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### 401(K) PLANS

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### **Some Good Deeds Do Go Unpunished**

Over the last 10 years, employers have increasingly relaxed the eligibility requirements for employees to make salary deferral contributions into the company 401(k) plan. According to the Profit Sharing/401(k) Council of America's *401(k) and Profit Sharing Eligibility Survey 2007*, the number of employers allowing immediate entry into their 401(k) plans more than doubled from 1998 through 2007. The number of plans allowing entry in the first three months of employment rose to 70.5%, while the number of plans retaining the maximum of one year of service fell to only 17%.

The average salary deferral contribution by this group of shorter-service employees, however, is often lower than that for longer-term employees. This, in turn, has a negative impact on non-discrimination testing results and potentially limits the contributions by highly compensated employees. Congress and the IRS recognized this disconnect and created several testing alternatives that allow for early participation without the non-discrimination side-effects.

In short, the Internal Revenue Code and related regulations allow separate ADP/ACP testing of "otherwise excludable employees" or "nonstatutory employees"—that is, eligible participants who would not enter the plan if they were subject to the maximum eligibility requirements of age 21 and completion of one year of service. Unlike the election to use current or prior year testing, the separate testing of these so-called otherwise excludable employees is an operational election the plan sponsor can make from one year to the next without the need to amend the plan.

### **Who Is Otherwise Excludable**

The process begins by determining which participants fall into the group of otherwise excludable employees. This is a multi-step process.

1. *Determine the latest plan entry date that can be used to measure satisfaction of the statutory eligibility requirements.* While there is some ambiguity when comparing the statutory and regulatory language, some representatives from the IRS have indicated at past benefit conferences that it is the more logical interpretation to measure satisfaction of the statutory eligibility requirements using the plan entry date system described in [Code §410\(a\)\(4\)](#), e.g., the earlier of the first day of the plan year and the date six months after the completion of the statutory eligibility requirements. This is true even if the plan otherwise uses more frequent plan entry dates such as quarterly, monthly, or daily. For a calendar-year plan testing the 2008 plan year, the latest entry date is

July 1, 2008. An internal memo from IRS Mid-Atlantic region [Memo from EPCRS Coordinator and Area Manager for the Mid-Atlantic Area, February 1, 2006] seems to confirm this interpretation.

However, at least one Treasury official disagrees, claiming the plan must determine the otherwise excludable employees using the plan's entry date definition. To be absolutely safe, plan language may provide for a defined entry date of the §410(b)(4) date for this purpose.

2. *Identify the clear-cut otherwise excludable employees.* Any participant who is under age 21 and/or who has not been employed for 12 months as of the latest entry date for the year (determined in step 1) is otherwise excludable for testing purposes for that year. Using the example from item one, above, the latest statutory entry date for the 2008 plan year is July 1, 2008. Therefore, any participant born after July 1, 1987, and/or hired after July 2, 2007, could not have satisfied the maximum age and service requirements in time to join the plan during 2008, so he or she is in the otherwise excludable group.

3. *Review longer-term, limited-service employees.* [Code §410\(a\)\(3\)\(A\)](#) generally defines the eligibility computation period (i.e., the period during which the completion of 1,000 hours of service is measured) as the 12-month period beginning on the employee's hire date and typically shifting to the plan year thereafter if the service requirement is not met in that first period. Thus, an employee who has worked for the company for several years but has never worked more than 1,000 hours during the relevant 12-month period has never completed one year of service and is also otherwise excludable.

4. *Determine if any of the otherwise excludable employees are highly compensated employees ("HCEs").* Although those in the otherwise excludable group are typically not highly compensated, there are exceptions. The child or spouse of an employee who owns more than five percent of the employer will immediately be an HCE, based on the ownership attribution rules. In addition, certain "senior-level" employees may receive signing bonuses or large enough salaries to push them over the HCE compensation threshold for the previous year, even though they worked for the employer for less than half of that year.

## Performing the Test

There are several variations available to take advantage of this rule. The first option, sometimes referred to as the "early participation rule" allows all otherwise excludable non-highly compensated employees ("NHCEs") to be excluded from the ADP and ACP tests. All employees (HCEs and NHCEs) who have satisfied the statutory age and service requirements (so-called "statutory" employees), as well as any otherwise excludable HCEs, are tested. The early participation rule may be appropriate when an otherwise excludable HCE has a very low deferral rate and his or her ratio will reduce the average for the entire HCE group.

### Example # 1

Prior Year			
	Meet Statutory Age/Service	Otherwise Excludable	Total
HCEs	15	0	15
NHCEs	25	8	33
Total	40	8	48
Current Year			
	Meet Statutory Age/Service	Otherwise Excludable	Total
HCEs	15	1	16
NHCEs	29	10	39
Total	44	11	55

### Current Year Testing

The current-year average rate of deferral for all 16 HCEs is compared to the current-year average for the 29 statutory NHCEs. The 10 otherwise excludable NHCEs are completely disregarded.

## Prior Year Testing

The current-year average rate of deferral for the 16 HCEs is compared to the prior-year average of the 25 statutory NHCEs.

The second variation, commonly known as the disaggregated plans rule, allows all otherwise excludable employees to be tested as if they were in a separate plan. To the extent the disaggregated group includes only HCEs or only NHCEs, the separate test is deemed to automatically pass the ADP/ACP tests. However, if the otherwise excludable group includes both HCEs and NHCEs, a second ADP/ACP test must be performed. This option may be preferable when an otherwise excludable HCE has a higher deferral ratio than the average for the rest of the HCE group. While the separate test for the disaggregated group may still fail, corrective refunds will be required only for the HCEs in that group instead of all HCEs in the plan as a whole.

### Example #2

The participant counts are the same as described in Example #1.

## Current Year Testing

Test #1: The current-year average rate of deferral for the 15 statutory HCEs is compared to the current-year average for the 29 statutory NHCEs.

Test #2: The current-year average rate of deferral for the single otherwise excludable HCE is compared to the current-year average for the 10 otherwise excludable NHCEs.

## Prior Year Testing

Test #1: The current-year average rate of deferral for the 15 statutory HCEs is compared to the prior-year average for the 25 statutory NHCEs.

Test #2: The current-year average rate of deferral for the otherwise excludable HCE is compared to the prior-year average for the eight otherwise excludable NHCEs.

## Proceed with Caution

Although use of the otherwise excludable rule is an operational election, there are several additional items to keep in mind. First is the requirement to perform the ADP/ACP tests using the same groups used to perform the coverage test. Specifically, a plan cannot take advantage of the early participation rule or the disaggregated plans rule unless it also utilizes the rule to satisfy the minimum coverage test under [IRC §410\(b\)](#).

A second concern is the plan document. The internal IRS memo noted above indicates that, because plan documents are required to include language describing the ADP and ACP tests, a plan cannot take advantage of either of these testing methodologies unless the document includes authorizing language. The memo goes on to say that plans not including this language can be retroactively amended to add it under the Self Correction Program of the Employee Plans Compliance Resolution System ( [IRS Revenue Procedure 2008-50](#)). Many document-drafters are now aware of this requirement and are including the requisite language as they prepare restated plans.

Plans that are top-heavy must also be cognizant of the contribution cost that may accompany early participation. While otherwise excludable employees may be disregarded or tested separately for purposes of the ADP and ACP tests, [Code §416](#) and related regulations require every non-key employee who is a participant in a top-heavy defined contribution plan to receive a minimum contribution—generally equal to three percent of compensation. While there are some limited exceptions, the minimum contribution also must be made on behalf of otherwise excludable employees.

## Conclusion

According to the Bureau of Labor Statistics' Employee Tenure Summary [Employee Tenure Summary, Table 1, Bureau of Labor Statistics, September 2006], the median job tenure for workers from age 18 to 34 is only 2.9 years. With statutory eligibility requirements that can require participants to be employed for up to 18 months before they are able to make elective deferrals, workers in this age group may be precluded from saving for retirement until their 30s. If employees are to build sufficient savings on which to retire, it is important for them to begin saving as early as possible. The otherwise excludable rule allows employers to do the good deed of allowing more immediate eligibility without being punished by negative testing implications.