

Overview of required Coverage Testing under IRC 410(b)

Every employer must perform certain coverage tests to demonstrate that their plan benefits a non-discriminatory cross-section of employees. The following describes the fundamentals of the ratio percentage coverage test including which employees must be included and which may not.

Overview of Coverage Testing:

The coverage test demonstrates that a qualified retirement plan (or plans) provides benefits to a significant percentage of a plan sponsor's (employer) Non-Highly Compensated Employees (NHCEs). Qualified retirement plan tax treatment results in the Federal government foregoing considerable tax revenue. In return for the tax benefits, Congress has imposed a requirement that retirement plan benefits are provided to a significant portion of the plan sponsor's eligible NHCEs.

The coverage tests were developed to measure the ratio of NHCEs to HCEs *benefiting* under the plan. An individual is considered to be benefiting under the plan if the individual receives a contribution or accrues a benefit from the retirement plan or, in the case of a 401(k) plan, is eligible to make elective deferrals. The coverage requirements may be tested on a daily, quarterly or annual basis. 401(k) elective deferral and matching contribution percentage testing must be performed on an annual basis. The principal coverage test is the Ratio Percentage Test (RPT). The number to remember with the Ratio Percentage Test is 70%. The ratio test is passed if 70% of the eligible NHCEs receive benefits. For plans that do not pass this test, Congress has provided an alternative coverage test known as the Average Benefits Test (ABT). However, because of the level of expertise required to perform it, the ABT is extremely complex to understand, time consuming, and may result in considerable expense for the employer and the plan. See below for description of the Average Benefits Test.

Who Must Be Considered in Coverage Testing:

For purposes of the coverage requirements, all eligible (some exclusions permitted - see below) employees of the employer must be considered, including leased employees and those employed by Controlled Groups and Affiliated Service Groups (multiple companies - common ownership and/or shared revenue).

Exclusions from the Coverage Test (otherwise excludable employees) – TR §1.410(b)-4(b) & -6:

1. Employees that have not met the statutory age (21) or service requirements (1 year of service based on 1,000 hours in a 12-month period).

Note: Plans that permit earlier entry are permitted to test affected employees separately. Specifically, the plan would test the "otherwise excludable group" that is those under age 21 and those with less than 1 year of service as a separate testing group.

2. Terminated participants who have completed less than 500 hours of service during the year tested.
3. Employees who are members of a collective bargaining unit (union) if retirement benefits have been the subject of good faith bargaining.
4. Nonresident aliens with no U.S. source of income.
5. Employees of an employer which is part of the controlled group but which is considered a separate line of business (generally separate business with 50 or more employees).

Note: Employees that are eligible and cannot be excluded as described above are considered "non-excludable" and therefore must be included in testing.

Employees that may be excluded by Classification:

To be deemed reasonable, the classification first must be established under objective business criteria that identify a category of employees who benefit under the plan.

Acceptable business criteria include classifications based on:

1. Geographic location
2. Job description or job categories
3. Nature of compensation, such as hourly or salaried

Unacceptable criteria include a classification of employees based on:

1. Part-time employment
2. Individuals who are named in the plan document (exceptions may apply)

Employee classifications must satisfy a **Nondiscriminatory Classification Test**. This test utilizes a coverage ratio that is described below. The result passes or does not pass based on comparison to the IRS Table of Safe Harbor and Unsafe Harbor percentages. To pass, the percentage of NHCEs who are benefiting under the plan result must be either:

1. A percentage equal to greater than the safe-harbor percentage (see table below)
2. The percentage exceeds unsafe-harbor percentage (see table below)
3. If in the range between safe and unsafe harbor percentages, the plan must pass a facts-and-circumstances test (described below)

In addition, employee classifications must satisfy a **NHCE Concentration Percentage Test**. This test utilizes a ratio of non-excludable (see above) NHCEs (numerator) over the total non-excludable employees of the employer. For example, if an employer had a total of 50 non-excludable employees of which 40 were NHCEs, the NHCE Concentration Percentage would be 80% (40/50). To satisfy this test, the following is required:

For plans with an NHCE concentration of 0 to 60%:

1. A plan is in the safe harbor range if the percentage of NHCEs who benefit is at least 50 percent of the percentage of HCEs who benefit
2. A plan fails the unsafe harbor if the percentage of NHCEs who benefit is 40 percent or less of the percentage of HCEs who benefit
3. A plan whose percentage falls between 50%/40% standards will be subject to a facts-and-circumstances test (see below)

For plans with an NHCE over 60%:

1. Both the safe-and unsafe-harbor percentages are reduced as the NHCEs concentration percentage increases above 60 percent
2. Unsafe-harbor percentage is always 10% less than the safe harbor, but never less than 20%
3. For every 1% increase in the concentration percentage, the 50% and 40% safe-harbor percentage levels decrease by .75%

For example: If a Plan Sponsor's NHCE concentration percentage is 75%, then a plan benefiting 40% of the NHCEs is in the safe harbor range (which is greater than 38.75%).

The safe and unsafe harbor percentages are shown in the table below. To select the safe and unsafe harbor percentages, first compute the NHCE concentration percentage by dividing the number of NHCEs by the total

number of employees. These numbers are calculated after disregarding non-excludable employees such as those who have not met the plan's eligibility requirements.

Safe Harbor and Unsafe Harbor Percentages Table					
NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

Examples to demonstrate NHCE Concentration Percentage Test :

A Plan Sponsor has 4 non-excludable HCEs and 9 non-excludable NHCEs of which 3 are not benefiting.

The NHCE Concentration Percentage:

Non-excludable NHCEs/total non-excludable employees is $9/13 = 69.2\%$ - Therefore the Safe Harbor percentage from the table above is 43.25%.

The ratio percentage:

$$6/9 \text{ NHCEs benefiting} = 66.67\% \text{ NHCEs}$$

$$\frac{4}{4} \text{ HCEs benefiting} = 100\% \text{ HCEs}$$

$$66.67\%/100\% = 66.67\% \text{ benefiting}$$

FACTS-AND-CIRCUMSTANCES TEST - Regs §1.410(b)-4(c)(3)

A plan that exceeds the safe harbor percentage is deemed to pass. A plan that is below the unsafe harbor percentage is deemed to fail. However, if a plan percentage is between the unsafe harbor and safe harbor percentage, the fact and circumstances test may be run.

A plan that fails to satisfy the safe harbor percentage but meets or exceeds the unsafe harbor percentage can still satisfy the reasonable classification requirement based on all the relevant facts and circumstances of the case. The factual determination is based on:

1. Business reason for the classification
2. Percentage of all employees eligible by statute who are benefiting under the plan
3. Percentage of employees are eligible by statute and benefit in each salary range
4. Difference between the plan's ratio percentage and the safe harbor percentage
5. Extent to which the plan's average benefit percentage exceeds 70%

I. Primary Coverage Test – Ratio Percentage Test (RPT)

Steps required to perform the 70% Ratio Percentage Test:

1. **Step one:** Separate all excluded employees from the eligible employees. This requires identifying those employees who are eligible to participate in the plan and who are benefiting (as defined above) from employees who may be excluded pursuant to the regulation outlined above.
2. **Step two:** Divide the eligible employees into two groups: HCEs and NHCEs.
3. **Step three:** Divide the number of NHCEs benefiting in the plan by the total number of all non-excludable NHCEs.
4. **Step Four:** Divide the number of HCEs benefiting in the plan by the total number of all non-excludable HCEs.
5. **Step Five:** Divide the NHCE percentage in #3 above by the HCE percentage in #4 above. If the result is 70% or greater, the coverage test is passed. If the percentage is less than 70%, it fails.

Examples of the Ratio Percentage Test:

Assume that a plan sponsor (employer) has 13 employees (3 HCEs and 10 NHCEs). If all 3 HCEs were benefiting, the HCE ratio would be 100%. If all 10 NHCEs were benefiting, the NHCE percentage would be 100%. The ratio of 100% over 100% would be 100%. This is a passing result.

Using the same example, if 3 NHCEs did not benefit because these three did not meet the plan's requirement for an allocation (for example: not employed on the last day of the plan year or were not credited with the 1,000 hours required to receive an allocation), then the NHCEs' percentage would be 70%, which, if divided by the 100% rate of the HCEs, would still pass the coverage test.

However, if only 6 NHCEs received an allocation because the other four NHCEs failed to satisfy the allocation requirements, then the test would fail, because the NHCE/HCE ratio percentage would be 60% (60% NHCE divided by the HCE 100%).

If only 2 HCEs benefited, then the HCE ratio would be 66.7% (2/3); 70% of that would be 46.7%, so that the minimum number of NHCEs that would need to benefit under the plan would be 5. In this example, when the NHCEs' 50% benefiting percentage is divided by the HCEs' 66.7% benefiting percentage, the ratio percentage equals 75%, which allows the plan to pass.

Will Certain Plan Designs Automatically Pass Coverage?

Yes. Examples of plans that automatically pass Coverage Testing include:

1. Plans that do not benefit any NHCEs
2. Plans that do not benefit any HCEs
3. Plans that benefit collectively bargained employees only
4. Plans that do not accrue a benefit for any participant for a plan year (for example: discretionary Profit Sharing Plan with no contribution for a specific year)

What if the plan does not pass?

Generally, the plan document may have provisions to use the alternative coverage test called the Average Benefits Test or the document will provide a method of providing enough additional employees with a benefit so that the plan passes coverage.

There are many other complex issues involved in performing required coverage testing. These include how HCEs are defined, the definition and role of leased employees, and the aggregation or disaggregation of plans.

II. Alternate Coverage Test – Average Benefits Test (ABT)

If a plan fails to pass coverage testing using the ratio percentage test, there is an alternative test, the average benefits test, which may be used to satisfy coverage testing. A plan only has to pass one of the coverage tests each year. The coverage test being used can change from year-to-year. This is not a document issue but rather an administrative testing issue.

A plan may call for the correction of the ratio percentage test and preclude the use of the average benefits test. Those using our plan document may use the average benefits test.

Typically, the ratio percentage test is done first as it is administratively much easier to perform. If the plan fails the ratio percentage test, the employer can either take steps to pass the ratio percentage test by providing a benefit to enough individuals in order to pass the ratio test or the employer may perform the average benefits test to see if the coverage requirement can be passed using that test.

The average benefits test is actually two tests, the nondiscriminatory classification test and the average benefits percentage test. Both parts of the average benefit test must be passed in order to satisfy coverage testing.

The ABPT is satisfied if the average benefit percentage (ABP) of the NHCEs is at least 70 percent of the ABP of the HCEs. To perform this test, the employer must determine a benefit percentage for each nonexcludable employee. All qualified plans, including 401(k) plans and ESOPs, must be tested together. The only amounts excluded are after-tax contributions; thus, even elective deferrals are considered part of this test. In summary, the ABPT test is done as follows:

1. The employer determines an annual contribution or accrual rate for each employee covered under the plan. Alternatively, an accrued-to-date method may be used.
2. The contribution or accrual rate determined in step 1 is divided by the employee's compensation to determine a percentage.
3. If the plan may use and utilizes permitted disparity, the percentage determined in step 2 may be increased by an amount representing the employer-provided portion of Social Security. This provides a higher rate for those earning lower amounts. The resulting percentage is added to the

percentage for plans that cannot use permitted disparity (for example, CODAs and ESOPs), and the result is the benefit percentage for each employee.

- The individual benefit percentages are then averaged for both HCEs and NHCEs to determine whether the average benefit percentage for NHCEs is at least 70 percent of the ABP for HCEs.

Example of the Average Benefits Test (ABT):

A plan sponsor has:

- o 4 non-excludable HCEs, all benefiting
- o 9 non-excludable NHCEs of which 6 were benefiting*

Calculate the HCE Benefit Percentage		Calculate the NHCE Benefit Percentage	
Each HCE Benefit Percentage (Based on benefit/compensation)		Each NHCE Benefit Percentage (Based on benefit/compensation)	
HCE 1	7.05%	NHCE 1	9.32%
HCE 2	6.01%	NHCE 2	8.75%
HCE 3	5.31%	NHCE 3	6.32%
HCE 4	4.54%	NHCE 4	5.32%
Total	22.91%	NHCE 5	5.18%
Divided by Number of Nonexcludable HCEs	22.91% / 4 = 5.72%	NHCE 6	4.87%
HCE benefiting percentage	5.72%	NHCE 7	0%
		NHCE 8	0%
		NHCE 9	0%
		Total	39.76%
		Divided by Number of nonexcludable NHCEs	39.76%/9 = 4.41%
		NHCE Benefiting Percentage	4.41%
		*NOTE: NHCEs 1-6 are covered by the plan, NHCEs 7 - 9 are not covered but must be included in the test as zeros.	

4.41%/5.72% = 77.1%. This plan sponsor passes both parts of the ABT test.

If the allocation fails the average benefits percentage test on a contribution allocation basis, the allocation may be cross-tested to see if the allocation passes on a benefit accrual basis.

The following example plan tested 4 HCEs and 6 NHCEs who are benefiting.

- Column 1 Age of Participant
- Column 2 Participants compensation
- Column 3 Participant's allocation
- Column 4 The 8.50% rate for this plan is a given in this example

- Column 5 Obtain the “value at normal retirement age” (NRA) by multiplying the current year allocation by the interest factor (columns 3 times column 4)
- Column 6 The 8.50% annuity factor in this example under the UP 1984 GAM Table is 7.949
- Column 7 Divide the value at NRA (column 5) by the 8.50% Annuity factor which is 7.949(column 6) to arrive at the normalized benefit
- Column 8 Calculate the equivalent accrual rate by dividing the normalized benefit (column 7) by the compensation (column 2). For example, employee D $3,109.54/37855.14 = 8.21\%$

Finally, run rate group testing by creating a rate group for each HCE that includes all NHCEs and HCEs with an equivalent accrual rate at least equal to or higher than the HCE being tested. (If each rate group has no NHCE with an equivalent accrual rate lower than any HCE, the plan passes.) For example:

- For the rate group based on HCE F, all other HCEs have a lesser equivalent accrual rate and all equivalent accrual rates of the NHCEs are equal to or greater than the rate of HCE F. Note that NHCE D has the same equivalent accrual rate as HCE F, this does not affect the test. Rate Group for HCE F ¼ HCEs for 25% and 6/6 NHCEs for 100% for a $100\%/25\% = 400\%$.
- For the rate group based on HCE C, only HCE A and B are at a lesser rate than HCE C and all NHCEs are at a greater rate. Rate Group for HCE C 2/4 HCEs for 50% while there are 6/6 NHCEs for a $100\%/50\% = 200\%$.
- The rate group for both HCE A and B would contain all employees and none would be less than the equivalent accrual rate for HCE A and B of 1.26%. Rate Group for A and B HCEs is 4/4 HCEs = 100% and 6/6 NHCEs = 100% $100\%/100\% = 100\%$.

This test can be estimated as passing because all HCEs are at an equivalent accrual rate; equal or less than all NHCEs.

EQUIVALENT ACCRUAL RATE WORKSHEET

(Measuring Period is the Plan Year)

	1	2	3	4	5	6	7	8
Emp.	Age	Testing Compensation	10% ctbn Allocation	8.50% Interest Factor	Value @ NRA	8.50% Annuity Factor	Normalized Benefit	Equivalent Accrual Rate
A*	67	200,000.00	20,000.00	1	20,000.00	7.949	2,516.04	1.26%
B*	65	200,000.00	20,000.00	1	20,000.00	7.949	2,516.04	1.26%
C*	62	200,000.00	20,000.00	1.277289	25,545.78	7.949	3,213.71	1.61%
D	42	37,855.14	3,785.51	6.52956	24,717.74	7.949	3,109.54	8.21%
E	40	34,435.32	3,443.53	7.686762	26,469.61	7.949	3,329.93	9.67%
F*	42	91,913.27	9,191.33	6.52956	60,015.32	7.949	7,550.05	8.21%
G	40	86,105.74	8,610.57	7.686762	66,187.43	7.949	8,326.51	9.67%
H	33	44,978.50	4,497.85	13.606663	61,200.73	7.949	7,699.17	17.12%
I	40	44,986.97	4,498.70	7.686762	34,580.41	7.949	4,350.28	9.67%
J	31	49,806.99	4,980.70	16.018103	79,781.35	7.949	10,036.65	20.15%

* HCEs