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A Twist on DC Plan Design—Supports Lower Paid and Higher Paid Employees

By Ruth Schau

I was going to write about a nondiscrimination friendly defined contribution (DC) plan design long before COVID-19 hit our world, but now the design has even one more benefit. I'll explain as the design unfolds.

First, here's a little background to help set the stage.

Like qualified defined benefit plans, qualified defined contribution plans in the U.S. must meet nondiscrimination requirements to ensure that the plan doesn't unfairly benefit highly-compensated employees (HCEs), either in coverage or amounts. Defined contribution plans with employee deferral and employer matching contribution features demonstrate compliance with the nondiscriminatory amounts requirements by passing ADP and ACP testing or by adopting a safe harbor plan design. The Actual Deferral Percentage (ADP) test and Actual Contribution Percentage (ACP) test are the two tests that companies with non-safe harbor plans must pass to demonstrate compliance with the nondiscrimination requirements for amounts. The ADP test measures the employee's contributions (deferrals) to the plan. The ACP test measures the employer matching contributions to the plan.

Additionally (but not the focus of this article), DC plans must meet nondiscriminatory coverage requirements under IRC 410(b), and meet separate amounts testing requirements under IRC 401(a)(4) if any non-matching employer contributions are provided, as well as benefits, rights, and features testing under IRC 401(a)(4).

Although a DC plan can provide that all employees are eligible to participate, nondiscrimination testing may be problematic. Even if auto-enrollment/auto-escalation is employed,



nondiscrimination testing may result in failure. That's why safe harbor plans are adopted—to remove the possibility of ADP/ACP failures. There are several safe harbor plan design options that a plan sponsor can adopt and thus avoid the need to conduct nondiscrimination testing.

As we found in 2008/2009 and now again in our COVID-19 environment, safe harbor plans challenge organizations that want to revise plan designs mid-year. The IRS provides the safe harbor options so plans can automatically pass nondiscrimination tests, but there are many requirements and restrictions, including restrictions on mid-year design changes. As a result, reducing or suspending employer contributions mid-year could nullify the plan's safe harbor status and subject it to ADP/ACP testing.

So, how can we design DC plans to pass nondiscrimination testing and provide more flexibility for mid-year changes, if the "automatic" safe harbor option isn't feasible? I will share one design option below for your consideration. I think it's a powerful design and there are a lot of options to explore.

Example:

A plan provides greater of 100 percent match on \$2,000 or 50 percent match up to 8 percent of employee compensation.¹

I used a test group of approximately 500 employees. With all HCEs contributing the maximum, and non-highly compensated employees (NHCEs) contributing the typical wide range of contributions, Figure 1 shows the ACP test results I found.

FIGURE 1
ACP TEST RESULTS

ACP	Initial	With 3% auto enrollment
HCE	6.10%	6.10%
NHCE	4.99%	6.11%

CHANGING SAFE HARBOR CONTRIBUTIONS MID-YEAR

I don't want to make this article about changing contributions mid-year, but to be fair, there are a few instances where mid-year changes would not forfeit the plan's safe harbor status. For example, an organization needs to have financial difficulties meeting IRS requirements, or it needed the foresight to include in the annual notice to participants prior to the start of the plan year that a change is possible. In addition, IRS compensation limits need to be prorated, employee notices need to be provided, and there are still some grey areas to address ensuring that no HCE receives a match percentage greater than any NHCEs' match percentage. I'd anticipate that few, if any, plans would meet these requirements.

Note that the SECURE Act eliminates the notice requirement for non-elective safe harbor plans, although it still applies for matching safe harbor plan designs. IRS Notice 2020-52 provides welcome COVID-19 related relief for mid-year changes adopted during March 13, 2020 through Aug. 31, 2020

How many plans can really make use of a stretch match? This one might be able to depending upon plan demographics. The design produces great ACP results, which for a 403(b) plan that is all that is needed.³ Yes, that was my initial exploration of this idea. However, the ADP test may be more troublesome, and the plan may need to offer automatic enrollment support and/or use some of the excess ACP test results to support ADP.

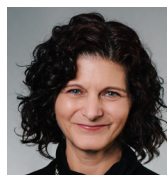
So, what happens if the ADP estimates don't produce passing results? There is still hope for this design if you can make use of the solidly passing ACP test results to bolster the ADP test results by use of the "borrowing method." To be able to do this requires immediate vesting, and no hardship withdrawals and no loans available from the portion of the employer match used to "borrow" from the ACP test to the ADP test. This could be a deal breaker for the employer, depending on factors such as employee turnover, as well as the

employer's philosophy regarding whether employer DC money should strictly be set aside for retirement, whether it can be accessed to meet current employee needs as they arise, and whether or not the recordkeeper can accommodate an additional employer match source type with the vesting, hardship, and loan constraints applied.

Note that the design blends a flat dollar amount with a percentage of pay. This could be considered a different pay philosophy as the flat dollar provides a higher level of benefits to lower paid participants.

The fixed dollar amount can be raised to increase the ACP passing even more if needed. As you explore the possibilities of this design further, you might identify the right combination solving some of your clients' issues especially with the safe harbor restrictions. If nothing else, you may get some interest and may have some fun modeling this design to meet a stated budget.

With a focus on helping lower paid employees and a desire to support higher paid employees in their desire to maximize retirement savings, you might find a unique approach using this design. Happy modeling. ■



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ENDNOTES

- 1 Note this sample design is modified from Google's DC design.
- 2 For those less familiar with DC plans, in a "stretch match," the employer matches 50 percent of employee contributions (as opposed to 100 percent) up to a higher total percentage of compensation (For example: 50 percent of the first 8 percent of employee compensation instead of 100 percent of the first 4 percent of employee compensation).
- 3 Section 403(b) plans are not subject to the ADP test. Instead, 403(b) plans must provide universal availability (allowing all eligible employees to participate).