

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to:

Area Counsel
(Tax Exempt & Government Entities Division Counsel)

from: Stephen B. Tackney
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subject: Testing Otherwise Excludable Employees

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Issue

You have asked whether certain positions related to the definition of “otherwise excludable employees,” used for purposes of coverage testing under § 410(b)(4)(B) and computing the actual deferral percentage (ADP) under § 401(k)(3), are supportable. Specifically, you have asked whether it is a permissible application of the statutory and regulatory provisions to treat the population of excludable employees for these purposes as comprising employees participating in the plan (1) for any period during which the participant has not attained age 21 or completed 1 year of service, and (2) for any subsequent period ending on the earlier of (A) the first day of the next plan year after attaining age 21 and completing 1 year of service, or (B) 6 months after satisfying those requirements. We conclude that this is a permissible application of the relevant statutory and regulatory provisions, although not the only acceptable application of those relevant provisions.

Background

Section 410(a)(1)(A) provides that participation in a plan cannot be conditioned on the employee completing a period of service with the employer maintaining the plan that extends beyond the later of the employee's attainment of age 21 or completion of 1 year of service. Section 410(a)(4) provides that a plan is treated as not meeting the requirements of § 410(a)(1) unless it provides that an employee who has satisfied the minimum age and service requirements of such paragraph commences participation in the plan no later than the earlier of the first day of the next plan year after satisfying such requirements or 6 months after satisfying such requirements.

Section 410(b) provides that a plan must satisfy certain minimum coverage requirements. For example, § 410(b)(1)(A) provides that a plan satisfies the minimum coverage requirements if it benefits at least 70% of the employer's nonhighly compensated employees (NHCEs). In determining if a plan meets the minimum coverage requirements, certain employees are disregarded. Section 410(b)(4)(A) provides that employees not meeting a plan's minimum age and service requirements are disregarded. Section 410(b)(4)(C) provides that an employee is not treated as meeting the age and service requirements described in § 410(b)(4) "until the first date on which, under the plan, any employee with the same age and service would be eligible to commence participation in the plan."

Section 410(b)(4)(B) provides that if a plan covers employees not meeting the minimum age or service requirements of § 410(a)(1)(A) and the plan satisfies the minimum coverage requirements of § 410(b)(1) separately with respect to such employees, then such employees may be excluded. That is, two coverage tests are performed: one basing the calculation on plan participants who are not required to be covered by the plan because they have not reached age 21 and completed 1 year of service ("otherwise excludable employees"), and a second based on all other plan participants ("non-excludable employees").

Section 401(k)(3)(F) allows an employer to exclude from the ADP test NHCEs "who have not met the minimum age and service requirements of section 410(a)(1)(A)" if the employer applies § 410(b)(4)(B) in determining whether the plan meets the coverage requirements of § 410(b)(1).

Section 1.410(b)-6(b)(3) provides that an employer may treat a plan benefitting otherwise excludable employees as two plans, one for the otherwise excludable employees and one for the other employees benefitting under the plan. Section 1.410(b)-6(b)(3) also provides that the effect of this rule is that employees who would be excludable but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be treated as excludable employees with respect to the plan.

Section 1.410(b)-7(c)(3) similarly provides for disaggregation and separate testing of plan populations consisting of employees who have satisfied the plan's age and service conditions but not the greatest minimum age and service conditions permitted under

§ 410(a), and employees who have satisfied the greatest minimum age and service conditions permitted under § 410(a).

Section 1.401(k)-2(a)(1)(iii) provides that if a § 401(k) plan covers employees before they have completed the minimum age and service requirements of § 410(a)(1)(A) and the plan applies § 410(b)(4)(B) in determining if it meets the minimum coverage requirements of § 410(b)(1), then the plan can either perform one ADP test pursuant to § 401(k)(3)(F) or perform two ADP tests, one on each group of participants determined under § 410(b)(4)(B).

For example, assume a plan with a calendar-year plan year allows employees to make elective deferrals immediately upon hire, and an employee aged 24 is hired on August 10, 2014. In performing the minimum coverage and ADP tests for 2014 plan year, pursuant to § 410(b)(4)(B) the employee is in the “otherwise excludable employee” group. You have asked whether it is an acceptable application of the statutory and regulatory provisions to also treat the employee as remaining in the “otherwise excludable employee” group for an additional year, until 2016, based on statutory and regulatory authority to exclude an employee until the earlier of the first day of the first plan year or 6 months after the employee attained age 21 and completed 1 year of service.

Analysis

Section 410(b)(4)(B) describes the covered employees that may be tested separately (the “otherwise excludable employees”) as those “not meeting the minimum age and service requirements of [§ 410(a)(1)(A)].” For this purpose, one could argue that the reference to the applicable minimum age and service requirements of § 410(a)(1)(A) incorporates the provisions of § 410(a)(4) since an employer is not required to make the employee eligible immediately upon reaching age 21 and 1 year of service, but rather may apply a waiting period of up to the earlier of 6 months or the first day of the plan year after meeting the requirements. Under this reading, the time an employee remains an “otherwise excludable employee” would be extended beyond age 21 and 1 year of service to include the period ending on the earlier of the first day of the next plan year or the date that is 6 months after initially meeting the age and service requirements.

Section 1.410(b)-7(c)(3) (issued in 1991) describes otherwise excludable employees as “employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permissible under section 410(a).” (Emphasis added.) Similar language is used in § 1.410(b)-6(b)(3). The use of the word “greatest” together with reference to § 410(a) (which includes the statutory entry dates of § 410(a)(4)) can be read to mean that employees are in the otherwise-excludable-employee group until completion of the § 410(a)(4) period.

To the extent a statute or regulation interpreting the statute is ambiguous, it is appropriate to consider legislative history. The legislative history accompanying

§ 410(b)(4)(C), which was added by TAMRA, effective for plan years beginning after December 31, 1988, includes this statement: “For purposes of the separate testing of excludable employees, employees who have not attained the statutorily permitted entry dates may be considered excludable employees.” H.R. Rep. No. 100-795 (1988). This provides further support for the proposed application of the statutory language.

The special rule in § 401(k)(3)(F) for early participation requires the employer to use § 410(b)(4)(B) in order to take advantage of the rule that NHCEs who have not met the minimum age and service requirements of § 410(a)(1)(A) are excluded from the ADP test. Since § 401(k)(3)(F) both requires the use of § 410(b)(4)(B) and uses the same terms to partition groups of employees, it follows that the same cut-off points should be used in defining the testing populations. In other words, if an employee is an “otherwise excludable employee” under § 410(b)(4)(B) until the applicable § 410(a)(4) date, then an NHCE is excluded from the ADP test until the same date. See, General Explanation of Tax Legislation Enacted in the 104th Congress, (JCS-12-96) Dec. 18, 1996, pp 179-180, for an explanation of § 401(k)(3)(F).

Section 1.410(b)-6(b)(3)(ii) provides how separate testing under § 410(b)(4)(B) works and, in illustrating these rules, *Example 4* in § 1.410(b)-6(b)(4) defines the group of otherwise excludable employees as those who either do not have 1 year of service or are not at least age 21. This example does not explicitly provide that the § 410(a)(4) period is tacked on to age 21 and 1 year of service to keep employees in the “otherwise excludable employee” group, and therefore does not expressly support that proposition. However, the example could be read as not contrary to the conclusion in this memo because, arguably, there are insufficient facts to determine if it addresses the issue.

Conclusion

It is an acceptable application of the statutory and regulatory provisions to treat the population of otherwise excludable employees for purposes of coverage testing under § 410(b)(4)(B) and performing the ADP test under § 401(k)(3) as including employees participating in the plan who have not satisfied the § 410(a)(4) period applicable to them (meaning through the earlier of the date 6 months after the participant attains age 21 and completes 1 year of service or the first day of the first plan year after the participant attains age 21 and completes 1 year of service).

We note that there are other readings that may also be acceptable applications of the statutes and regulations. For example, one could take the position that (1) a covered employee is an otherwise excludable employee only until the date on which he or she attains age 21 and completes 1 year of service (that is, no period is tacked on to the maximum age and service conditions specified in § 410(a)(1)(A)); or (2) a covered employee is an otherwise excludable employee for the period through the date on which he or she attains age 21 and completes 1 year of service and any additional waiting period specified in the plan before an employee who has satisfied the plan’s minimum age and service requirements actually enters the plan (that is, the plan’s waiting period, if any (and only the plan’s waiting period, if any), is tacked on to the maximum age and

service conditions specified in § 410(a)(1)(A)).

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