Journal of Pension Benefits - Ferenczy and Pozek, We've Got Testing Options…Otherwise, We'd Exclude You, (Jul. 1, 2012)

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Plan sponsors looking to attract new employees may want to offer more liberal eligibility requirements without significantly increasing costs or limiting the contributions of longer-term employees. The otherwise excludable rule may alleviate some of these concerns by allowing plan sponsors to disregard the typically lower participation rates of shorter-term employees in certain nondiscrimination tests.

Anyone who prepares nondiscrimination testing for defined contribution plans is used to dealing with the statutory eligibility and entry requirements of age 21 and one year of service (12 months with 1,000 hours of service) with entry dates set semi-annually. In fact, if a new client comes to you looking to set up a 401(k) plan, I would be willing to bet that your standard suggestion is to implement those statutory eligibility requirements. And, most often, the plan sponsor will accept that suggestion. However, some prefer to allow their employees to join earlier, perhaps to coincide with eligibility for company health benefits or because they expect low turnover. At one time, especially in 401(k) plans in which the owners' elective deferral contributions are limited based on the rate of staff deferrals, you might have urged them to reconsider. As a stereotype, new hires are less likely to defer at all, never mind at a rate significant enough to improve ADP testing results. Owners seeking to provide new employees the opportunity to defer were often impaired in their own ability to defer because of this generosity.

The IRS, in an effort to mitigate the damage associated with more generous eligibility requirements, added a testing methodology that allows plans to split their testing population into two groups: those who have met the statutory eligibility requirements (nonexcludable) and those who have been permitted to enter the plan under its more generous eligibility provisions who would not have met the statutory requirements (otherwise excludable).

The general idea is that you can permit newer employees to participate in the plan but separate them from the general population for testing purposes, in essence, creating two separate "plans." Each plan must pass the applicable nondiscrimination tests, e.g., minimum coverage, ADP/ACP, etc., on a stand-alone basis. The more seasoned employees, who may be more likely to contribute to the 401(k) (helping the ADP test) and to whom the employer is more inclined to provide contributions as a benefit for continued service, can be tested together. The second plan is comprised of those otherwise excludable employees who may be tested as a separate group while not impacting the level of benefits available to the seasoned employees.

If a plan provides for more generous eligibility requirements, it may elect to test using permissive disaggregation (testing the otherwise excludable employees as a separate plan). This is an operational election that may be made in some years and not in others, as circumstances may dictate. In fact, this method can be used for each plan component that is subject to mandatory disaggregation, e.g., nonelective contributions, elective deferrals, and employer matching contributions. So long as the plan component satisfies the minimum coverage test using permissive disaggregation, the applicable nondiscrimination test (e.g., ADP, ACP, general nondiscrimination) can be performed on a disaggregated basis.

Determining Otherwise Excludable Status

Consider a calendar year plan that allows eligible employees to become participants on January 1 or July 1 coincident with or next following completion of six months of service and attainment of age 18. Employees who enter the plan under these requirements but have not completed any one of the following requirements by July 1 of a given plan year are otherwise excludable for that year:

- Employed for at least 12 months;
- Completed at least 1,000 hours of service in an eligibility computation period (first one year of service and, usually, plan years, thereafter); or
- Attained age 21.

Although eligible for the plan, such employees are disaggregated and tested separately. The statutory entry dates shown below indicate when these participants are no longer able to be disaggregated.

Early Participation Rule

There are two variations for utilizing the otherwise excludable rule in nondiscrimination testing. Under the first option, as described above, the entire participant population is divided into the nonexcludable and otherwise excludable groups, with the highly compensated employees (HCEs) being tested against the non-HCEs (NHCEs) in their respective group. Although one or both groups may still fail testing, the failures are either usually less severe or they apply to the shorter-service employees.

Alternatively, all HCEs can be considered under the nonexcludable plan, and only the NHCEs who are otherwise excludable are disaggregated. Since there are no HCEs in this second testing group, it automatically satisfies nondiscrimination testing. This NHCE-only "carve out" is sometimes referred to as the early participation rule.

In many cases, the two methods generate the same result since it is unusual for a plan to include an HCE who has not met the statutory eligibility requirements. However, do not take it for granted, since there are occasions when HCEs may be otherwise excludable, e.g., HCEs through family attribution of stock, and including these participants in the nondiscrimination testing may greatly improve the results. Consider an owner's child who joins the plan under a six-month elapsed time eligibility requirement but works minimal hours and does not defer. Using the early participation rule rather than the otherwise excludable method results in the inclusion of an HCE with a zero percent deferral rate while carving out similarly situated NHCEs, leading to improved test results.

One interesting example of the early participation rule occurs in a startup plan for a new company. The company is formed and immediately adopts a 401(k) plan in the same year. The plan is written to allow all active employees as of a specified date (e.g., the initial plan effective date) to join the plan. Since the company is new, none of the employees could have satisfied the statutory eligibility requirements in the initial year, and they cannot be HCEs based on compensation since none of them received compensation from the employer during the preceding year. That leaves the owners as the only HCEs in the first year. All NHCEs can be carved out, leading to automatic passage of the applicable tests. If the company and plan are established in the later half of the initial year (as illustrated below), all employees remain otherwise excludable in the second year, resulting in automatic passage in that year as well.

Maintain Records

This goes without saying for all things retirement plan related. Thorough records must be maintained to support the determination of those that are tested as "otherwise excludable." Plan sponsors must understand that while they can simplify some administrative recordkeeping by counting service using the elapsed time method, being able to provide detailed records of employees' service histories can be critical to the use of these testing methods. In order to take advantage of the potential benefits of using the otherwise excludable rule, records must support the division of participants into the excludable and nonexcludable groups.

Date of Birth	Date of Hire	Service	Plan Entry	Statutory Entry
Jul 15, 1987	Apr 13, 2011	1,000+ per year	Jan 1, 2012	Jul 1, 2012
Jul 15, 1992	Apr 13, 2011	1,000+ per year	Jan 1, 2012	Jan 1, 2013
Jul 15, 1987	Dec 13, 2011	1,000+ per year	Jul 1, 2012	Jan 1, 2013

Jul 15, 1987	Dec 13, 2011	<1,000 per year	Jul 1, 2012	*None* until Hours Met

Company Formed	**Plan Effective Date**	**One Year Minimum**	**Minimum Statutory Entry**
August 17, 2010	September 1, 2010	August 16, 2011	January 1, 2012

Watch Out for Pitfalls

The otherwise excludable rule does not provide relief from the top heavy requirements under Code Section 416. If a plan is top heavy, all nonkey employees must generally receive a minimum employer contribution equal to up to three percent of compensation (assuming key employee(s) receive allocations). This does not apply only to those meeting the statutory eligibility requirements; it applies to all nonkey employees who are eligible for any component of the plan, determined using the plan's stated eligibility criteria. Thus, if an employer intends to provide more generous eligibility requirements only for the 401(k) portion of the plan, the top heavy status must be taken into consideration.

Another potential limitation to recall is that neither version of the otherwise excludable rule can be used under the Employee Plans Compliance Resolution System when a plan has not timely corrected a failed ADP test, i.e., within 12 months following the year of the failure. [IRS Revenue Procedure 2008-50, Appendix A.03] Specifically, a plan that initially failed the ADP test for a given plan year and could have corrected the failure via a relatively small refund using the otherwise excludable rule if corrected timely may have a much more significant correction under EPCRS since the otherwise excludable rule is no longer available.

Conclusion

There are certainly other factors to consider when establishing eligibility requirements that are less strict than the statutory maximums. Smaller balances may drive up costs; higher turnover may mean more abandoned accounts; and the cost of employer contributions, especially in a top heavy plan, may increase. However, nondiscrimination testing alone should no longer be a deterrent in setting up plans with less restrictive eligibility, especially in an environment where the potential to become eligible sooner may be an attractive benefit for those looking to change jobs to work with a new employer.