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RETIREMENT PLAN NEW MINIMUM COVERAGE RULES UNDER §410(b)

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Retirement plan minimum coverage rules, under Internal Revenue Code Section 410(b), refer to the number of active employees who are actually eligible to participate in the qualified plan of a sponsoring employer. These coverage rules refer to what percent of a plan sponsor's employees are actually eligible to benefit from the employer contributions made to an ERISA qualified retirement plan. Those employees eligible to participate means those who are not excluded from the plan because of age or a minimum service requirement, like 1000 hours of service. These rules do not refer to the precise number of employees who actually have benefits credited to their accounts from employer contributions in a year. Those rules are called the minimum participation rules, under Code Section 401(a)(26), and have different standards which will be addressed in a later article.

The importance of these coverage rules is that a qualified plan must continue to maintain employees eligibility to participate above the minimum percentage levels in order for that plan and its annual income to continue to enjoy its tax deferred status under the Code. In addition, these coverage levels must be maintained in order for the employer contributions allocated to an account of an eligible employee to be treated as tax deferred and not as income to that participant.

The effective date of these new rules, as a part of the Tax Reform Act of 1986, is generally effective for plan years beginning after December 31, 1988. So calendar year plans will be measured by these standards for last year. The new annual report for 1989, Form 5500-C/R, requires that this new analysis be reported and computed on the form itself.

These new minimum coverage proposed regulations were published in the Federal Register by the Internal Revenue Service on May 18, 1989. These Regulations also contain amendments to the proposed regulations for the minimum participation requirements under Section 401(a)(26). (The minimum participation rules measure the number and percentage of those employee who actually receive a share of the employer-provided benefit, rather than simply the ability or "eligibility" to receive a benefit.)

Old Rules. The rules under the pre-1989 law specified a minimum specific percentage of employees that must be covered under the plan to have the plan continue to enjoy tax exempt status under the Internal Revenue Code. Those minimum coverage rules were met if the plan covered: (1) 70% or more of all employees or (2) 80% or more of all eligible employees if 70% or more of all employees were eligible to participate in the plan.

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For example, if an employer had 150 employees and 50 of those were not eligible to participate in the plan because of a minimum service requirement (1000 hours) or a minimum age requirement (age 21), then 100 employees would be tested as eligible to participate in the plan. To meet the old coverage test, (1) 70 employees would have to be covered by the plan or (2) if at least 70 employees were eligible, then 80% of the 70 employees, or 56 employees, would have to be covered by the plan. A plan would fail this test if a large segment of the employees were excluded from the plan by definition; e.g., waiters and waitresses in a restaurant plan, grocery clerks from a supermarket plan, or production employees in a factory plan. Such employees may be eligible to participate by the age and service hours standard, but would not be covered by the plan.

New Minimum Coverage Rules. Under these new rules, a plan is a qualified only if it satisfies one of these three tests: (1) the percentage test; (2) the ratio percentage test; or (3) the average benefit test.

The Percentage Test. The percentage test requires that a plan must benefit at least 70% of the employer's nonhighly compensated employees ("NHCEs"). This is calculated in the same way as under the old rules. If an employer has 100 employees who meet the criteria for participation in the plan, and 70 of those 100 are eligible to participate, then the percentage test is satisfied with 70% (70/100).

The Ratio Percentage Test. The ratio percentage test requires that a plan must benefit a percentage of NHCEs that is at least 70% of the percentage of the highly compensated employees ("HCEs") who benefit under the plan. If an employer has failed the Percentage Test, then it must pass this test (or the third test). This test is satisfied only if the percentage of NHCEs benefiting in the plan is 70% or greater than the percentage of HCEs benefiting in the plan.

First, determine the percentage of the NHCEs by dividing the actual number of employees benefiting under the plan by the actual number of active NHCEs. Second, determine the same percentage for the HCEs by the same method. Third, divide the NHCE percent by the HCE percent. The result must be 70% or more.

For example, if you have 100 eligible employees and 90 of those are NHCEs and 10 are HCEs. Assume that 65 of the 90 NHCEs are actually benefiting by the retirement plan and all 10 of the HCEs benefit. The percentage of the NHCEs is determined as follows: 65/90 = 72%. The percentage of the HCEs is determined as follows: 10/10 = 100%. The ratio percentage test is performed as follows: divide the NHCE percentage (72%) by the HCE percentage (100%). The result is 72%, a passing grade. However, if the number of NHCEs were to fall below 63, say, 55, then the NHCE percentage would be 61% and this employer would fail to pass this test.

An employer may only include those employees actually benefiting under the Plan. In a defined contribution plan, "benefiting" means an employee who receives an allocation of contributions or forfeitures from the plan. In a defined benefit plan, "benefiting" refers to an employee who accrues an additional benefit under the plan. 401(k) plans with an elective contribution and 401(m) plans with after-tax employee contributions and matching contributions

have a special rule: an employee is benefiting only if the individual is eligible currently to make the elective or after-tax contribution. There is a special transitional rule for plan years beginning after January 1, 1989. This rule permits employers to treat employees as benefiting if such employees fail to receive an allocation or benefit solely because they worked less than 1000 hours during that year or because they were not employed on the last day of the plan year.

The Average Benefits Test. Under the average benefit test, (a) the plan must benefit a classification of employees that the Secretary of the Treasury finds not to be discriminatory in favor of HCEs (the "nondiscriminatory classification test") and (b) the average benefit percentage of the NHCEs must be at least 70 percent of the average benefit percentage of the HCEs (the "average benefit percentage test"). (Sound like Section 89?) This is a two part test and the employer must pass both parts. This test only applies if an employer has failed both of the earlier tests.

Part 1. The first part of the average benefits test consists of two subparts both of which must be passed.

(a) The first subpart is like the Section 89 Nondiscriminatory Classification Test, a facts and circumstances test which looks at all of the relevant facts and determines whether the classification set up for the covered employees is truly based on an objective business reason. This nondiscrimination test looks to the total percentage of employees benefiting under the plan, whether the number of employees benefiting in a particular salary range is representative of the whole of the work force, and the degree of difference between the percentages of NHCEs and HCEs participating in the plan.

(b) The second subpart looks again to the relationship between the NHCE and the HCE percentages that were obtained in the Ratio Percentage Test. The regulations set out a table of "Safe" and "Unsafe Harbor" percentages. These "safe harbor percentages" allow a lower NHCE percentage to pass muster depending upon the relationship between the NHCE percent and the HCE percent. For example, the "safe harbor" percent is 50% and the "unsafe harbor" is 40%. If the NHCE percent multiplied by the HCE percent is 50% or greater, then the Plan is nondiscriminatory. If that result is 40% or lower, then the plan is discriminatory. If that result falls in between 40% and 50%, then the IRS looks to other factors of subpart one, above, to see if the plan is truly nondiscriminatory. If both of these two subparts of the test are met, then the first leg of the average benefits test is met.

Part 2. The second part of the average benefits test separately measures the actual individual percentage of the benefits received by each employee-participant. (Sound like Section 89 yet?) This average benefit percentage is determined by dividing the actual benefit percentage for the active NHCEs (whether or not they actually receive a benefit) by the actual benefit percentage of the active HCEs. The result must be 70% or greater. For each employee, both NHCE and HCE, the actual benefit percentage is calculated by totaling the benefit percentages of each group, e.g the NHCEs, divided by all active and not excluded NHCEs. The actual benefit percentage for the HCEs is determined in the same manner. The NHCEs actual benefit

percentage is divided by the HCEs actual benefit percentage. The result is the average benefit percentage and must be 70% or greater.

Special Rules. There are a number of special rules for testing former employees, terminating employees, employees involved in acquisitions and dispositions, separate lines of businesses, employers with only HCEs, ESOP plans and church plans.

These rules are in addition to the minimum participation rules (50 employee/40% test) of Section 410(a)(26) of the Tax Reform Act of 1986. These rules measure those employees who actually receive an allocation of the employer contribution.

The next item to impact the employee benefits area will be the new nondiscrimination rules. The Internal Revenue Service has promised to publish but has not, as of this writing, published the Regulations which govern the important nondiscrimination requirements under §401(a)(4).

In concluding, new minimum coverage plan rules apply to plan years beginning after January 1, 1990. In general, if 70% or more of an employer's employees are eligible to participate in that plan (whether or not they actually receive a benefit), then that plan will meet the new rules. If that percentage falls below 70%, then detailed new rules may apply to that plan which could help it pass this test.

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