Advanced Testing II: Coverage, Top-Heavy, and Non-Discrimination Testing

Richard S. Phillips, AIF, ERPA, CPC, QPA, QKA
President and CEO
ERISA Consultants, Inc.
Contributions or benefits must not exceed IRC 415 limits.

**Top-Heavy**
Top-heavy if more than 60% of the benefits are attributable to key employees.

**Coverage**
Must benefit at least 70% of the % of HCEs benefiting.

**Non-Discrimination**
Component plans must demonstrate the allocations are not discriminatory in favor of HCEs.

**Benefit Limits**
Contributions or benefits must not exceed IRC 415 limits.

- IRC 410(b)
- IRC 416
- IRC 401(a)(4)
- IRC 415
Annual Compliance Testing

COVERAGE
IRC 410(b – at least 70% of the % of HCEs benefiting must benefit NHCEs
Annual Compliance Testing

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IRC 401(a)(26) – Only applicable to DB plans
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IRC 401(a)(4), 401(k), 401(m)

**CONTRIBUTION LIMITS**
IRC 415
The average benefits test will be covered in more detail in the non-discrimination testing section.
**Coverage Test: Three-Stage Process**

<table>
<thead>
<tr>
<th>Daily</th>
<th>Quarterly</th>
<th>Annual</th>
<th>Workforce</th>
<th>Excludable</th>
<th>Exception</th>
<th>70% Ratio</th>
<th>Ratio % Test</th>
<th>ABT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Each day of the plan year.</td>
<td>4 test dates. One each quarter.</td>
<td>Standard. Last day of the plan year.</td>
<td>All employees.</td>
<td>Excludable for entire period</td>
<td>Job Class Exclusion</td>
<td>No exclusions</td>
<td>70% of the % of HCEs</td>
<td>Average Benefits Test</td>
</tr>
</tbody>
</table>

- **Testing Period**
  Determine the testing period. The most common is annual on the last of the plan year but other options may improve results.

- **Coverage Testing Group**
  Non-excludable employees in the workforce. Depending on the terms of the plan, the coverage testing group may include more employees than are included in the benefiting group.

- **Available Methods**
  The ratio percentage test is the easiest method and is not subjective. The alternative is the Average Benefits Test.
Coverage: Mandatory Disaggregation

- Elective Deferrals
- Employer Match
- Employer Non-Elective

IRC 401(k)
IRC 401(m)
IRC 401(a)
Coverage: Permissive Aggregation

Plan #1: 401(k)

Plan #1: Profit Sharing

Elective deferrals tested separately

Plan 1 profit sharing independently satisfies coverage

Plan #2: Profit Sharing

Non-Discrimination

Plan 2 fails coverage. Aggregated with 1 to pass
Case Study 1: Coverage Principles
# Top-Heavy Test

<table>
<thead>
<tr>
<th>Key Employee</th>
<th>Benefits &gt; 60%</th>
<th>Factors</th>
<th>Aggregation</th>
<th>THM Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 5% Owner</td>
<td>• Defined Benefit – Present Value of Accrued Benefit</td>
<td>Determination Date</td>
<td>• Required Aggregation Group</td>
<td>• Full-Year Comp</td>
</tr>
<tr>
<td>• 1% Owner</td>
<td>• Defined Contribution – Account Balance</td>
<td>Calculating the Ratio</td>
<td>• Permissive Aggregation Group</td>
<td>• Defined Benefit Plan</td>
</tr>
<tr>
<td>• Officer</td>
<td></td>
<td>$ added or excluded</td>
<td>• Multiple Employer Plan</td>
<td>• Defined Contribution Plan</td>
</tr>
</tbody>
</table>

- **Rollovers**
- **Terminated and Frozen Plans**

- **Terminated and Frozen Plans**
- **May trigger Gateway**
Top-Heavy Test

Key Employee

- 5% Owner
- 1% Owner
- Officer

5% Owner: Owns more than 5% at any time during the year. Compensation is irrelevant.

1% Owner: Owns more than 1% at any time during the year and compensation > $150,000 (unindexed)

Officer: An officer at any time during the year and compensation > $175,000 (indexed)
Top-Heavy Test

Defined Benefit Plans: If the accrued benefits for key employees is > 60% the plan is top-heavy.

Defined Contribution Plans: If the account balances of key employees is > 60% the plan is top-heavy.
Top-Heavy Test

**Factors**

** Determination Date:** Last day of the preceding plan year. New plan exception is the last day of the plan year.

**Calculating the Ratio**

**Top-Heavy Ratio** = \( \frac{\text{Sum of Key EE Benefits}}{\text{Total of a EE Benefits}} \)

**Added:** Distributions in the past year. Performance of services in the past year.

**Excluded:** Distributions > 1 year. Former Key. Performance of services more than 12 months ago.

**Related:** Into another plan maintained by the employer. NOT initiated by the participant.

**Unrelated:** Initiated by the participant.

**Terminated:** < 5 year and would have been part of the required aggregation group

**Frozen DB:** Must provide top-heavy minimum accruals

**Frozen DC:** No top-heavy minimum unless key employee benefits
Top-Heavy Test

**Aggregation**

- **Required Aggregation Group:** Consists of each plan of the employer in which a key employee is participating during the determination year and other plan that the key employee participates in to satisfy IRC 410(b) and IRC 401(a)(4).

- **Permissive Aggregation Group:** Allows the employer to aggregate plans to demonstrate they are not top-heavy. Top-heavy status of the aggregation group determines the top-heavy status of underlying plans.

- **Multiple Employer Plan:** Subject to the top-heavy rules on an employer-by-employer basis.
Top-Heavy Test

- Full-year compensation instead of plan-year compensation
- Non-key must accrue a benefit if excluded from the plan on the basis of compensation < a stated dollar amount
- Service requirement not applicable when determining who receives the top-heavy minimum
- Defined Benefit TH Minimum = (comp x (lesser of 2% x YOS or 20%))
- Defined Contribution TH Minimum = 3% of comp or 1/3 the highest contribution rate to a benefiting key not to exceed 3%
- Top-heavy minimum contribution is made to the ongoing plan, not to a terminated plan.
- DB/DC Combo – only has to be made to one of the plans
Case Study 2: Top-Heavy Test
Case Study 3: Top-Heavy Test
Non-Discrimination Testing: IRC 401(a)(4)

Mandatory Disaggregation

Elective Deferrals: IRC 401(k)(3): ADP

Employer Match: IRC 401(m): ACP

Employer Non-Elective: IRC 401(a)(4)
Rate Groups

Each rate group must pass coverage using one of the prescribed methods or a combination of the methods.

1. Ratio Percentage: simple mathematical test
2. Average Benefits Test: • Nondiscriminatory Classification • Average Benefits % Test

SH
- Designed Safe Harbor
- Non-Designed Safe Harbor
IRC 401(a)(4): Safe Harbor

**Design Based**
Uniform allocation on IRC 414(s) comp

**Benefiting Only**
Only participants benefiting are taken into account.

**Non-Design Based**
Uniform points on YOS, age and compensation

**Average Rates**
Satisfied if average allocation rates for HCEs < allocation rates for NHCEs

**Permitted Disparity**
Cannot impute permitted disparity in Uniform Points
IRC 401(a)(4): Rate Groups

How Many Groups?
One rate group for each HCE benefit rate

Gateway
Precondition for cross-testing

Nondiscrimination
- Ratio % Test
- Average Benefits Test

Benefit Rate
Expressed as an allocation rate or equivalent benefit rate
IRC 401(a)(4): Ratio Percentage Test

Mathematical Test

\[ \frac{\text{NHCE}\%}{\text{HCE}\%} \geq 70\% = \text{Pass} \]
IRC 401(a)(4): Average Benefits Test

Average Benefits Test
A two-part test and each part must pass.

1. Safe Harbor % Test
2. Facts and Circumstance

Nondiscriminatory Classification Test

Average Benefits Percentage Test
Nondiscriminatory Classification Test

Safe Harbor % Test

• Coverage ratio at least equal to midpoint between safe harbor % and un-safe harbor %

• Coverage ratio needed to pass will depend on NHCE concentration percentage

Facts and Circumstances

• Coverage ratio must be greater than or equal to the un-safe harbor percentage

• The classification is non-discriminatory under facts and circumstances
Average Benefits Percentage Test

Test Each Rate Group

Avg. NHCE% / Avg. HCE% ≥ 70% = Pass

All employer contributions are included. Elective deferrals are employer contributions.
Case Study 4: Nondiscrimination Test
Case Study 5: Plan Design Track
Questions?