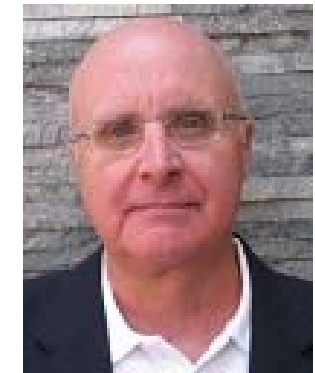

Covering Coverage - From A to Z

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Your Presenters Today

- Ilene H. Ferenczy, JD, CPC, APA
- Tim McCutcheon, JD, CPA, MBA



Covering Coverage – From A to Z

- Facilitator:
Chuck Gouge



- Question Board Moderator
Joanne Pecina



During the Webinar

- All attendees' lines are muted
- We will try to answer questions as we go. Send questions to all panelists.
- Slides and recording of webinar are available from ERISApedia.com/webcasts
- Certificates for CE credits will be sent in a few days. PLEASE check spam folders.



Key Concepts We Will Cover

- How does a plan satisfy coverage testing?
- What is the ratio percentage test (RPT)?
- What is the average benefit test (ABT)?
- How does the last-day rule affect coverage?
- What is “benefiting”?
- Who is an excluded employee for testing?
- Who is included in the coverage test?
- When is a plan deemed to pass coverage?
- What happens if the coverage test is failed?
- How is a failed test corrected?

Introduction to Coverage Rules



Coverage

- Employees can be excluded from the plan by classification:
 - Job class
 - Geographic location
 - Business division
 - Even by name



Coverage

- These exclusions are permitted only if the plan still covers a broad cross-section of employees
- Coverage testing determines that this requirement is met
- As with all nondiscrimination-related testing, the coverage test compares HCEs to NHCEs

Coverage

- There are two ways to demonstrate that coverage rules have been met

1. Ratio Percentage Test (RPT)

- Easy to do
- Compares % of benefiting HCEs to % of benefiting NHCEs – there is an acceptable tolerance rate

2. Average Benefit Test (ABT)

- More complex to do
- Compares both % and average benefits of HCEs to those of NHCEs

Ratio Percentage Test

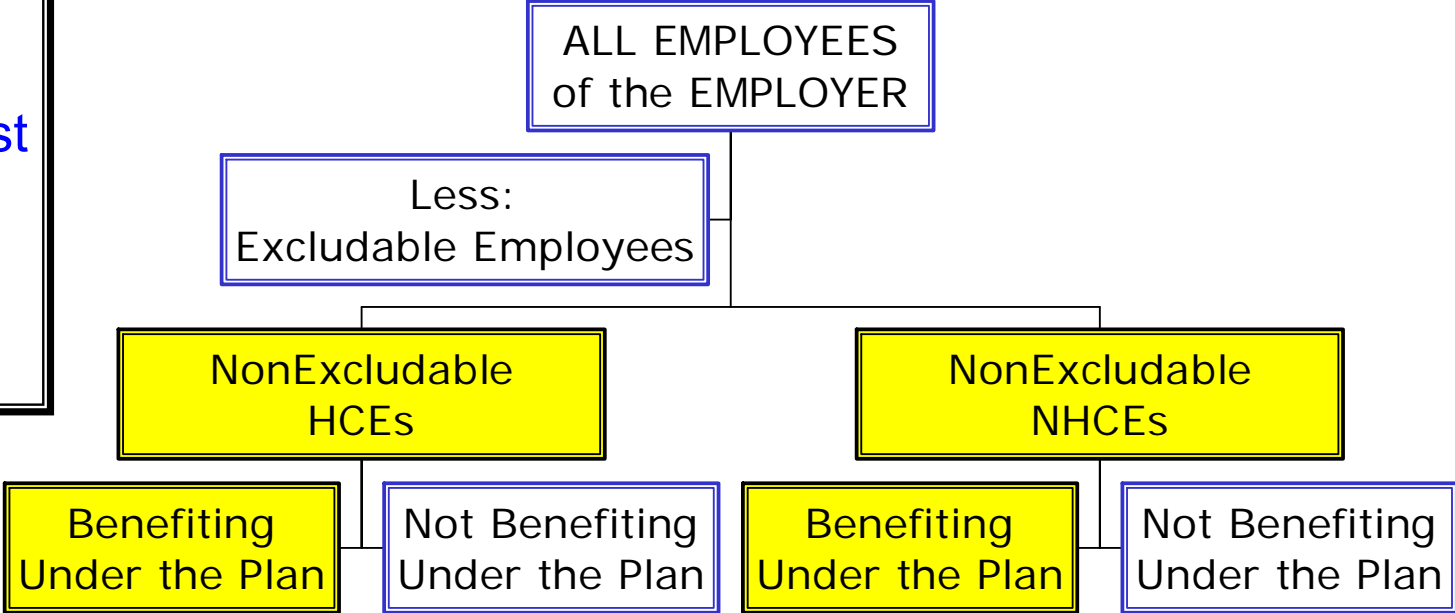


Steps

1. Who is the “employer” for testing purposes?
2. Who is in the workforce being tested?
3. Who are the excludable employees?
4. What is the testing group?
5. Categorize all employees in the testing group by HCE and NHCE
6. Who is benefiting under the plan?
7. Perform the ratio percentage test

Ratio Percentage Test

% benefiting NHCEs
Must be at least 70% of
% benefiting HCEs



Step 1: Who Is the Employer?

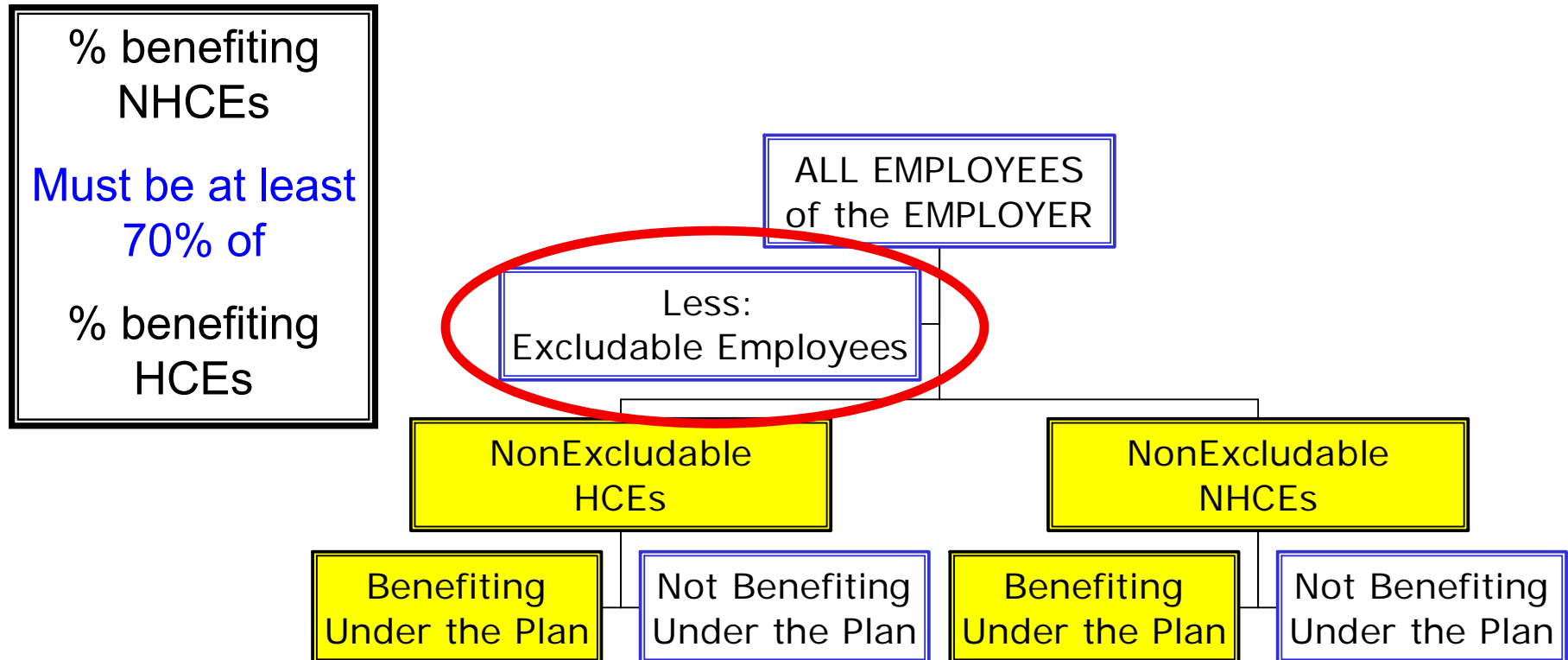
- The plan sponsor; and
- All members of the controlled/affiliated service group
- Be careful of foreign parents with other US subsidiaries



Step 2: Who Is in the Workforce?

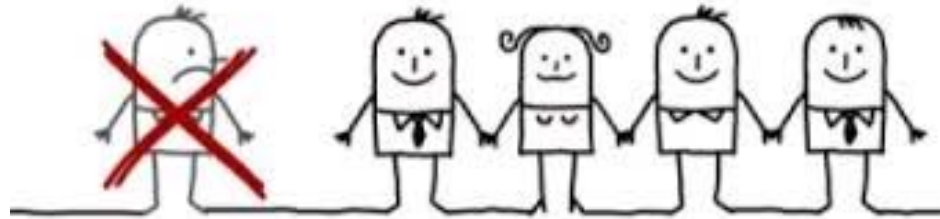
- Workforce includes all employees
- Leased employees included:
 - Leasing organization is common law employer;
 - Leasing organization contracts to make individual available to the recipient for a fee;
 - Recipient has primary direction and control over the individual; and
 - The individual performs services on a substantially full-time basis for at least one year

Step 3: Excludable Employees



Step 3: Who Is Excludable?

- Remember: this is for the coverage test *only*, and not for participation
- The question is: who is not part of the coverage test?



Step 3: Who Is Excludable?

- An excludable employee is one who, for the entire testing period:
 - a) Does not meet age/service requirements;
 - b) Collectively bargained and plan does not cover union employees;
 - c) Nonresident alien (no U.S. source income); or
 - d) Participant who is not employed on last day of the plan year, has fewer than 501 hours, and is not benefiting under the plan

Step 3: Who Is Excludable?

- 3a: Did not meet age/service:
 - Plan must have age/service requirements
 - Individuals who have completed eligibility requirements but have not yet entered are excludable
 - Example: Louise completed the eligibility requirements for the plan on 10/25/16. Her entry date is 1/1/17. Louise is an excludable employee for the 2016 calendar plan year

Step 3: Who Is Excludable?

- 3a: Did not meet age/service:
 - Note: someone who is not eligible to enter the plan due to age/service but is allowed to roll over his/her account from another plan is a limited participant and is excludable



Step 3: Who Is Excludable?

- 3b: Union employees
 - Benefits must have been the subject of good faith bargaining
 - If employee was union employee for part of the year, he/she is not an excludable employee for that year
 - Exclusion works vice-versa in union plan
 - Davis-Bacon employees are *not* collectively bargained

Step 3: Who Is Excludable?

- 3c: Nonresident aliens
 - Note: this means:
 - Not U.S. citizen (“alien”)
 - Not U.S. resident (“nonresident”)
 - Performing services and getting paid for work done outside the U.S. (“no U.S. source income”)

Note: Puerto Ricans,
Virgin Islanders,
Guamanians are not aliens



Step 3: Who Is Excludable?

- 3d: Terminated with < 501 hours and not benefiting
 - Conditions for this exclusion:
 - Otherwise eligible to participate;
 - Plan has minimum hours or last-day requirement to accrue a contribution allocation;
 - Participant fails to earn an allocation because of this requirement; AND
 - Participant is not employed on the last day of the plan year, has fewer than 501 hours, and is not benefiting

Step 3: Who Is Excludable?

- 3d: Terminated with < 501 hours and not benefiting
 - Example
 - Joe has been a participant in the plan for four years.
 - Plan has a last-day requirement for allocations.
 - Joe terminates during the year after completion of 400 hours.
 - Joe does not get a contribution allocation due to the operation of the last-day requirement.
 - Joe is an excludable employee.

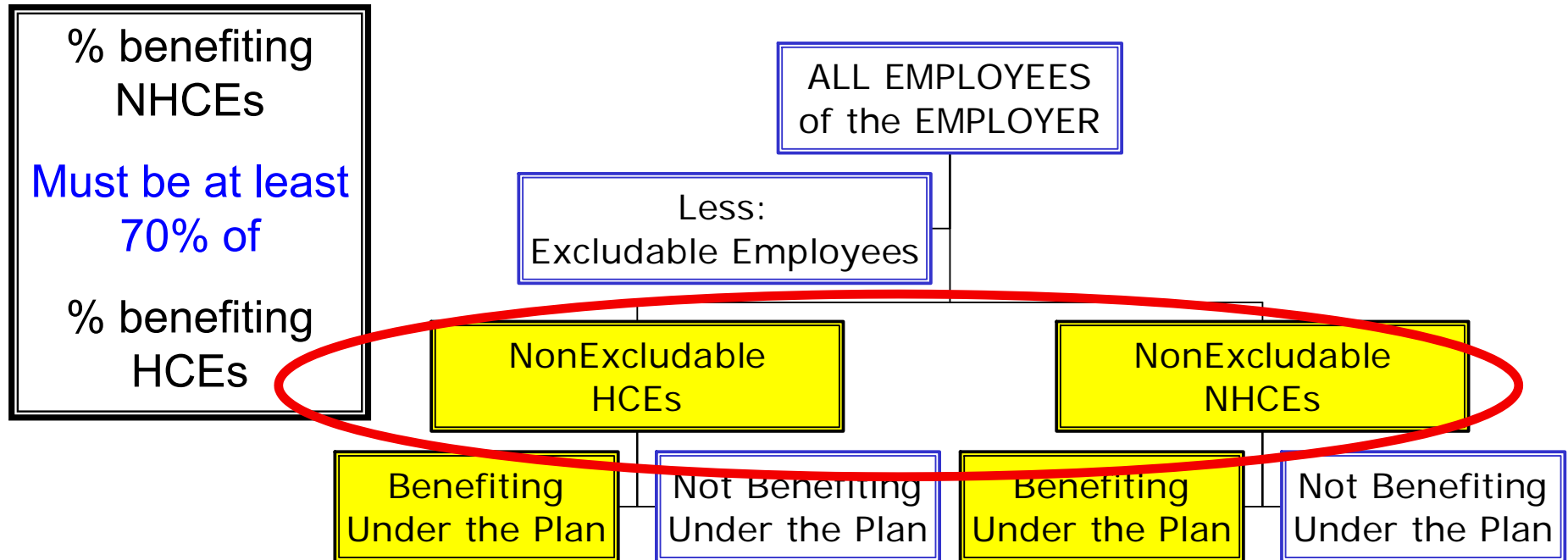
Step 3: Who Is Excludable?

- 3d: Terminated with < 501 hours and not benefiting
 - Example
 - Joe has been a participant in the plan for four years.
 - Plan has a last-day requirement for allocations.
 - Joe terminates during the year after completion of 800 hours.
 - Joe does not get a contribution allocation due to the operation of the last-day requirement.
 - Joe is an not excludable employee because he has more than 500 hours.

Step 3: Who Is Excludable?

- 3d: Terminated with < 501 hours and not benefiting
 - Example
 - Joe has been a participant in the plan for four years.
 - Plan has a 1,000 hours requirement for allocations.
 - Joe terminates during the year after completion of 800 hours.
 - Joe does not get a contribution allocation due to the operation of the 1,000 hour requirement.
 - Joe is an not excludable employee because he has more than 500 hours.

Step 4: Testing Group



Step 4: What Is the Testing Group?

- The testing group is the remaining employees after the excludable employees have been removed
- Note that this is not necessarily the people who are actually in the plan. It just represents those includable in the testing

Step 5: Characterize All Members of the Testing Group

- Each member of the testing group must be identified as either an HCE or an NHCE



Step 6: Who Is Benefiting Under the Plan?

- Whether someone is benefiting is determined separately for these parts of the plan:
 - Nonelective contributions
 - 401(k) salary deferrals
 - Matching contributions
- If the plan has each of these features, the test will need to be done three times



Step 6: Who Is Benefiting Under the Plan?

- Nonelective contributions:
 - Benefiting means *receiving an allocation of contributions or forfeitures* for the plan year
 - If there is no nonelective contribution, no one is benefiting



Step 6: Who Is Benefiting Under the Plan?

- Example:
 - A plan has last-day rule and a 1,000 hour requirement
 - Carrier and Ives are both participants in the plan
 - Carrier had 1,500 hours of service and received an allocation
 - Ives has 800 hours of service and has not terminated, but received no allocation
 - Carrier is benefiting, Ives is not

Step 6: Who Is Benefiting Under the Plan?

- Elective contributions:
 - Benefiting means *being eligible to defer*, whether the participant did so or not



Step 6: Who Is Benefiting Under the Plan?

- Example:
 - Fred entered the plan on 7/1 and was eligible to make salary deferrals for the balance of the calendar year
 - Barney was a participant in the plan and terminated employment on 3/1. He was eligible to defer up until he terminated
 - Wilma was eligible to defer until 10/20, when she became an excluded union employee

Step 6: Who Is Benefiting Under the Plan?

- Example:
 - As all three employees could have deferred had they chosen to do so during the year, they are all benefiting



Step 6: Who Is Benefiting Under the Plan?

- Matching contributions:
 - Benefiting means the participant *would receive a matching contribution* if he or she deferred, whether they actually did or not



Step 6: Who Is Benefiting Under the Plan?

- Example:
 - Hawkeye deferred \$1,000 to the plan and received a \$500 matching contribution
 - Trapper John chose not to defer, but his deferrals would have been matched had he done so
 - Hot Lips terminated before year end after deferring \$1,000. The plan has a last-day rule for matching contributions
 - Frank also terminated before year end but chose not to defer before that

Step 6: Who Is Benefiting Under the Plan?

- Example:
 - Hawkeye and Trapper John are both benefiting – they either got a match or would have gotten one had they chosen to defer
 - Hot Lips and Frank are not benefiting – they either failed to get a match or would not have gotten one had they deferred

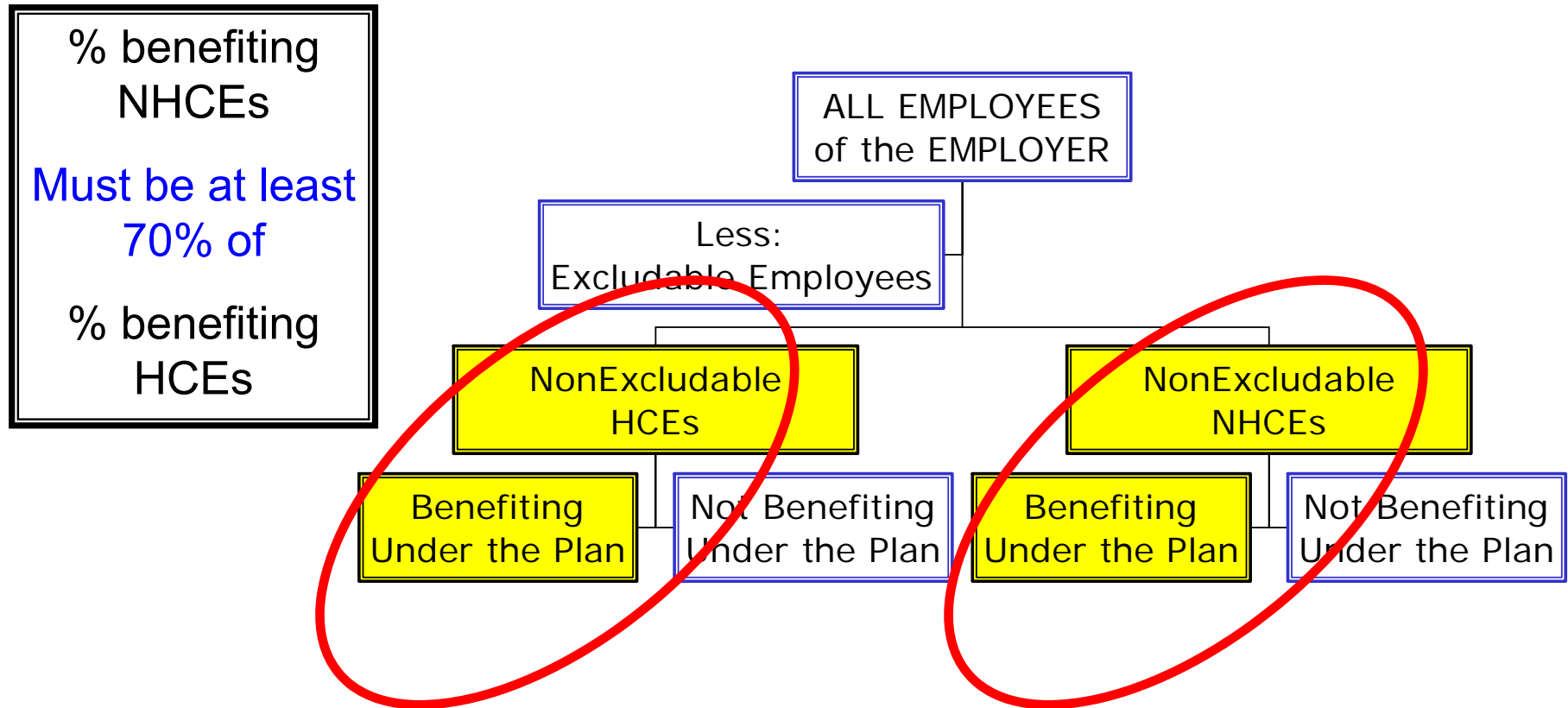
Step 6: Who Is Benefiting Under the Plan?

- Note: “benefiting” measures whether someone is getting anything in the plan
- It does not measure how much they get (as compared to anyone else)
- That is measured in the normal nondiscrimination testing (ADP, ACP, or general testing)

Step 7: Perform the Ratio Percentage Test

- NHCE ratio: $\frac{\text{\# of benefiting NHCEs}}{\text{Total nonexcluded NHCEs}}$
- HCE ratio: $\frac{\text{\# of benefiting HCEs}}{\text{Total nonexcluded HCEs}}$
- NHCE ratio/HCE ratio must be at least 70%

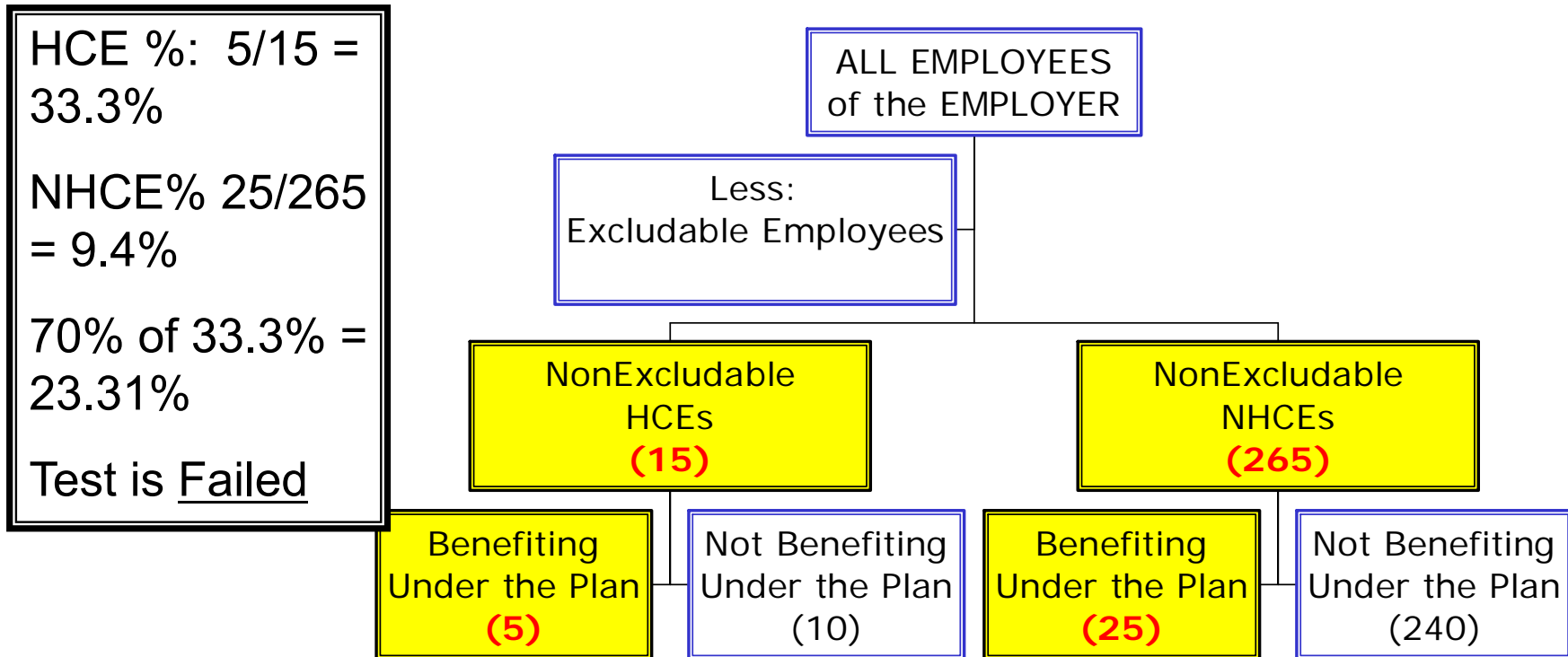
Step 7: Perform the Test



Example #1

- Employer A has 30 Employees, 5 of whom are HCEs, 25 of whom are NHCEs
- Subsidiary B has 250 Employees, 10 of whom are HCEs, 240 of whom are NHCEs
- Question: Can Employer A's Employees participate in a plan without covering the Employees of Subsidiary B?

Example #1



Example #2

- Employer A has 30 Employees, 5 of whom are HCEs
- Subsidiary B has 250 Employees, 10 of whom are HCEs
- Can **Employer B's** Employees participate in a plan without covering the Employees of **Subsidiary A**?

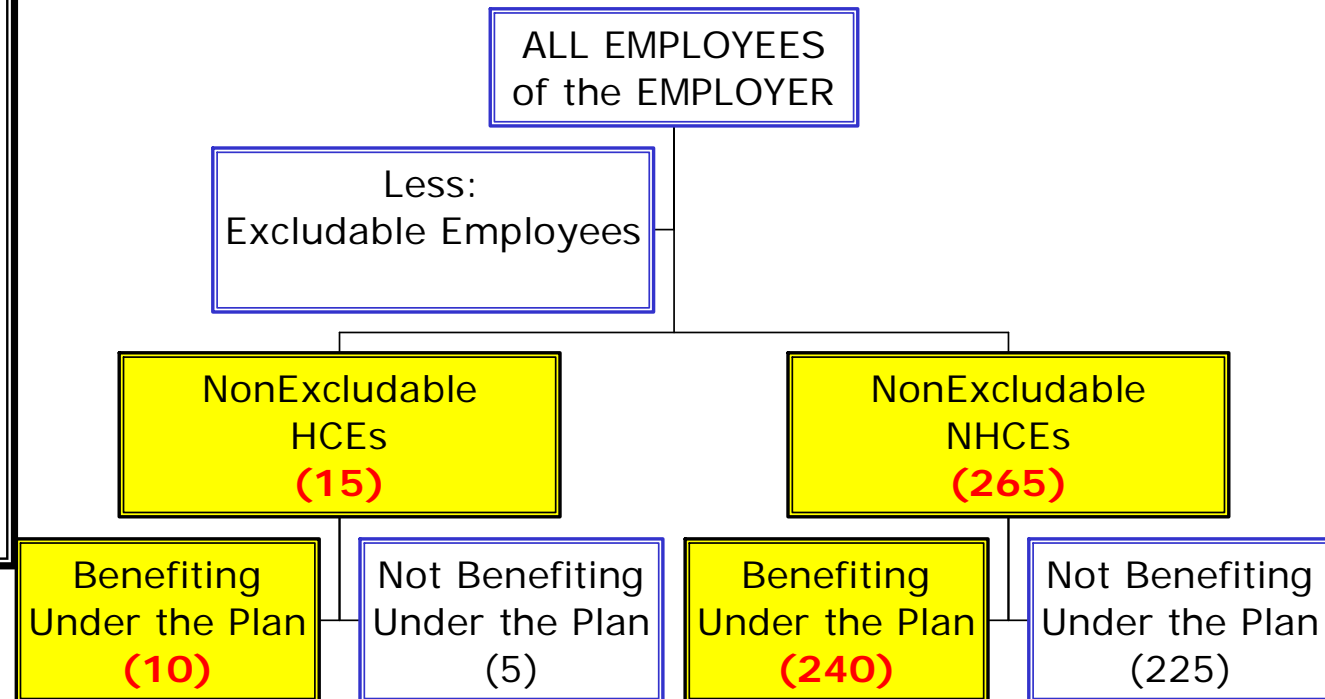
Example #2

HCE %: 10/15
= 66.7%

NHCE%
240/265 =
90.6%

70% of 66.7% =
46.69%

Test is Passed



Aggregation and Disaggregation



Mandatory Disaggregation

- Employer required to disaggregate:
 - 401(k)
 - 401(m)
 - 401(a)
- Although ADP and ACP testing permits shifting of QMACs and Elective Deferrals to pass testing, *for coverage purposes* they remain with like type funds

Permissive Aggregation

- May use two or more plans of the employer to meet the coverage test if:
 - Plans have the same plan year;
 - Plans are all qualified (no 403(b) or SEP)
 - Plans are also tested on an aggregated basis for nondiscrimination

Elective Disaggregation

- Qualified separate lines of business (QSLOBs)
 - Separate lines of business: can test QSLOBs separately as if they were separate, unrelated employers
 - Each QSLOB must have at least 50 employees



Elective Disaggregation

- Can separately test “Otherwise Excludable”
- Otherwise Excludable means: participants who would not meet statutory eligibility requirements if the plan used them
 - Do one coverage test for otherwise excludables
 - Do one coverage test for those who are not excludable even if increased eligibility requirements
 - If both tests pass, coverage is passed

Otherwise Excludable

- Note: controversy regarding entry dates
 - If someone fulfills statutory eligibility requirements; and
 - Would have entered the plan under the plan's entry dates; but
 - Would not have entered if the plan used statutory entry dates, is he/she excludable?
- Controversy was resolved by IRS in General Counsel Memorandum 201615013: Yes

Dual Eligibility Requirements

- These rules apply if:
 - One plan has multiple eligibility requirements; or
 - Two plans are being aggregated but have different eligibility requirements
 - Determine “excludables” using *least restrictive* age/service requirements

Example #3

- Plan A and Plan B are being aggregated for coverage testing
- Plan A's eligibility requirements are age 21, 1 year of service
- Plan B's eligibility requirements are age 18, 3 months of service

Example #3

- Result:
 - Everyone in test older than 18 and with 3 months of service are in testing group
 - Those in Plan A who are younger than 21 and have less than 1 year of service are not benefiting for purposes of the coverage test

Leased Employees

- Contributions or benefits provided by the leasing organization that are attributable to service performed for the recipient are treated as provided by the recipient
- Therefore, leased employees are generally considered to be benefiting

Deemed to Pass Coverage



Plans Deemed to Pass Coverage

- Collectively bargained plans
- No NHCEs in the testing group
- No HCEs benefiting in the plan

Failing Coverage



Effect of Failed Coverage

- Plan is subject to disqualification
- Under usual disqualification, only vested contributions made to a participant's account are taxed to the participant
- If plan is disqualified for coverage failure, entire vested HCE account is taxed through to the HCE, and plan is considered qualified for the NHCEs (unless disqualification has other reasons)

Correcting Failed Coverage

- Treas. Reg. §1.401(a)(4)-11(g)(3) permits a corrective amendment to be adopted up to 9½ months after the plan year end to correct failed testing
- Amendment must let in people who would otherwise not be eligible or benefit otherwise nonbenefiting participants (i.e., must provide for increased NHCE benefits)

Correcting Failed Coverage

- Examples:
 - Failed 401(k) coverage: make QNEC to some NHCEs who were not permitted to defer
 - Failed match coverage: make contribution to provide additional match to those who weren't eligible (or provide QNEC to people who were permitted to enter under amendment who did not previously receive a matching contribution in the plan)

Correcting Failed Coverage

- Examples:
 - Failed nonelective coverage:
 - May not reallocate – that takes away earned allocations from others
 - Must make additional contribution to allocate to previously excluded employees

Correcting Failed Coverage

- Some plans have “failsafe” provision:
 - If so, must follow failsafe rules in the plan
- If violation is not corrected within 9 ½ months
 - Demographic failure under EPCRS
 - Must be done through VCP (self-correction outside the 9 ½ months not permitted)
 - Will render disqualification threat not applicable

Questions?



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