

Advanced Testing: 410(b) Coverage Testing of Combo Plans, ESOPs, and 403(b) Plans



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Objectives

- Functional Review of 410(b) – It is a required test to demonstrate that the plan benefits at least a minimum number of eligible employees.

Objectives *(continued)*

- Case Studies – Redesign plans to focus on client objectives, and achieve better outcomes.

Objectives *(continued)*

- Coverage Failure – correction methods and timing.

Introduction

- A plan is not qualified unless it benefits a minimum number of employees. *IRC §410(b)*
 - Annual Requirement – Must be satisfied for each plan year, including short plan years.

Introduction *(continued)*

- There are two available tests, the ratio-percentage test, and the average-benefits test.

Introduction *(continued)*

- The Ratio-Percentage Test is satisfied if the ratio is at least 70 percent.
- An alternative is the Average-Benefits Test. This is a two-part test and each part must be passed for the test to be satisfied.

Introduction *(continued)*

- The plan must pass at least one of these tests in every plan year, including short plan years.
- In addition to the coverage test, DB plans must also satisfy the minimum-participation test under IRC §401(a)(26).

Coverage-Testing Group

- Coverage-testing group consists of employees who are not excludable.
- Coverage-Testing Group = (total workforce for the testing period) “minus” (excludable employees)

Excludable Employees

1. Does not satisfy the statutory minimum age and service requirements of the plan.
2. A participant who is not employed on the last day of the plan year, and is credited with 500 or fewer hours for the plan year.

Excludable Employees *(continued)*

3. Union (collectively bargained) employee
4. Certain nonresident alien employees

Note: Must be excludable for the entire testing period.

Excludable Employees *(continued)*

Tripwire – Exclusion by job category

- Failure to accrue a benefit must be based solely on service and/or last-day condition.

Excludable Employees *(continued)*

Tripwire – Exclusion by job category

- Exclusion from the coverage testing group on age and service is not permissible if the participant doesn't accrue a benefit because of job classification.

Excludable Employees *(continued)*

Tripwire – Exclusion by job category

Example: A participant who doesn't benefit because of a job class exclusion, and terminates with 500 or fewer hours would be included in the coverage testing group even if they have not satisfied the service or last-day requirement!

Coverage Testing Group

Coverage testing group calculation.

a) Workforce		35
b) Less Excludable Employees:		
i. Age/Service	12	
ii. Terminated	3	
c) Subtotal:	15	
d) Coverage Testing Group = (a) – (c) =		20

Coverage Testing Group *(continued)*

- If the plan benefits all participants in the coverage testing group, coverage is 100 percent and 410(b) is satisfied.
- If the benefiting group is less than 100 percent, then coverage testing must be performed.

Benefiting Group

The benefiting group consists of employees in the coverage testing group who benefit from the plan for the plan year.

Benefiting Group *(continued)*

- Defined Contribution Plan – Considered to benefit if the participant receives an allocation of employer contributions or forfeitures for the plan year. Special rules for 401(k) and 401(m) plans.

Benefiting Group *(continued)*

- Defined Benefit Plan – A participant is considered to benefit if his or her accrued benefit increases for the plan year.

Note: Allocation conditions may affect coverage.

Testing Period

There are three options for determining the testing period for the plan year. The method selected impacts the coverage testing group.

Testing Period *(continued)*

1. Annual Testing – Everyone who is employed at any time during the plan year is included in the workforce.

Testing Period *(continued)*

2. Quarterly Testing – Four testing dates, one for each quarter of the plan year.
3. Daily Testing – Coverage is tested each day of the plan year.

Testing Period *(continued)*

Annual Testing: *Snapshot Method*

- Coverage testing period is a single day in the plan year.
- Should be reasonably representative of the workforce and coverage group for the plan year.

Testing Period *(continued)*

Annual Testing: *Snapshot Method*

- Generally should be early in the plan year (i.e., during the first quarter of the plan year).

Identify HCEs

- More than a five-percent owner at any time during the plan year or previous plan year.
- For 2017 earned compensation of \$120,000 or more in the 2016 lookback year.
- Attribution rules apply.

Identify NHCEs

Any employee who is not an HCE.

Performing the Ratio Test

1. Identify HCEs and NHCEs.
2. Determine the coverage testing group.
3. Determine the benefiting group.

Performing the Ratio Test *(continued)*

4. Calculate the NHCE Ratio.
5. Calculate the HCE Ratio.
6. Coverage Ratio = NHCE Ratio “divided” by HCE Ratio.

Performing the Ratio Test *(continued)*

1. NHCE Ratio: The number of NHCEs benefiting “divided” by the number of NHCEs in the coverage testing group.

Performing the Ratio Test *(continued)*

2. HCE Ratio: The number of HCEs benefiting “divided” by the number of HCEs in the coverage testing group.

Performing the Ratio Test *(continued)*

3. Coverage Ratio: The NHCE Ratio “divided” by the HCE Ratio.

Note: The plan satisfies coverage under the ratio-percentage test if the coverage ratio is at least 70 percent.

Example: Ratio-Percentage Test

a) Workforce	60
b) Exclusions:	7
I. Age/Service	
II. Terminated 500 or fewer hours	
c) Coverage Testing Group	53

Example: Ratio-Percentage Test

d) Terminated before YE with more than 500 hours	6
e) Excluded by job class	10
f) Benefiting Group:	37

Example: Ratio-Percentage Test

- | | |
|---|----|
| g) Number of employees in “c” who are HCEs | 8 |
| h) Number of employees in “c” who are NHCEs | 45 |

Example: Ratio-Percentage Test

- i) Number of employees in “e” who are HCEs 6
- j) Number of employees in “e” who are NHCEs 31

Example: Ratio-Percentage Test

k) NHCE Ratio:	68.89%
l) HCE Ratio:	75.00%

Example: Ratio-Percentage Test

m) Coverage Ratio:

91.85%

Average-Benefits Test

If the plan fails the ratio-percentage test, then there are two options.

1. Expand coverage to pass the ratio-percentage test
2. Pass using the average-benefits test.

Average-Benefits Test *(continued)*

There are two parts to the average-benefits test.

1. The nondiscriminatory-classification test.

Note: The information needed to run the nondiscriminatory-classification test is the same that is needed for the ratio-percentage test.

Average-Benefits Test *(continued)*

2. The average-benefits percentage test.

Note: Information about the amount of the allocation or benefits is necessary to calculate the average-benefits percentage test.

Average-Benefits Test *(continued)*

Both parts of the average-benefits test must be satisfied in order for the plan to pass coverage using the average-benefits test!

Average-Benefits Test *(continued)*

Nondiscriminatory-Classification Test

1. Reasonable classification – Satisfied if the classification of employees who benefit under the plan is based on objective business criteria.

Average-Benefits Test *(continued)*

Nondiscriminatory-Classification Test

1. Reasonable Classification

Examples: job categories, nature of compensation (hourly, salary), geographic location

Average-Benefits Test *(continued)*

Nondiscriminatory-Classification Test *(continued)*

2. Nondiscriminatory classification – Satisfied if the plan meets the safe harbor-percentage test or the facts and circumstances test.

Average-Benefits Test *(continued)*

Nondiscriminatory-Classification Test *(continued)*

2. Nondiscriminatory classification

- a) Safe harbor-percentage test – The percentage of the workforce that is composed of NHCEs. The safe harbor percentage is 50 percent, reduced by three-fourths of a percentage point for each whole percentage point by which the NHCE concentration percentage exceeds 60 percent.

Average-Benefits Test *(continued)*

Nondiscriminatory-Classification Test *(continued)*

2. Nondiscriminatory

- b) Facts and circumstances – The coverage ratio must be greater than the unsafe harbor percentage (table), and the classification is nondiscriminatory under the facts and circumstances.

Average-Benefits Test *(continued)*

Facts and circumstances *(continued)*

Relevant factors to consider:

1. Underlying business reason for the classification.

Average-Benefits Test *(continued)*

Facts and circumstances *(continued)*

2. Percentage of all employees benefiting under the plan.
3. The number of benefiting employees in a salary range is representative of all employees in that salary range

Average-Benefits Test *(continued)*

Facts and circumstances *(continued)*

4. The difference between the plan's coverage ratio and the safe harbor percent.
5. The degree by which the plan's average benefit percentage exceeds 70 percent.

Average Benefits-Percentage Test

Average Benefit Percentage = The NHCE benefit percentage divided by the HCE benefit percentage.

Average Benefits-Percentage Test *(continued)*

- Benefit Percentage – An employee's benefit percentage may be expressed as an allocation rate or a benefit rate for the plan year.

Average Benefits-Percentage Test *(continued)*

- Averaging Period Permitted – Benefit percentages can be averaged for the current plan year and the preceding one and two plan years.

Average Benefits-Percentage Test *(continued)*

Note: If the employer maintains more than one qualified plan, then all plans, except union plans and QSLOBs, must be included in the average benefit-percentage testing group.

Average Benefits-Percentage Test *(continued)*

- NHCE benefit percentage – The average of the individual benefit percentage of each NHCE in the coverage testing group.

Average Benefits-Percentage Test *(continued)*

- HCE benefit percentage – The average of the individual benefit percentage of each HCE in the coverage testing group.

Special Rules

- 401(k) and 401(m) Plans – Required disaggregation. Each disaggregated portion is treated as if it were a separate plan. Annual testing method required for 401(k) plans.

Special Rules *(continued)*

- No aggregation permitted with 401(k) and 403(b). Special coverage testing rules apply. IRS Notice 96-64.

Special Rules *(continued)*

- Permissive aggregation – If an employer maintains more than one qualified plan, the employer may permissively aggregate the plans to satisfy coverage testing.

Special Rules *(continued)*

CAUTION: If plans are aggregated for coverage, they must be aggregated for nondiscrimination testing.

Special Rules *(continued)*

- Plans subject to mandatory disaggregation cannot be aggregated.

Special Rules *(continued)*

Example: Employer maintains a 401(k) plan and a profit-sharing plan. The profit-sharing plan cannot be aggregated with the 401(k) plan to satisfy coverage.

Special Rules *(continued)*

- Same plan year required for plans to be aggregated.

Special Rules *(continued)*

- ESOP – The ESOP portion of a plan must be disaggregated from the non-ESOP portion of the plan for coverage-testing purposes.

Special Rules *(continued)*

- Separate testing of otherwise excludable employees.

Special Rules *(continued)*

- Related Employers – If an employer is part of a control group or affiliated service group, then all members of the group are treated as a single employer for coverage testing.

Special Rules *(continued)*

Note: If employers in the control group maintain separate plans, they can attempt to satisfy coverage testing on a disaggregated basis.

Case Studies

Case Study 1

Case: Nursing home client with 265 employees and one HCE maintains a 401(k) with a non-safe harbor match. Only 16 active participants with an account balance.

Case Study 1 *(continued)*

Problem: Low participation. High plan operational cost (annual plan audit).

Case Study 1 *(continued)*

Solution

1. Exclude HCE to eliminate coverage test.
2. Redefine Eligible Employee to reduce headcount below 100.
3. Audit savings earmarked as match to encourage participation.
4. Consider second plan if participation improves.

Case Study 2

CFOs seek outcomes that are within an expected range. Cost overruns are undesirable. Cost stabilization methods are available under 410(b).

Case Study 2 *(continued)*

Snapshot testing on March 1

- Coverage-testing group clearly identified early in the plan year. Would include any employee with 500 or fewer hours if allocation condition is other than service or last day.

Case Study 2 *(continued)*

- Benefiting group can be adjusted.

Note: Coverage failure can lead to an unexpected benefiting group.

Case Study 2 *(continued)*

Case: Architectural and engineering firm with 85 employees, one owner, four additional HCEs. Current plan is 401(k) with safe harbor match. High plan participation.

Case Study 2 *(continued)*

Problem: Owner needs a higher contribution than is provided by the 401(k) plan, but wants to control staff cost. Consistency of staff cost is important.

Case Study 2 *(continued)*

Solution:

1. Establish second defined contribution plan.
 - a. 401(k) with safe-harbor match
 - b. Profit Sharing feature – only covers “professional employees”

Note: The benefiting group is one HCE and 34 NHCEs.

Case Study 2 *(continued)*

Solution:

2. Establish cash-balance plan.
 - a. Eligible employee is defined as “professional employee”

Note: The benefiting group is one HCE and 34 NHCEs.

Case Study 2 *(continued)*

Applicable Coverage Testing:

- The 401(k) and 401(m) plans must be disaggregated for coverage testing.

Case Study 2 *(continued)*

Applicable Coverage Testing:

- Each 401(k) and 401(m) plan satisfies coverage as a stand-alone plan. Permissive aggregation is not necessary.

Case Study 2 *(continued)*

Applicable Coverage Testing:

- The profit-sharing plan and cash-balance plan satisfy coverage testing under the Average-Benefits Test.

Case Study 2 *(continued)*

Applicable Coverage Testing:

- The employer contribution is limited to four percent safe-harbor match for non-professional employees.

Case Study 2 *(continued)*

Applicable Coverage Testing:

- The employer contribution is expected to be eight percent for professional employees.

Case Study 2 *(continued)*

Unintended Consequences:

- If the benefiting group is expanded due to a coverage failure, employer staff cost escalates.

Consultative Opportunity

Coverage Failure Threshold (CFT) - The point at which an increase in the number of NHCEs in the coverage-testing group would result in a coverage-testing failure.

Consultative Opportunity *(continued)*

CFT = (Number of Benefiting NHCEs) “divided” by (HCE Ratio
“multiplied” by 70 percent)

Consultative Opportunity *(continued)*

$$\text{CFT} = \frac{\text{\# of Benefiting NHCEs}}{\text{HCE Ratio x 70 percent}} \quad \textit{*round down to the nearest whole number}$$

Correcting Failures

1. Failsafe Language – Expands coverage by default.

Correcting Failures *(continued)*

2. Expand the group of NHCEs who benefit under the plan to include more NHCEs.

Caution: Evaluate the cost of increasing the number of NHCEs who benefit.

Correcting Failures *(continued)*

3. Increase allocations or benefits to the NHCEs who already benefit under the plan.

Caution: Compare the cost of increased allocations or benefits versus expanding the number of benefiting NHCEs.

Correcting Failures (*continued*)

Timing: Testing failures must be corrected within nine and one-half months after the close of the plan year.

Questions?