

Average Benefits Test

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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 needs to pass one of the coverage tests each year. The coverage test used can change from year-to-year, and the selection of the test is not a document issue but rather an administrative testing issue. However, a plan may call for the correction of the ratio percentage test and preclude the use of the average benefits test.

Typically, the ratio percentage test is done first since 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 benefits test must be passed in order to satisfy coverage testing under this method.

Although this article provides an overview of the average benefits testing process, it is not intended to be an all-inclusive treatise on the subject. A word of caution for those who have never seen the average benefits test before: it is more than the usual test in complexity!

Part One: The Nondiscriminatory Classification Test

Regs §§1.410(b)-4(b)

To pass the nondiscriminatory classification test, two criteria must be met.

1. The reasonable classification requirement

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

Bona fide business criteria include classifications based on:

- Geographic location
- Job description or job categories
- Nature of compensation, such as hourly or salaried

Unacceptable criteria include a classification of employees based on:

- Part-time employment
- Enumeration by name (Though other professionals may disagree, the author takes the position that enumeration by name is generally not considered a reasonable classification.)

2. The nondiscriminatory classification requirement

This mathematical portion of the nondiscriminatory classification test utilizes a coverage ratio that is described below. Whether the test results in the plan passing coverage testing or not is determined by looking at the IRS Table of Safe Harbor and Unsafe Harbor Percentages. To

pass, the percentage of NHCEs (nonhighly compensated employees) who are benefiting under the plan result must be either:

- At least equal to the Safe Harbor Percentage; or
- The percentage exceeds the Unsafe Harbor Percentage (see the table below). If the percentage is in the range between the safe and unsafe harbor percentages, the plan must pass an additional Facts and Circumstances test (described below).

Definitions

The following two definitions are needed in order to understand the explanation of how the nondiscriminatory classification test is performed.

Nonexcludable employees: Generally, all employees who are not excluded from the coverage test by law. All nonexcludable employees are used in this test. The statutory exceptions are:

- a. Employees who have not met the plan's minimum age requirement.
- b. Employees who have not met the plan's service requirement.
- c. Employees covered by a collective bargaining agreement who negotiated for retirement benefits as part of the collective bargaining process.
- d. Non-resident aliens with no US source of income.

NHCE concentration percentage: The ratio of nonexcludable NHCEs (numerator) over the total nonexcludable employees of the employer. For example, if an employer had a total of 500 nonexcludable employees of which 400 were NHCEs, the NHCE concentration percentage would be 80%.

$$\frac{\text{Nonexcludable NHCEs}}{\text{All nonexcludable employees}} = \text{NHCE Concentration Percentage}$$

Overview of Applying the Results of the NHCE Concentration Percentage to the IRS Table

Once the NHCE Concentration Percentage is determined, the table provides a corresponding percentage of NHCEs that must be benefiting.

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

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

For plans with an NHCE concentration over 60%:

- Both the safe and unsafe harbor percentages are reduced as the NHCEs concentration percentage increases above 60%.

- Unsafe Harbor percentage is always 10% less than the Safe Harbor, but never less than 20%.
- For every 1% increase in the concentration percentage, the 50% and 40% Safe Harbor Percentage levels decrease by 0.75%.
- For example, if the employer's NHCE concentration percentage is 75%, then a plan benefiting 40% of the NHCEs is nonetheless in the safe harbor range (which is above 38.75%).

To recap: 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 nonexcludable 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

Example 1

Joe's Pizza Company has 4 nonexcludable HCEs and 9 nonexcludable NHCEs of which 3 are not benefiting.

The NHCE Concentration Percentage is $9/13 = 69.2\%$
 (Nonexcludable NHCEs/total nonexcludable employees)

The ratio percentage is calculated
 6/9 NHCEs benefiting = 66.67% NHCEs
 4/4 HCEs benefiting = 100% HCEs

$66.67\%/100\% = 66.67\%$ benefiting

The safe harbor percentage from the table is 43.25; thus, with 66.67% benefiting, this portion of the test passes.

Example 2

JW Counseling and Mose Editing, Inc., are a controlled group and maintain one plan. JW participates in the plan while Mose does not. This scenario is acceptable **if** the controlled group can pass coverage including all companies. The plan does not satisfy the 70% ratio percentage test. Thus, the average benefits test must be utilized, assuming the plan does not call for the correction of the ratio percentage test instead.

Step 1: Calculate the NHCE Concentration Percentage

Nonexcludable Employees	JW	Mose	Total
HCE	40	50	90
NHCE	<u>150</u>	<u>360</u>	<u>510</u>
Total	190	410	600

The NHCE concentration percentage is $510/600 = 85\%$
(all nonexcludable NHCEs/all nonexcludable employees)

According to the above table, the NHCE benefiting safe harbor percentage is 31.25%. Therefore, the percentage of NHCEs benefiting under the plan must be at least 31.25% of the percentage of the HCEs who are benefiting under the plan.

Step 2: Calculate the Ratio of Benefiting Employees

Benefiting Employees	JW	Mose	Total	Ratio
HCE	40	0	90	44.44% (40/90)
NHCE	150	0	510	29.41% (150/510)

Ratio benefiting = $29.41\%/44.44\% = 66.18\%$

Step 3: Compare the Ratio of Benefiting Employees to the Safe Harbor Percentage

The table Safe Harbor Percentage is 31.25%, and since this plan has a ratio of 66.18%, it passes.

Facts and Circumstances - 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's percentage is between the unsafe harbor and safe harbor percentage, the fact and circumstances test may be run.

- i. 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.
- ii. The factual determination for the fact and circumstances test is based on:
 - (A) The business reason for the classification.
 - (B) The percentage of all employees eligible by statute who are benefiting under the plan.
 - (C) The percentage of employees eligible by statute in each salary range who benefit under the plan.
 - (D) The difference between the plan's ratio percentage and the safe harbor percentage.
 - (E) The extent to which the plan's average benefit percentage exceeds 70%.

Part Two: The Average Benefit Percentage Test

Regs §§1.410(b)-5

Once a plan satisfies the nondiscriminatory classification test, it then must satisfy the average benefit percentage test (ABPT). The ABPT is satisfied if the average benefit percentage (ABP) of the NHCEs is at least 70% of the ABP of the HCEs. To perform this test, the employer must determine a benefit percentage for each nonunion 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 approach 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.
4. 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% of the ABP for HCEs.

Note: The ABPT may be calculated on a contributions or benefits basis, regardless of the type of plan involved.

Example

Joe's Pizza Company has 4 nonexcludable HCEs and 9 nonexcludable NHCEs of which 6 were benefiting.

Calculate the HCE Benefit Percentage

HCE	Benefit Percentage (based on benefit/compensation)
1	7.05%
2	6.01%
3	5.31%
4	<u>4.54%</u>
Total	22.91%

HCE Benefit Percentage divided by number of nonexcludable HCEs = $22.91\%/4$

HCE benefiting percentage = 5.72%

Calculate the NHCE Benefiting Percentage

NHCEs 1-6 are covered by the plan, NHCEs 7-9 are not covered, but must be included in the test as zeros.

1	9.32%
2	8.75%
3	6.32%
4	5.32%
5	5.18%
6	4.87%
7	0%
8	0%
9	<u>0%</u>
Total	39.76%

NHCE Benefiting Percentage divided by the number of nonexcludable NHCEs = $39.76\%/9$

NHCE Benefiting Percentage = 4.41%

The ratio of benefiting NHCEs to benefiting HCEs must be at least 70%.

$4.41\%/5.72\% = 77.1\%$

Thus, Joe's Pizza Company passes both parts of the ABT test.

Conclusion

There are many other facets involved in coverage, such as the definitions of Highly Compensated Employee, Leased Employee and Qualified Separate Line of Business (QSLOB), as well as

issues of aggregation and disaggregation. Readers should familiarize themselves with these additional topics to gain a more thorough understanding of coverage issues.

Note: This article provides an opportunity for two additional Continuing Education credits if you pass the quiz located in the Members Only section of ASPA's Web site.

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