

Retirement PLAN news

An introduction to controlled groups

The controlled group rules were adopted as part of the coverage and nondiscrimination regulations to ensure that a plan (or plans) maintained by an employer does not discriminate in favor of highly compensated employees (HCEs). A controlled group is considered a single employer for purposes of a qualified plan.

A controlled group of business entities can exist when one business owns a controlling interest in another business or when five or fewer individuals have ownership interests in two or more businesses. In service industries, such as medical practices and accounting, engineering, and consulting firms (among others), a controlled group can exist when an element of control exists and two or more entities are regularly associated in providing services to third parties.

Controlled group of corporations

A controlled group of corporations includes a parent-subsidary controlled group, a brother-sister controlled group, or a combination of the two.

Parent-subsidary group: A controlled group exists if one corporation owns an 80% or more interest in another corporation. The situation is a bit more

complex where a holding company exists and the ownership interest it holds in other companies varies.

Control is determined by two criteria:

- At least 80% of each entity's interest must be owned by the common parent or by one or more of the other businesses, and
- The common parent must own at least an 80% interest in one or more of the other organizations.

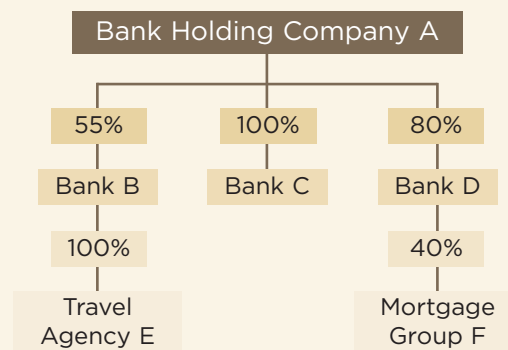
The 80% ownership threshold is determined either by owning stock with 80% of the voting power of all classes entitled to vote or owning 80% of the total value of all shares of all classes of stock. (See Example 1.)

Brother-sister group: Two or more organizations are within a brother-sister group if:

- The same five or fewer shareholders (individuals, estates, or trusts) own at least an 80% controlling interest in each company, *and*
- The same five or fewer shareholders have an identical ownership among all companies which, in the aggregate, is more than 50%.

In determining which five shareholders to consider, certain family members may be aggregated and treated as one shareholder.

Example 1: Parent-subsidary group



Controlled group 1: Companies A, C, and D
Controlled group 2: Companies B and E

If stockholder 1 owns 50% of Company A, 20% of B, and 10% of C, his identical ownership in all three companies is the smallest percentage he owns in any one, or 10%. Stockholder 2 owns 25% of Company A, 20% of B, and 15% of C, resulting in an identical ownership of 15%. In the aggregate, stockholders 1 and 2 have an identical ownership of 25%.

Example 2: Brother-sister group

Ownership in company

| Stockholder | Co. A | Co. B | Co. C | Identical Ownership |
|-------------|-------|-------|-------|---------------------|
| 1 | 50% | 20% | 10% | 10% |
| 2 | 25% | 20% | 15% | 15% |
| | | | | 25% |

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An IRA rollover question

Q. May a participant roll over a traditional IRA into a 401(k) account to delay his or her required beginning date (the date required minimum distributions — RMDs — begin)?

A. In the following situation, yes.

An IRA account holder, age 71, is working and participating in a 401(k) plan that accepts rollovers from traditional IRAs. The participant is not a 5% owner of the entity sponsoring the plan. The plan permits non-5% owners to defer the required beginning date for taking required minimum distributions until *the later of*:

- (1) April 1 of the year following the year the participant reaches age 70½ or
- (2) April 1 of the year following the year the participant terminates employment with the employer.

IRS guidance (Revenue Ruling 2004-12) permits assets that are rolled over from a traditional IRA to receive the same treatment as the other funds in a 401(k). The IRA owner in this scenario must take an RMD from the IRA for the current year *before* the rollover is made. Then, the rest of the IRA assets may be rolled over into the 401(k). Once the rollover is completed, the required beginning date for taking RMDs from the funds rolled over from the traditional IRA is deferred until April 1 of the year following the year the participant terminates employment with the employer, just like the other 401(k) funds.

The Roth option. The participant also has the option of converting a traditional IRA to a Roth IRA.* Roth IRAs are not subject to RMDs. Of course, a Roth IRA conversion would require the participant to pay taxes on the amount converted. Ordinarily, taxes are due the year of the conversion. However, taxpayers that complete Roth IRA conversions in 2010 have the option of paying tax on half the converted amount in 2011 and the other half in 2012.

Note: While it would seem to make sense to split the amount and pay tax in later years, it is important to look at the individual's tax bracket. The lower tax rates enacted in 2001 are set to expire at the end of 2010. The four top tax brackets in 2010 are 25%, 28%, 33%, and 35%. Barring new legislation, the four top tax brackets in 2011 will be 28%, 31%, 36%, and 39.6%. Also, provisions in the health-care reform act could impose additional penalties on alleged high wage earners beginning in 2011. Depending on the facts and circumstances, paying tax on the full amount in 2010 might result in a lower overall tax bill.

* Prior to 2010, Roth conversions were off limits for taxpayers with adjusted gross income (AGI) of \$100,000 or more.

...controlled groups

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There is no controlled group among Companies A, B, and C, since the identical ownership is less than 50%. However, when looking at just Companies B and C, there is a different result.

Example 3: Brother-sister group

Ownership in company

| Stockholder | Co. A | Co. B | Co. C | Identical Ownership |
|-------------|-------|-------|-------|---------------------|
| 1 | 100% | 15% | 15% | 15% |
| 2 | 0 | 40% | 50% | 0 |
| 3 | 0 | 40% | 20% | 0 |
| | 100% | 95% | 85% | 15% |

There is a controlled group among Companies B and C, since the three stockholders together own more than 80% of B and C and their identical ownership is greater than 50%.

Ownership in company

| Stockholder | Co. B | Co. C | Identical Ownership |
|-------------|-------|-------|---------------------|
| 1 | 15% | 15% | 15% |
| 2 | 40% | 50% | 40% |
| 3 | 40% | 20% | 20% |
| | 95% | 85% | 75% |

Combined group: Three or more corporations are a controlled group if each is a member of a parent-subsidary or brother-sister group of corporations and one is:

- A. A common parent corporation included in a parent-subsidary group and
- B. Is also included in a brother-sister group of corporations.

Example 4: Combined group

An individual stockholder owns 80% of Corporation X and 85% of Corporation Y, thus forming a brother-sister controlled group. Y owns 100% of Corporation Z, thus forming a parent-subsidary controlled group. Since Y is the parent in a parent-subsidary group and is also part of a brother-sister group, a combined controlled group exists between X, Y, and Z.

Partnerships, proprietorships, etc.

The statute provides that rules similar to those prescribed for a controlled group of corporations are applicable to a controlled group of unincorporated businesses.



Back to basics: The ADP test

Congress has devised several nondiscrimination tests to prevent qualified retirement plans from favoring highly compensated employees (HCEs) by more than de minimis amounts. The first test that must always be done is the coverage test, which ensures that the plan benefits a sufficient number of nonhighly compensated employees (NHCEs). Once the coverage test is passed or, if the test is not passed, once the necessary steps have been taken to correct the failure, then the average deferral percentage (ADP) test may be performed.

Both the coverage test and the ADP test use mathematical techniques to compare the eligibility and contribution rates of HCEs and NHCEs to determine whether the plan is discriminating in favor of the HCEs.

Who is a highly compensated employee?

Generally, a highly compensated employee is an employee who is either:

- A more-than-5% owner of the business (also known as a 5% owner) in the year of testing or the prior year or
- Someone who earned more than \$80,000 in compensation in the prior year, as adjusted annually for cost-of-living increases (COLA). Currently, the COLA adjusted limit is \$110,000.

It is possible to further limit the number of HCEs to those in the top 20% paid group by compensation (which may be a particularly effective tactic in small plans, such as law firms and physician groups).

All in the family

The 5% owner rule requires careful review of the ownership attribution rules for families and trusts. Based on

their relationship, an owner is deemed to share in the interests held by certain other family members. The family relationships taken into consideration when determining attribution of ownership include spouses, parents, children (including adopted children) regardless of age, and grandchildren. *Not included* are siblings, grandparents, and in-laws.

Here's an example of how the family attribution rules work: If a husband and wife each work for a firm and the husband is actually the sole owner, the wife would also be considered a 100% owner of the business and, thus, a highly compensated employee. This is because she is also deemed to be a 5% owner. One issue this raises is that the total ownership pool may exceed 100%. In a situation where a husband, wife, and two children are all in business together, each is deemed to be a 100% owner and there will be 400% ownership.

Performing the test

To perform the ADP test, first determine all the employees who are eligible to make elective deferrals. It does not matter if an employee actually *made* a deferral, only whether the employee was eligible. Divide the eligible employees into HCEs and NHCEs. Then, starting with the NHCEs, determine each employee's actual deferral ratio (ADR) by dividing the employee's compensation into the amount he or she deferred. Employees who are eligible but did not defer are included in this calculation at 0%. Once each employee's ADR is determined, the ADRs are averaged to arrive at the ADP for all NHCEs. Here's an illustration:

| NHCE | Compensation | Deferral | ADR |
|-----------------|--|----------|-------|
| 1 | \$70,000 | \$4,000 | 5.71% |
| 2 | \$28,000 | \$0 | 0% |
| 3 | \$30,000 | \$800 | 2.67% |
| 4 | \$10,000 | \$0 | 0% |
| 5 | \$47,000 | \$2,000 | 4.26% |
| NHCE ADP | $(5.71 + 0 + 2.67 + 0 + 4.26) = 12.6 \div 5 = \mathbf{2.53\%}$ | | |



The same process is used to calculate the ADP for all HCEs. For a plan to pass the ADP test, the amount by which the HCE ADP exceeds the NHCE ADP is limited. The limits may be summarized as follows:

| NHCE ADP | Maximum HCE limit |
|----------|-------------------|
| 0 to 2% | NHCE limit x 2 |
| 2% to 8% | NHCE limit + 2 |
| >8% | NHCE limit x 1.25 |

For the plan in our example to pass the ADP test, HCE ADP is limited to 2.53% (NHCE ADP) plus 2 for a maximum of 4.53%.

Timing the test

In general, the ADP test must be completed within two and a half months following the end of the plan year. The test must be made using the *entire* year's compensation and deferrals and thus cannot be completed before year-end. It is in the best interest of the employer and plan recordkeepers to complete the test within the allotted period so the employer has time to make any refunds or contributions that may be required to pass the test. A 10% excise tax penalty is due on refunds (principal amount only, not earnings) made after the two and a half month period.

Other factors

This is the big picture of the ADP test. There are a variety of additional factors to be taken into consideration when deciding which testing methods may lead to the most favorable result. These issues will be addressed in a future newsletter.



RECENT developments

▶ PBGC premium increase

The Pension Benefit Guaranty Corporation (PBGC), which insures defined benefit retirement plans, announced a change in premiums for single employer plans in 2010: The flat-rate premium increases from \$34 to \$35 per plan participant. The premium for multiemployer (union negotiated) plans remains at \$9 per participant, and the variable rate premium for underfunded plans is unchanged at \$9 per \$1,000 of underfunded vested benefits. The PBGC's program for certain distress and involuntary pension plan terminations requires an annual premium of \$1,250 per plan participant, while an annual premium of \$2,500 per participant applies to certain airline related plans.

▶ Summary prospectus

Recently, the Department of Labor (DOL) issued Field Assistance Bulletin

(FAB) 2009-3 allowing for the use of a *summary prospectus* to satisfy the prospectus delivery requirements of ERISA Section 404(c). The summary prospectus is a short-form document with a clear, concise format written in plain English. It provides a summary of key information about a mutual fund that participants and beneficiaries can use to evaluate and compare plan investment options. The summary prospectus replaces the mutual fund profile. Plans can begin using the summary prospectus immediately.

▶ Plan amendment deadlines extended

In Notice 2009-97 (issued December 11, 2009), the IRS extended the deadline for adopting certain Pension Protection Act of 2006 (PPA) changes from the last day of the 2009 plan year to the last day of the 2010 plan year. The extended deadline applies to amend-

ments regarding funding based limits on benefit accruals and distributions under single employer defined benefit (DB) plans, vesting and other special rules applicable to cash balance and certain other DB plans, and diversification requirements for certain defined contribution (DC) plans that use employee deferrals or employer matching contributions to buy employer stock.

These deadlines were extended as industry practitioners contended with how to comply with the recently released guidance and awaited additional guidance on specific PPA provisions. It is important to note that plan amendments reflecting all other PPA provisions still had to be completed prior to the end of the 2009 plan year.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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