned)
- Personalize retirement goal
- Tax deferred earning potential
- Greater planning flexibility – short and long term goals
- Estate planning tool – supplemental survivor benefits available

Employer Perspective

- Recruit, reward, retain, retire
- Can provide additional benefits for selected groups within the plan
- Proper funding strategy can have positive effect on P&L
- Stay competitive – executives have come to expect these plans – 92% of companies surveyed have true DCPs*
- Enhances employee benefit program
- Golden handcuffs – provide credits subject to a vesting schedule to incent executives to remain in employment
- A properly designed program gives ABC Company a cost-efficient result

**Source: Newport Group Executive Benefit Survey 2017 Edition*

Types of Non-Qualified Deferred Compensation Plans

Elective Deferral Plans

- Employee defers compensation (salary, bonus, commissions, etc.) on a pre-tax basis

Supplemental Benefit Plans

- Company-provided benefits (not derived from employee deferrals)
- Often referred to as Supplemental Executive Retirement Plans or “SERPs”
- Frequently designed as defined benefit/defined contribution plans, either as a stand-alone plan or paired with a qualified pension plan



Tax Consequences

Employee

- All deferrals are income tax-deferred
 - No current tax to the participant
- FICA is withheld at the time of deferral or vesting
- All distributions are taxed as ordinary income to the participant
- Survivor benefits are taxed as ordinary income and are included in the participant's estate and are tax-deductible to the corporation

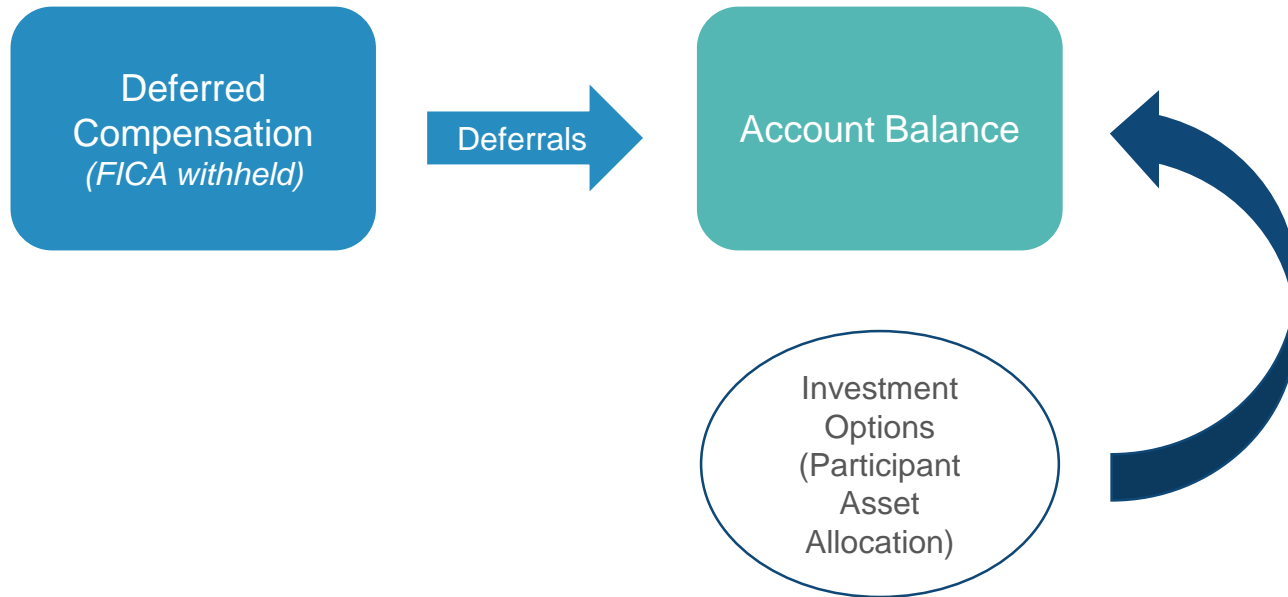
Employer

- Grantor trust rules
- No deduction for funding of trust
- Benefit payments are tax deductible to the corporation
- Treated as owner of trust
- Pays tax on trust assets

FUNDING

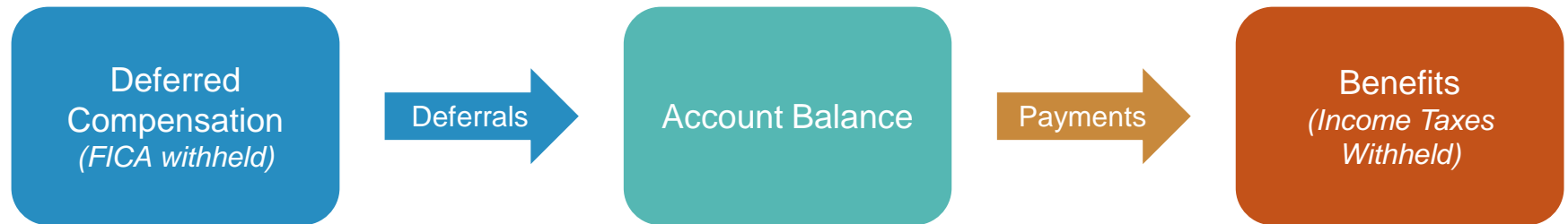
How the Plan Works

The account balance is **indexed** to the asset allocation from a 'menu' of investment portfolios or a fixed rate



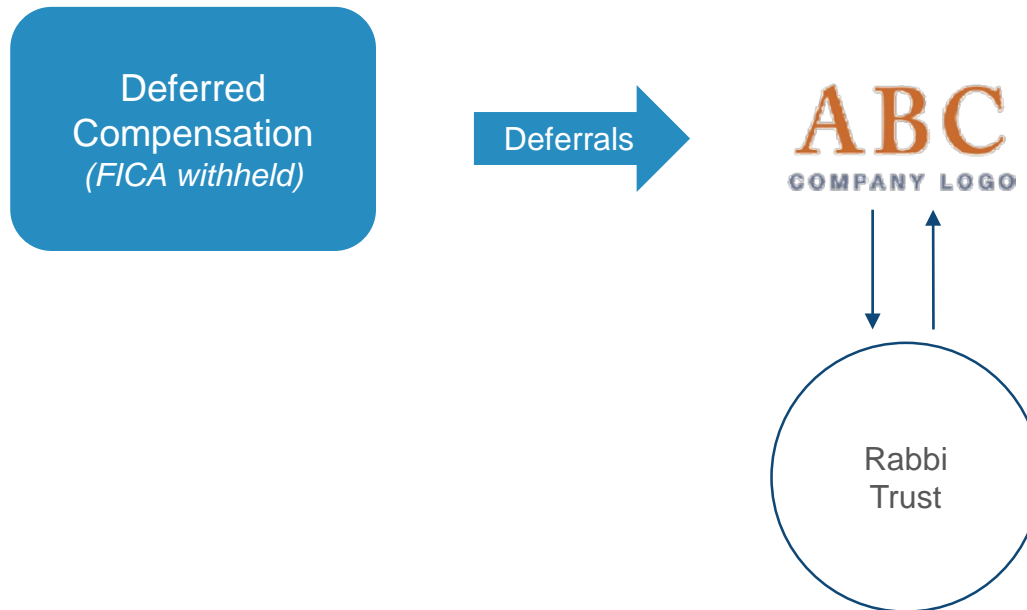
How the Plan Works

Distributions are taxed as ordinary income to the participant with a corresponding tax deduction to the corporation.



How the Plan Works

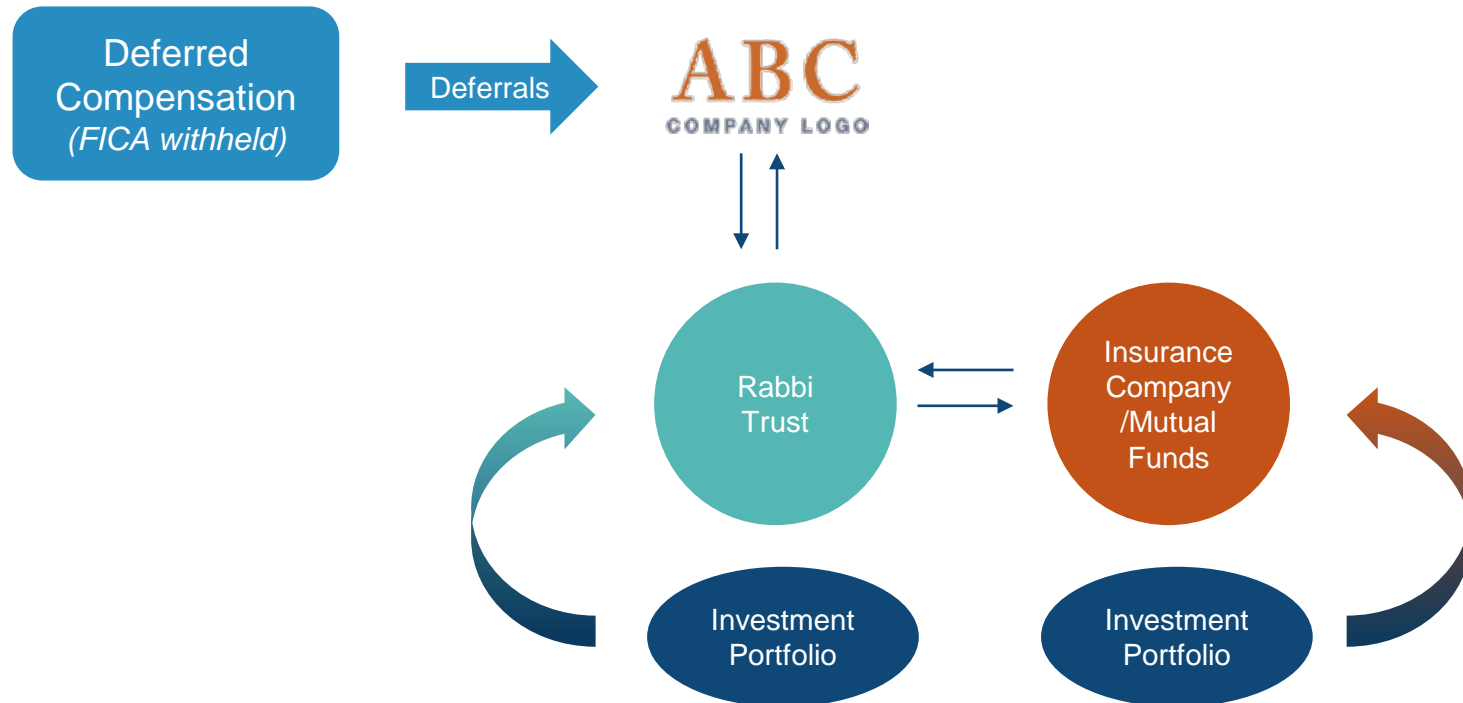
Companies often invest deferred compensation in insurance / mutual funds owned by the Rabbi Trust



How the Plan Works

Mutual Funds/COLI

Mutual fund investment gains are taxable to the plan sponsor.
The insurance company charges fees and expenses which includes the cost of insurance.



Funding of Deferred Compensation Plan Liabilities

Non-Tax Managed Assets

Taxable Returns

Familiar vehicle

Funds similar to 401(k) plan or may be enhanced by additional funds

Benefit of simplicity

The Company pays taxes on earnings (150~250 bps)

Cost of money on taxes adversely affects P&L

Potential adverse accounting treatment

Tax Managed Assets (Corporate Owned Life Insurance)

Tax Deferred Returns

Investment funds similar to those available in 401(k)

Requires some understanding of the funding vehicle

The Company pays insurance expense, but defers tax (50-70 bps vs. 250 bps)

Reduces plan costs

Favorable accounting treatment

Tax arbitrage flows to P&L

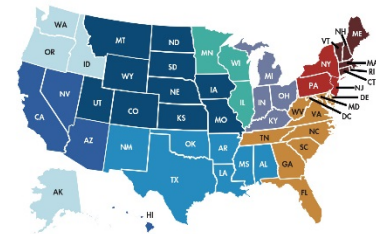
Implementation Milestones

1. Kick-off meeting
2. Document design and execution
3. Communication planning
4. Systems and website configuration
5. Data transfer from prior recordkeeper
6. Funding/asset transfer
7. Plans go live
8. Monitoring and benchmarking



Questions?

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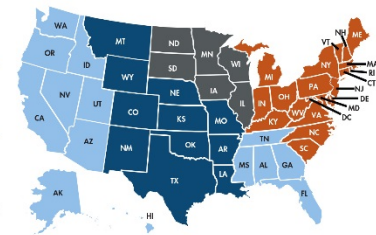
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