Using the Power of Coverage Testing for Creative Plan Design

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Introduction

- Discrimination testing encompasses a plan satisfying a number of rules.
- In particular, discrimination rules require meeting the requirement of IRC §§ 410, 401(a)(4), and 401(a)(26).
  - Last requirement only applies to DB plans, and requires a minimum number, or percentage, of employees benefit (no aggregation for this purpose).
  - Our emphasis will be IRC §410
Introduction

• To pass §410 a plan must meet the requirements of §410(a) and benefit a group of employees that satisfies §410(b). For this latter purpose, multiple plans may be
  – Aggregated for testing, and/or
  – Disaggregated (either on a permissive or mandatory basis) for testing.
Introduction

- §410(a) has maximum minimum age and service requirements that may be imposed to enter a plan.
  - May exclude employees who have not attained age 21.
  - May exclude employees who have not completed a year of service (two years if immediate vesting).
Introduction

• §410(b) requires that a plan either:
  – Satisfy the Ratio Percentage Test;
  – Satisfy the Average Benefits Test;
  – Not benefit any Highly Compensated Employees (HCEs); or
  – The employer has no non-excludable Non-highly Compensated Employees (NHCEs).
Highly Compensated Employees

• §414(q) defines HCE as employee who
  – Was five percent owner at any time during plan year or previous plan year, or
  – Earned more than threshold amount in preceding plan year - threshold amount
    • $115,000 looking back to 2014
    • $120,000 looking back to 2015
Highly Compensated Employees

• Five percent owner defined in IRC 416(i) as one who owns
  – If the employer is a corporation, either
    • More than five percent of the outstanding stock of the corporation, or
    • More than five percent of the total combined voting power of all stock of the corporation
  – If the employer is not a corporation, more than five percent of the capital or profits interest in the employer
  – Constructive ownership rules of IRC 318 apply
Highly Compensated Employees

• Constructive ownership rules of IRC 318 apply
• Most relevant are family attribution rules
• A person is considered to own stock (or other interest) owned by his or her
  – Spouse
  – Children (irrespective of age)
  – Parents
  – Grandparents
  – Don’t get burned by different last names – ask!
Highly Compensated Employees

• Can limit HCEs due to compensation to those in “Top-Paid Group” (TPG) in preceding year
  – Employee in TPG if employee in group consisting of top 20 percent of employees when ranked on basis of compensation. In making determination may exclude union employees and
  • Employees who have not completed six months of service
  • Employees who work less than 17.5 hours per week
  • Employees who work during less six months during the year
  • Employees who have not attained age 21
  – My experience has been TPG election usually only useful for purposes of ADP test
Ratio Percentage Test

• To satisfy the “Ratio Percentage Test” a Plan must have a “coverage ratio” of at least 70 percent.
  – Plan’s coverage ratio:
    • NHCE coverage ratio divided by
    • HCE coverage ratio
Ratio Percentage Test

• NHCE Coverage Ratio:
  – NHCEs benefiting under the plan divide by
  – Non-excludable NHCEs (even if excluded from plan)

• HCE Coverage Ratio:
  – HCEs benefiting under the plan divided by
  – Non-excludable HCEs (even if excluded from plan)

• “Benefiting” simply means receiving an allocation (or accruing a benefit); amount not relevant
Ratio Percentage Test

• Except ...
  – An employee is treated as benefiting under a 401(k) plan if the employee is eligible to defer, whether or not he/she does so
  – An employee is treated as benefiting under a 401(m) plan if the employee would receive a match had they deferred
Additionally

- A DB plan may ignore the effect of the 415 limit when determining if the accrued benefit increased
  - Presuming it is also ignored in the 401(a)(4) testing
Ratio Percentage Test

• And, an employee in a DB plan is treated as benefiting if the employee would have benefited except that:
  – The employee's benefit exceeds a uniform plan limit (on benefit, service or compensation);
  – A prior accrued benefit is greater than the accrued benefit otherwise determined;
  – A floor offset arrangement restricts the increase in accrued benefit (but not all offsets apply);
  – The actuarial increase due to a delayed retirement is larger than the benefit that would have otherwise accrued.
Consider an actual case from our office (though ‘covered’ here was relevant for 401(a)(26) instead of 410(b) concept same)

- Hospital-based medical practice of two Drs. (1 & 2) - no other employees
- DBP 1 terminated when Dr. 1 retired (each Dr. had $10,500 benefit)
- Replacement (Dr. 3) hired and 401(k) plan implemented
- Three years later Dr. 3 wishes to shelter more dollars so wants DB plan
- IRC 401(a)(26) requires both Drs. to be covered but Dr. 2 not looking for additional retirement
- DBP 2 created with benefit of $1,750 per year of participation
- DBP 2 benefit is offset by benefit under DBP 1
- Dr. 2 considered benefit under DBP 2 even though no actual benefit
Ratio Percentage Test

• Amount of benefit only relevant for non-discrimination testing under IRC 401(a)(4)

• Important to understand that all Non-Excludable Employees considered in denominator. Including:
  – Non-Excludable Employees excluded from plan
    • Even those signing waiver of participation
  – Participants not benefiting under terms of plan
    • E.g., last day or 1,000 requirement
Ratio Percentage Test

• Consider employer that has 11 Non-Excludable Employees
  – Three HCEs – husband, wife, son
  – Eight NHCs
• Desire to cover husband and wife
  – HCEs coverage ratio = 2/3 = 66.67 percent
Ratio Percentage Test

• To pass ratio test need to cover four NHCs
  – Need coverage ratio of at least 70 percent
  – 70 percent * 66.67 percent = 46.67 percent
  – 46.67 percent * eight (NHCs) = 3.73 (round to four)

• Plan’s coverage ratio (if only 4 NHCs covered)
  – NHC ratio 50 percent/HCE ratio 66.67 percent = 75 percent
  – At least 70 percent so ratio test passed
Ratio Percentage Test

• Plan could therefore exclude four of eight NHCs
  – By class
  – By name
• Or cover by inclusion
  – I.e., only those specifically named are in plan
  – Not uncommon in ‘carve-out’ DB plans
Non-Excludable Employees

• Non-Excludable Employees means all employees except [1.410(b)-6]):
  – Those that fail to meet age and service -
    • BUT, why exclude 20 year old NHC? Can be VERY helpful in testing → lose age requirement?
  – Non-resident aliens with no US income
  – Employees subject to collective bargaining
  – Terminated employees with no more than 500 hours
  – Employees of QSLOBs
Non-Excludable Employees

• Important to remember that the employees of all members of related employers must be taken into account
  – Controlled groups - 414(b)
  – Controlled groups of trades or business under common control - 414(c)
  – Affiliated service groups – 414(m)
Non-Excludable Employees

• Consider two companies owned 100 percent by same person
  – Therefore brother/sister controlled group
• Company 1 has three HCEs and 25 NHCs
• Company 2 has two HCEs and 35 NHCs
• Assume only Company 1 sponsors plan
• Ratio percentage is 41.67 percent/60 percent = 69.44 percent
  – NHC 25/60 = 41.67 percent
  – HCE 3/5 = 60 percent
  – Ratio test fails – possibly use average benefits test (later)
Non-Excludable Employees

- Exclusion of EEs failing to meet statutory age and service requirements
  - Where plan has more liberal eligibility may exclude these “otherwise excludable” employees from testing
    - If excluded from testing don’t need gateway for example
  - BUT, if there are otherwise excludable EEs that are HCEs then either:
    - Test otherwise excludables separately, or
    - Test without using exclusion
Non-Excludable Employees

• Terms with ≤ 500 hours only excludable if
  – Plan requires minimum hours and/or EOY employment to receive benefit/allocation
  – And employee:
    • Is eligible to participate in the plan;
    • Does not benefit under the plan for the year;
    • Fails to receive benefit/allocation solely because of above requirement(s); and
    • Terminates with no more than 500 hours of service during the year.
Non-Excludable Employees

• So, e.g., employee excluded from plan **not** excludable -
  – Employee not eligible to participate
  – I.e., a terminated employee with \( \leq 500 \) hours of service that was **excluded from participation** in plan is NOT an excludable employee and therefore must be counted in denominator when determining coverage ratio
Non-Excludable Employees

• Employee receiving three percent SH not excludable -
  – Employee is **benefiting**
  – So e.g., they need gateway
Non-Excludable Employees

• Similarly, PS plan with no hours or EOY requirement may NOT exclude from testing terminees ≤ 500 hours to whom employer could have but decided not to give an allocation-
  – Termination ≤ 500 hours not SOLE reason allocation not provided
Non-Excludable Employees

• Exclusion of such terminees from testing is elective and consistency is only required within a plan year -
  – So in a given year if you exclude such folks from testing you must exclude all terminated NHCs and HCEs with no more than 500 hours of service
  – But you may, e.g.,
    • Exclude such folks from testing in years where it helps testing – i.e., you’re excluding from testing non-benefiting NHCs
    • But include such folks in years when it helps testing – i.e., you’re including in testing non-benefiting HCEs.
Non-Excludable Employees

- Consider an employer with three HCEs and nine NHCs
- All covered under employer’s PS plan
- Under plan each employee in own class for purposes of PS allocation
  - Employer determines on ee by ee basis who gets PS $$
  - Terms with \( \leq 500 \) hours may not get allocation
  - Goal is to allocate $$ to all actives
Non-Excludable Employees

• Assume three of nine NHCs terminate
  – One of whom worked ≤ 500 hours
• Ignoring terminee rule ratio test fails
  – NHC ratio = 6/9 = 66.67 percent
  – HCE ratio = 3/3 = 100 percent
  – 66.67 percent/100 percent = 66.67 percent < 70 percent
Non-Excludable Employees

• But may exclude terminee ≤ 500 hrs from test
• Ratio test passes
  – NHC ratio = 6/8 = 75 percent
  – HCE ratio = 3/3 = 100 percent
  – 75 percent/100 percent = 75 percent > 70 percent
• Important that under terms of plan terminee could not receive an allocation
  – But was otherwise a participant
Non-Excludable Employees

• Assume instead that all three NHCs termed with more than 500 hours
• But an HCE also termed but with ≤ 500 hours
• If elect to exclude terms ≤ 500 hours from testing ratio test fails
  – NHC ratio = 6/9 = 66.67 percent
  – HCE ratio = 2/2 = 100 percent
  – 66.67 percent/100 percent = 66.67 percent < 70 percent
Non-Excludable Employees

• Here we would **not** elect to exclude terms ≤ 500 hours from testing
• Ratio test passes
  – NHC ratio = 6/9 = 66.67 percent
  – HCE ratio = 2/3 = 66.67 percent
  – 66.67 percent/66.67 percent = 100 percent > 70 percent
Non-Excludable Employees

• A special applies under the regulations for plans that cover otherwise excludable employees
• Such a plan may be bifurcated and tested as two plans
  – One covering otherwise excludable employees
  – One covering not otherwise excludable employees
• Or may be tested as single plan
Non-Excludable Employees

• In either case need to compare what eligibility can be (i.e., 21/1) and what it is (e.g., three months)
• Where tested as single plan non-excludable employee definition expanded to all who have met more liberal eligibility
Non-Excludable Employees

• Where tested separately
  – One plan would include in testing those that would be non-excludable if plan had statutory requirements (21/1)
  – Other would include in testing those that did not meet such requirements but did meet lesser requirements (three months)
Don’t Blow Top-Heavy Waiver!

- Maybe I’m the only one that didn’t know this.
- IRC 416(g)(4)(H) provides that the term “top-heavy plan” does not include a plan which consists solely of:
  - A cash or deferred arrangement which meets the requirements of section 401(k)(12) or 401(k)(13), and
  - Matching contributions with respect to which the requirements of section 401(m)(11) or 401(m)(12) are met.
Don’t Blow Top-Heavy Waiver!

• So an otherwise top-heavy safe harbor plan that provides no other contributions does not need to provide top-heavy minimums (this much I knew!)
• But what if plan allows for early entry but gives SH only to those that meet 21/1?
• Since early entry folk get no SH, TH exemption blown and top-heavy minimums must be provided (See Revenue Ruling 2004-13)
  – This can be particularly painful if SH match as those not deferring would get no employer dollars if TH exempt
Average Benefits Test

- To satisfy the Average Benefits Test for 410(b) purposes, a plan must pass both the average benefit percentage test and the nondiscriminatory classification test.
  - A plan passes the nondiscriminatory classification test if the plan benefits a classification of employees that is both reasonable and nondiscriminatory.
Average Benefits Test

- A plan satisfies the **average benefit percentage test (ABPT)** if plan’s **average benefit percentage** at least 70 percent
- Average benefit percentage determined by dividing **actual benefit percentage** of NHCEs by actual benefit percentage of HCEs
- Actual benefit percentage of NHCEs (HCEs) is average of **employee benefit percentages** for each non-excludable NHCE (HCE)
Average Benefits Test

- With certain exceptions all plans of employer aggregated when calculating employee benefit percentages for ABPT
- Elective deferrals and matching contributions under a 401(k) plan are taken into account in determining employee benefit percentages for ABPT
  - Even though otherwise disaggregated for coverage and nondiscrimination testing
  - Same for ESOPs
Average Benefits Test

• **Employee benefit percentages** determined on *either* contributions or benefits basis,
  
  – Consistently for all plans in testing group

• This is same rate that would be determined for purposes of rate group testing but with all plans are aggregated

• For example, if employee benefit percentages are determined on a benefits basis, and there are both DC and DB plans in testing group, an employee's employee benefit percentage is his/her aggregate normal accrual rate **but with** the inclusion of elective deferrals and matching contributions
Average Benefits Test

• Plans with differing plan years
• In general, plans must have the same plan year to be combined for testing
• However, for purposes of the average benefits percentage test, all plans must be aggregated
• Accordingly, the regulations provide that employee benefit percentages in such a case are determined based on all plan years ending with or within the same calendar year
Average Benefits Test

• There is a special rule, for purposes of the average benefits test only, that allows the EBARs to be averaged over the current and prior year or the current and two prior years
  – Assume sole HCE with ABPT EBAR of 10 percent in 2015, 8.5 percent in 2014 and 7 percent in 2013
  – The only NHC has EBAR of 6 percent for each of the 3 years
    • I.e., numerator 6 percent whether or not average used
  – Looking at 2015 ABPT is 6 percent/10 percent = 60 percent and fails
  – Averaging 2014 and 2013 is 6 percent/9.25 percent = 64.6 percent and fails
  – Averaging all 3 years -> 6 percent / 8.5 percent = 70.5 percent and passes
Average Benefits Test

• A plan passes the first part **nondiscriminatory classification test** if it covers a classification of employees that is "reasonable and is established under objective business criteria"

  – Examples under regulations are "specified job categories, nature of compensation, geographic location"

  – “An enumeration of employees by name **or other specific criteria having substantially the same effect as an enumeration by name** is not considered a reasonable classification.”
Average Benefits Test

• The second piece of the nondiscriminatory classification test requires the plan to have a coverage ratio that is
  – At least as high as the Safe Harbor Percentage, or
  – At least as high as the Un-Safe Harbor Percentage and pass a facts and circumstances test
Average Benefits Test

• **Safe harbor** percentage is 50 percent, less .75 percent for each **whole** point by which the “NHCE concentration percentage” exceeds 60 percent
  
  — *So safe harbor never greater than 50 percent*

• **Unsafe harbor** is 40 percent, less .75 percent for each whole point by which the NHCE concentration exceeds 60 percent, but not less than 20 percent

• **NHCE concentration percentage** = percent of Non-Excludable Employees who are NHCEs
Average Benefits Test

• Let’s return to our employer with three HCEs and nine NHCs
• Let’s further assume that four of the NHCs were hired after 12/31/2012 and the plan was frozen to new participants as of such date
• So only five of nine NHCs are covered under the plan
• Plans coverage ratio is therefore 55.56 percent
  – Since over 50 percent, we know safe harbor passed
Average Benefits Test

• All participants receive allocation of nine percent of compensation
• All NHCs under taxable wage base
• All HCEs over $265K
• Let’s first look at average benefits percentage test
  – As indicated on next slide ABPT over 70 percent so passes
## Average Benefits Test

### PERMITTED DISPARITY ON ALLOCATION BASIS

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Value 1</th>
<th>Value 2</th>
</tr>
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<tbody>
<tr>
<td>A</td>
<td>Unadjusted allocation rate</td>
<td>9.00%</td>
<td>9.00%</td>
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<tr>
<td>B</td>
<td>Plan Year comp.</td>
<td>265,000</td>
<td>30,000</td>
</tr>
<tr>
<td>C</td>
<td>TWB</td>
<td>118,500</td>
<td>118,500</td>
</tr>
<tr>
<td>D</td>
<td>Covered comp (lesser B/C)</td>
<td>118,500</td>
<td>30,000</td>
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<tr>
<td>E</td>
<td>PD rate (5.7%)</td>
<td>5.70%</td>
<td>5.70%</td>
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<tr>
<td>F</td>
<td>Max PD (lesser A/E)</td>
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<td>5.70%</td>
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<td>G</td>
<td>Theoretical Disparity Allocation (F*D)</td>
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<td>1,710</td>
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<td>H</td>
<td>Imputed PD G/B</td>
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<td>L</td>
<td>Average HCE - -&gt; 3/3 all get same</td>
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<td></td>
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<tr>
<td>M</td>
<td>Average NHC - 5 of 9 all get same (others zero)</td>
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<td>8.17%</td>
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<tr>
<td></td>
<td>Average benefit percentage M / L</td>
<td></td>
<td>70.71%</td>
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</tbody>
</table>
Average Benefits Test

- Recall nondiscriminatory classification requirements. Classification of employees covered must be
  - Reasonable, and
  - Nondiscriminatory
    - Cover safe harbor percent or unsafe harbor and facts/circ
    - Our safe harbor is 39.75 percent
      - NHC concentration = 9/12 = 75 percent (15 more than 60)
      - Safe harbor = 50 percent - (15 * .75) = 39.75 percent
    - With coverage of 55.56 percent we pass here – no F/C requirement.
Average Benefits Test

• But is our classification reasonable?
• Specifically asked in Q&A 18 of 2015 Gray Book
• “Such a classification is reasonable as long as it is not a substitute for listing by name. Regulation 1.410(b)-4 provides that a reasonable classification is based on objective business criteria ... There is nothing to indicate date of hire would not be an “objective” business classification.”
Average Benefits Test

• What if all nine were covered under the plan, but four of the nine terminated (with more than 500 hours) and this is why they did not receive an allocation?
• All of the math is the same
• Only question is whether those employed at end of year is a “reasonable” classification
• IRS has given conflicting answers to this question at ASPPA meetings – I have zero concern –
  – In my opinion it clearly IS a reasonable classification
Dealing With Failure

• Failsafe language
• OR
• Corrective amendments
Failsafe Language

• Some plans include failsafe language
• Such language prevents plan from failing coverage testing
  – Normally requires passage of 70 percent ratio test
  – Normally results from end of year or hours requirement reducing benefiting group to a level where coverage ratio less than 70 percent
Failsafe Language

- If plan fails coverage, failsafe language causes a group of employees that otherwise would not have benefited to benefit for the plan year
  - Group of employees added back must be definitely determinable in document
Failsafe Language

• Norm is in order of termination dates
  – Such that if coverage ratio below 70 percent terminees benefit (last terminee first) until coverage ratio reaches 70 percent
• Note that if such language is in plan there is no discretion as to who to bring in
  – Must follow terms of the plan
  – Often not best (least expensive) result
Failsafe Language

• On the other hand, since there is no amendment bringing the terminees in, their vested status is not relevant
• Whereas vesting is relevant to corrective amendments ... which we discuss next
Corrective Amendments

• Post year-end amendments may be made to “correct” failed 410(b) or 401(a)(4) tests. Such amendments may either –
  – Increase benefits for existing participants; or
  – Create benefits for employees that otherwise did not benefit under plan

• Such amendments must meet each of the following requirements:
Corrective Amendments

• Benefits may not be reduced
• The amendment must be made by the 15\textsuperscript{th} day of the 10\textsuperscript{th} month after the plan year-end
• The increase in benefits must satisfy 410(b) and 401(a)(4) on a stand-alone basis
  – Automatic if only NHCEs increased/added
• The increase must have substance
  – E.g., cannot increase benefit to non-vested terminated employee
Corrective Amendments

- Consider the following:
  - Owner and four NHCs
  - NHCE1 - Non-excludable—comp $200K – NHC due to prior year comp; terminated 10/1/14
  - NHC2 - Non-excludable—comp $50K – NHC due to prior year comp; terminated 9/30/14
  - NHC3 and NHCE4 non-excludable and active
Corrective Amendments

- Goal to benefit owner and active NHCs
- But assume coverage cannot pass without bringing at least one terminee back in
- Failsafe language normally would require bringing in NHCE1 – with higher comp would likely be more expensive – e.g., if cross testing would need gateway
- If no failsafe corrective amendment could specify NHCE2 brought in instead
Corrective Amendments

• Consider the following:
  – Owner, comp $265K
  – EE1 - Non-excludable – comp $200K – NHC due to prior year comp
    • Or top-paid group election
  – EE2 - Newly hired (excludable) earned $10K
    • Not yet eligible for plan
Corrective Amendments

• No other employees
• Company maintains PS plan
• Owner looking to maximize benefit
  – i.e., $53K or 20 percent of comp
• Assume ages such that cross testing will not work
• Would like to give EE1 allocation of five percent ($10K)
• As is would need to give EE1 19.17 percent (over $38K)
Corrective Amendments

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Corrective Amendments

• Consider amending plan to lower eligibility and bring in EE2
• Provide EE2 with allocation of 20 percent of comp
• And give EE1 desired five percent
• Total cost now $12K
Corrective Amendments

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Corrective Amendments

• Things to note from previous example
• Coverage did not fail – 100 percent before amendment
  – But to pass 401(a)(4) would have been costly
  – Bringing in new employee coverage still 100 percent
    • Definition of non-excludable employee broadened
    • But 401(a)(4) passes much less expensively
Corrective Amendments

- Must perform rate group testing
- Single rate group (one HCE)
  - Rate group includes those with benefit of at least 22.55 percent
- One of two NHCs in rate group (EE2 = 25.7 percent)
- Rate group coverage ratio = 50 percent
  - Always enough to pass if ABPT passes
  - I.e., midpoint never greater than 45 percent
  - No need to check gateway as not cross testing
Corrective Amendments

• Recall earlier discussion of plan covering otherwise excludable employees
  – I.e., eligibility something less than 21/1
• With corrective amendment we have such a case
  – And we’re testing as single plan – not bifurcating
• What if EE2 had three months of service and a second new employee (EE3) was hired the same day?
Corrective Amendments

- EE3 would need to be brought into the testing
- Coverage would now be \( \frac{2}{3} / \frac{1}{1} = 66.67 \) percent
  - Would probably fail as under 70 percent and likely not a reasonable classification
- ABPT would also fail as a zero would need to be averaged in
- Would therefore likely need to also cover EE3
Corrective Amendments

• But if EE3 hired any later than EE2 could avoid by making eligibility with corrective amendment such that EE3 still excludable

• E.g., if EE3 had two months of service and EE2 had three months of service, broaden eligibility to three months
Transition Rule

• Applies where change in related group members occurs due to acquisition or disposition
  – Plan deemed to pass coverage during transition period if satisfied coverage at time of event. Transition period:
    • Year of transaction and following plan year
  – Cannot be substantial change in coverage or benefits during transition period
Combining Plans for Testing

• Plans can be combined to pass coverage testing
  – Not if they must be disaggregated
  – Plans must have same plan year
• Often helpful with controlled groups
• When combining plans must do so for all testing
• Also beware of need to aggregate for TH (e.g., if covers no keys and otherwise THMs not required)
Combining Plans for Testing

• When combining plans the combined plan is considered to be a single plan ("the plan")
• So employee benefiting in any of the combined plans is considered to be benefiting in "the plan"
• Benefits under all plans then added together
  – Either on a benefits basis or a contributions basis
  – I.e., benefits in all plans making up the combined plan must be determined on a consistent basis
Questions?