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OFFICE OF THE CHIEF COUNSEL

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Dear _____ :

I am responding to your e-mail dated March 7, 2022. In your e-mail, you requested information related to testing the minimum coverage requirements under section 410(b) of the Internal Revenue Code (Code). You requested this information in connection with a plan that is not qualified under section 401(a), in order to apply the rules of section 402(b)(4). Generally, as described in Treas. Reg. § 1.410(b)-2, there are two minimum coverage tests under section 410(b), the "ratio percentage test" and the "average benefits test." A plan must satisfy one of those tests for each plan year that is being tested. If a non-qualified plan fails to satisfy one of those tests for a plan year, then the highly compensated employees of the plan are subject to section 402(b)(4)(A).

Ratio Percentage Test

Section 1.410(b)-2(b)(2) provides that a plan satisfies the ratio percentage test "if and only if the plan's ratio percentage for the plan year is at least 70 percent." Section 1.410(b)-9 defines "ratio percentage" as the "percentage determined by dividing the percentage of the nonhighly compensated employees ("NHCEs") who benefit under the plan by the percentage of the highly compensated employees ("HCEs") who benefit under the plan."

The percentage of NHCEs who benefit under the plan is determined by dividing the number of NHCEs who benefit under the plan by the total number of NHCEs of the employer. The percentage of HCEs who benefit under the plan is determined in the same manner except by substituting HCEs for NHCEs. Section 1.410(b)-2(b)(2) provides examples illustrating this test. Section 1.410(b)-6 specifies categories of

excludable employees who are not taken into account in applying the rules of section 410(b).

Average Benefit Test

Section 1.410(b)-2(b)(3) provides that a plan satisfies the average benefit test for a plan year “if and only if the plan satisfies both the nondiscriminatory classification test of § 1.410(b)-4 and the average benefit percentage test of § 1.410(b)-5 for the plan year.”

A plan will pass the nondiscriminatory classification test if the classification of employees who benefit under the plan is reasonable and nondiscriminatory. Whether a classification is reasonable depends on all of the facts and circumstances and whether the classification is based on objective business criteria that identify the category of employees who benefit under the plan. A classification is nondiscriminatory if the plan’s ratio percentage meets the safe harbor percentage test (meaning generally, the ratio percentage described above is at least 50 percent, or a lower percentage determined based on the percentage of the employees who are NHCEs) or meets the facts and circumstances test described in § 1.410(b)-4(c)(3).

In addition to satisfying the nondiscriminatory classification test, a plan must also satisfy the average benefit percentage test in order to satisfy the average benefit test. Section 1.410(b)-5(a) provides that in order to satisfy this prong, the plan must have an average benefit percentage at least equal to 70 percent. Generally, the average benefit percentage is calculated by dividing the actual benefit percentage under the plan of the NHCEs by the actual benefit percentage under the plan of the HCEs. If that resulting quotient is at least 70 percent, the plan satisfies the average benefit percentage test. For this purpose, the actual benefit percentage of a group of employees is the average of the employee benefit percentages of each employee in the group.

Applying the average benefits test is significantly more complicated than applying the ratio percentage test. It requires the determination of the employee benefit percentage for each employee benefitting under the plan and provides several methods for making this determination. Accordingly, it is recommended that a taxpayer consult a tax expert when conducting this test.

I hope this information is helpful and please reach out with any additional questions.

Sincerely,

Linda Marshall
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(Employee Benefits, Exempt Organizations,
and Employment Taxes)