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Coverage Testing – The Forgotten Nondiscrimination Rule

This blog post addresses retirement plans that are intended to be tax-qualified under Section 401(a) of the Internal Revenue Code (Code).

Specifically, this post will provide information related to:

- "Coverage Testing" rules under Code Section 410(b)
- Related "Controlled Group" rules under Code Section 414

Quite often, we see employers, particularly smaller employers, design and implement tax-qualified retirement plans without a basic understanding of how these rules apply to their plans. This results in confusion over if the plan is required to take corrective action under these rules in a particular plan year.

This blog post is intended to provide employers with a fundamental understanding of these rules, so that the plan sponsor can mitigate potential compliance issues at the time of the plan's implementation.

Background

In order for an employer sponsored retirement plan to be "tax-qualified," the plan must not discriminate in favor of "highly compensated employees" (HCEs), in either the plan design or administration.

"Discrimination" in favor of HCEs is generally measured in two fundamental ways:

1. The group of employees who are covered by the plan cannot discriminate in favor of HCEs (Coverage Testing)
2. The benefits provided within the plan cannot discriminate in favor of HCEs (Benefits Testing)

Plan administration service providers will usually include Benefits Testing for the plan, and most plan providers do a terrific job of monitoring compliance with the Benefits Testing rules.

For example, in a typical 401(k) plan, the provider will conduct the average deferral percentage (ADP) and average contribution percentage (ACP) tests for the plan, which measure whether contributions to the plan (both employee and employer matching contributions) discriminate in favor of HCEs. The plan provider also will examine the plan's compliance with other tax law rules, such as the "top-heavy" rules, and rules that limit maximum deferrals of participants and maximum benefits for participants.

However, quite often, and particularly with smaller employers, we do not see anyone focusing on Coverage Testing for the plan. This can create significant issues pertaining to the tax-qualification of the plan. Below is a primer on the Coverage Testing rules.

Basics of Coverage Testing

For retirement plans that are intended to be tax-qualified under Code Section 401(a), the basic Coverage Testing rules are found in Code Section 410(b).

The Section 410(b) rules have complexities that will boggle the mind, and an in-depth review is beyond the scope of this blog post. However, the basic notion is that the group of employees who are eligible to participate in the plan cannot just be limited to the company executives – the plan must be available to HCEs and non-highly compensated employees (NCHEs) alike.

Historically, Coverage Testing rules were somewhat vague. Today, the rules are much more mechanical:

1. HCEs include employees who earn more than a specific threshold (e.g., more than US$150,000 in 2023 for a determination of HCE status for 2024), as well as 5% owners of the employer's business.
2. The general Coverage Test is called a "Ratio Percentage Test." If the Plan covers all of the HCEs of the employer, it has to cover at least 70% of the NHCEs.

Note that under the Ratio Percentage Test, an employer's plan does not have to cover all of the NHCEs. The test is met if only 70% of the NHCEs are covered. That gives the employer some leeway for excluding some NHCEs.

If the plan does not cover all of the HCEs, the number of NHCEs that must be covered will go down. For example, if the plan covers 90% of the HCEs, it only has to cover 63% of the NHCEs (70% of 90%).

Coverage Testing Complications

The foregoing description of the Ratio Percentage is very simplified. There are many complications to the testing that can arise.

For example, there are detailed rules about which employees have to be counted in the testing data, and which employees can be excluded. Collectively bargained employees are almost always excluded. Employees do not have to be counted in the testing data if they have not attained age 21 or have less than one year of service.

In addition, if the plan cannot meet the Ratio Percentage Test, there is an alternative test called the "Average Benefits Test," which is more complicated. A good service provider can provide assistance to an employer to make sure that all of the complications to the Coverage Testing rules are addressed.

If a plan fails the Coverage Tests, the plan must implement corrective measures to bring the plan into compliance, which can include extending eligibility to more NHCEs or by increasing the contributions made for them. A coverage failure must be corrected within nine-and-a-half months of the end of the plan year in which the failure occurred – if left uncorrected, the plan could be subject to penalties, taxes and even disqualification.

Controlled Group Rules

To avoid any issues with the Coverage Testing rules, it is important for the plan sponsor to have all of the information needed to accurately complete the tests – this means employee demographics for the plan sponsor's employees and for employees of the other companies that may be part of the plan sponsor's controlled group or affiliated service group. The rules that determine which companies are part of the same controlled group or affiliated service group are referred to as the "Controlled Group" rules.

If you go back in time to the 1970s, it had become fashionable for some employers to try to avoid the Coverage Testing rules by simply creating multiple companies. The executives or other professionals (e.g., doctors or lawyers) could be employed by one company and participate in that company's retirement plan, and the rest of the employees could be employed by another company and be excluded from participation in the retirement plan.

The passage of Section 414(b) and Section 414(c) of the Code in 1974 addressed this attempt by employers to circumvent the Coverage Testing rules. For nondiscrimination testing purposes:

- Section 414(b) provides that a corporation and all of its 80% or more owned subsidiaries will be treated as one employer.
- Section 414(c) may treat groups of businesses as one employer, if they have common ownership by five or fewer individuals, estates or trusts. These are often referred to as "brother-sister" company rules.

For example, a parent holding corporation and all of its wholly-owned subsidiaries are treated as one employer. Thus, the parent company cannot just have a separate tax-qualified retirement plan for all for all of the executives and exclude the employees of its wholly-owned subsidiaries. For a retirement plan to be tax-qualified, retirement benefits will also have to be provided to employees at the subsidiary level.

Similarly, if an individual owns 100% of three different businesses, those three businesses have to be treated as one employer for Coverage Testing purposes.

Later on, people started to find creative ways around the Code Section 414(b) and (c) rules. Thus, in 1980, the law was amended to add Code Section 414(m). Under Section 414(m), businesses also have to be treated as single employer, if they comprise an "affiliated service group."

The Controlled Group rules in Code Section 414(b), (c) and (m) are very complex and have very detailed regulations under them. An explanation of the details of those rules is beyond the scope of this blog post. However, there is one important take away for an employer. All employers, particularly small employers, need to be aware that the Controlled Group rules exist, and may impact the retirement plan's tax-qualified status. Quite often, we see an employer contract with a plan service provider, and ignore the Controlled Group Rules, which could result in some very serious adverse tax consequences related to the retirement plan (noted above).

Thus, an employer should examine retirement plan eligibility with respect to all members of its controlled group (if any) on an annual basis, to ensure that its tax-qualified retirement plans pass the Coverage Testing requirements. Consulting legal counsel is probably the most desirable approach. Once the Controlled Group issue is examined, the employer can advise the plan service provider of the outcome and, if necessary, address it in the design of the plan.

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