

Pension
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IRS Publishes Final Rules on Coverage Testing For Tax-Exempt Entities

The Internal Revenue Service (IRS) has published final revisions to the qualified plan minimum coverage rules. These rules affect controlled groups that include both a 501(c)(3) tax-exempt employer that is eligible to sponsor both a 401(k) plan and a 403(b) arrangement, and a for-profit employer that can sponsor a 401(k) plan, but not a 403(b) plan.

The IRS issued this guidance to comply with a directive issued under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA directed the IRS to modify the minimum coverage rules to provide that employees of a 501(c)(3) tax-exempt organization who are eligible to make salary reduction contributions under a 403(b) arrangement may be treated as excludable employees when performing minimum coverage testing for a 401(k) or 401(m) plan.

These final rules apply retroactively to plan years beginning on or after December 31, 1996, which is the effective date of the provision that permitted tax-exempt employers to maintain 401(k) plans. However, there is a transitional rule for plan years beginning after December 31, 1996, and before January 1, 2007, which allows an employer to determine excludable employees using the provisions of either the proposed or final rules. The proposed rules required that only employees of the tax-exempt employer that maintained the 403(b) arrangement be excluded from the 401(k) plan. However, the final rules are more restrictive and require that all tax-exempt employers within the controlled group be excluded from the 401(k) plan.

The rules clarify that employees who are eligible to make salary reduction contributions under a 403(b) arrangement may be treated as excludable employees for purposes of minimum coverage testing for a related employer's 401(k) plan and associated 401(m) plan. This treatment allows a controlled group of employers to offer a 403(b) arrangement to employees of its tax-exempt organizations and one or more 401(k) plans to employees of its for-profit employers without having to provide coverage for the tax-exempt employees under both plans.

Employees of a tax-exempt organization are considered excludable employees for 401(k) and 401(m) plan minimum coverage testing if they are eligible to make contributions to a 403(b) arrangement and:

- No employee of the organization is eligible to participate in the 401(k) or 401(m) plan; and
- At least 95% of the for-profit employer's employees are eligible to participate in the 401(k) or 401(m) plan.

For example: A non-profit 501(c)(3) hospital maintains a 403(b) arrangement and its wholly owned for-profit clinic maintains a 401(k) plan for its employees. The hospital employees are excludable employees under the final rules for purposes of coverage testing for the clinic's 401(k) plan.

However, if there are two or more tax-exempt organizations in a controlled group, the special testing rule does not allow employees of one or more of the tax-exempt organizations to be covered by the 401(k) plan and treat the employees of the other tax-exempt organization as excludable employees.

For example: A controlled group includes three tax-exempt organizations, X, Y and Z and one taxable entity, Company P. Company P sponsors a 401(k) plan that covers its employees and the employees of organizations X and Y. The remaining tax-exempt organization Z sponsors a 403(b) arrangement for its employees. Since the 401(k) plan covers employees of X, Y and P, the plan cannot treat the employees of company Z who are eligible under the 403(b) arrangement as excludable employees, even if 95% of the nonexcludable employees of Company P are covered by the 401(k) plan.

A 401(m) plan is eligible for this special testing rule only if it includes only matching contributions that are made as the result of elective deferrals made to the 401(k) plan. A 401(m) plan that includes matching contributions made on account of both 401(k) plan deferrals and 403(b) salary reduction contributions is not eligible for this special rule. The guidance does not address the impact of employee post-tax contributions on this special testing rule. As a result, if there are no matching contributions but only employee post-tax contributions, it appears that the special testing rule does not apply. In the event there is both a 401(k) match and employee post-tax contributions, the special testing rule appears to apply only to the 401(k) match.

The guidance also confirms that employees of a tax-exempt organization who are nonresident aliens or who routinely work less than 20 hours per week are not taken into account for minimum coverage testing for the controlled group's 401(k) plan unless they are actually eligible to make salary reduction contributions to the 403(b) plan.

Next Steps

Plan sponsors should read the [guidance](#) described in this publication to determine the impact on their plans. For plan years beginning before January 1, 2007, which could include plan years beginning in both 2005 and 2006, some plan sponsors will have to choose whether to follow the proposed rules or the more restrictive final rules for performing minimum coverage tests for their 401(k) plans and associated 401(m) plans. Sponsors of plans that will not be eligible to use the special testing rule for plan years beginning on or after January 1, 2007, may even want to consider making plan design changes. If you have questions regarding the application of this special testing rule to your plan, please contact your Prudential Retirement representative.

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