EGPS
ECONOMIC GROUP
PENSION SERVICES

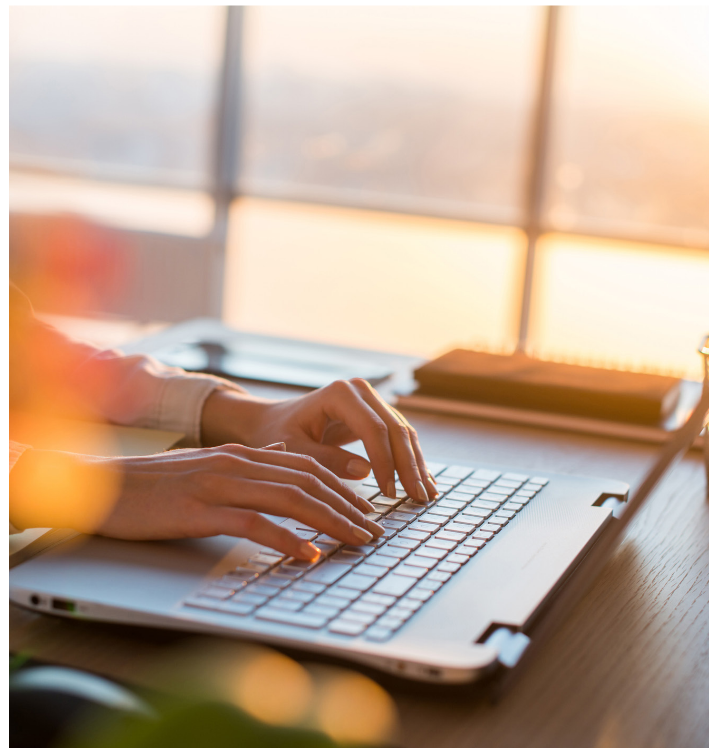
EMPLOYEE RETIREMENT COVERAGE REQUIREMENTS

What to know about retirement plan testing requirements

Pension, profit sharing, and 401(k) plans must cover enough of a company's employees to satisfy Section 410 of the Internal Revenue Code. If these requirements are not met, the plan will not qualify for tax-deductible contributions or tax-deferred earnings.

What does Section 410 say?

Section 410 requires plan coverage to be measured by comparing how many of the company's Highly Compensated Employees (HCEs) are covered versus how many of the Non-Highly Compensated Employees (NHCEs) are covered. If the percentage of NHCEs covered is at least 70% of HCEs covered, the plan will pass the test. For example, if a company establishes a plan covering 90% of its HCEs, then the plan must cover at least 63% (90% x 70%) of its NHCEs to qualify.



Which employees are included in calculating the 70% ratio?

All employees who are not "excludable" must be included. The statutory exclusions include:

- Employees under 21 years of age
- Employees with less than one year of service (a year of service is a 12-month period in which an employee works at least 1,000 hours)
- Employees covered by a collective bargaining agreement in which retirement benefits were subject to bona fide negotiation
- Employees who are non-resident aliens with no U.S. source earnings
- Employees who terminate employment with less than 501 hours of service in the plan year. This statutory exclusion does not apply to 401(k) plans.

The plan document may be written to provide for other, non-statutory exclusions. However, employees who are excluded under a non-statutory exclusion must be included in the coverage test as "not benefiting" and may cause the coverage test to fail.

For example, a company may have 10 HCEs, all covered by the plan. They may have 50 NHCEs, 10 of which are excludable because they are too young or have not completed a year of service. This leaves 40 NHCEs for the test. Since all the HCEs are covered, 70% of the non-excludable NHCEs, or 28, must be covered by the plan.

How is plan coverage defined?

For plan coverage testing purposes, an employee is "covered" if they are "benefiting" from the plan. In pension and profit sharing plans, an employee benefits if they receive plan contributions or forfeitures. Simply getting earnings on an existing account balance is not sufficient. In a 401(k) plan, an employee is considered benefiting if he or she is eligible to make 401(k) contributions and receive matching contributions, if applicable. ***Note:*** in 401(k) plans, an employee does not have to make a 401(k) contribution to be considered benefiting.

Many 401(k) plans, in addition to offering employee 401(k) contributions, also provide matching and profit sharing contributions. For coverage testing purposes, the IRS requires the coverage test be applied separately to each contribution type. If a plan has different eligibility requirements for different contributions, it is possible that the plan will pass the coverage test for one type of contribution but fail for another type.

Can employers exclude employees who leave during the year?

If the plan is written to require employment on the last day of the plan year for an employer contribution, they may. However, if too many eligible employees leave during a year, it may be necessary to contribute to pass the coverage test.

Let's look at a small company with one HCE and 10 NHCEs where all employees are eligible for the company's profit sharing plan. Assume that four NHCEs terminate employment during the year, and the plan requires them to be employed on December 31 to get a contribution for the year. If four of these terminees worked at least 501 hours during the year, they are all included in the coverage test. As of December 31, only the six remaining NHCEs share in the contribution, so the plan would fail the coverage test, as six out of 10 is less than the 70% required.

Consider the same example above, but now suppose two of the terminees who left worked less than 501 hours. These two terminees are excludable, so only eight NHCEs count for the coverage test. The plan allocates a contribution to six out of eight, or 75%, so the plan passes the coverage test.

Finally, consider the same example again, but the plan also offers employees 401(k) contributions, and the four terminees were eligible to make contributions. The 401(k) portion of the plan passes the coverage test, as 100% of the NHCEs were eligible to make contributions, but still fails coverage on the profit sharing contribution, as noted above.

If the coverage test fails, contributions can be allocated to enough terminees to pass the test, typically starting with those employed the longest.

Can employers exclude 30% of employees from the plan?

Yes, if the plan is written to exclude certain groups of employees. However, any such exclusion cannot be established retroactively and must be done carefully, as there are other legal considerations.

First, any such exclusion must not violate other federal or state laws that prohibit discrimination in employment. It is important to make sure that such exclusion, even if not explicitly based on a prohibited classification, does not create the same effect as if it were. An attorney familiar with employment law should review any proposed exclusion.

Second, such exclusions must consider the effects on the morale of the excluded employees.

Third, the percentage excluded should be significantly less than 30% to allow for changes in employee demographics. This is especially important in 401(k) plans. Suppose the coverage test fails in a 401(k) plan. In that case, the only way to correct it is for the company to amend the plan to increase the number of employees covered. As noted above, routine employee turnover can cause the plan to fail the coverage test. Additional exclusions in the plan make the test more difficult to pass when other circumstances arise.

If you're an EGPS client, all employees who worked at any time during the year must be reported to EGPS so that the coverage tests are appropriately performed.