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Multiemployer 401(k) Plan Nondiscrimination Testing

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Introduction

Section 401(k) of the Internal Revenue Code of 1986, as amended (the "Code") allows employers to establish qualified plans that permit employees to defer a portion of their compensation on a pretax basis. 401(k) plans may also provide for employer matching contributions, employee profit sharing contributions, Roth contributions, and after-tax employee contributions. A 401(k) plan may be established by a multiemployer plan, which is maintained by one or more collective bargaining agreements and to which as few as two employers are obligated to contribute.[1] To be "qualified" and receive favorable tax treatment, a 401(k) plan must satisfy various requirements under the Code. Generally, a qualified 401(k) plan must fulfill certain nondiscrimination requirements designed to prevent plans from discriminating in favor of "highly compensated employees"[2] with respect to coverage and contributions or benefits.

Increasingly, unions have been negotiating in collective bargaining for participation in multiemployer 401(k) plans.[3] In addition to complying with all the requirements applicable to a single employer plan, a multiemployer plan is also subject to special rules under the Code. Moreover, when a multiemployer plan includes noncollectively bargained employees in addition to collectively bargained employees, the legal issues involved become more complex. Trustees and plan administrators must pay particular attention to the special rules applicable to multiemployer plans when conducting nondiscrimination testing.

Section 413 of the Code provides special rules for collectively bargained plans.[4] Specifically, Code Section 413(b) states that a multiemployer plan is treated as a single plan for purposes of the Code Section 410 minimum coverage requirements and the nondiscrimination requirements of Code Sections 401(a)(4) and 411(d)(3). Moreover, under Code Section 413(b), employees cov-

[1] A multiemployer plan is a plan to which more than one employer contributes pursuant to one or more collective bargaining agreements. ERISA § 3(37)(A), 29 U.S.C. § 1002(37)(A), and ERISA § 4001(a)(3), 29 U.S.C. § 1301(a)(3); I.R.C. § 414(f)(1).

[2] The term "highly compensated employee" means any employee who (a) was a 5 percent owner in the current or preceding year, or (b) received compensation for the preceding year in excess of $120,000 from the employer, and if the employer elects, was in the "top-paid group" for that year. I.R.C. § 414(q)(1); IRS Announces 2015 Pension Plan Limitations, IRS New Release IRS-2014-99 (Oct. 23, 2014) and IRS Notice 2014-70.

[3] Internal Revenue Manual, Part 4 Examining Process, Chapter 72 Employee Plans Technical Guidelines, Section 14.2.2; Private Pension Plan Bulletin, 2008 data, U.S. Department of Labor, December 2010; It is estimated that there 150 multiemployer 401k plans have been established. http://www.401khelpcenter.com/mpower/feature_042401.html#.VSAPZ9J0x9A.

[4] See I.R.C. §§ 413(b)(1) and 413(b)(2); Employee Plans; Examination Guidelines, IRS Announcement 96-25, § 322 (April 22, 1996).

ered under a collective bargaining agreement who are subject to the same benefits computation formula, and who are employed by participating employers, are considered to be employed by a single employer.

Minimum Coverage

General Rules

Section 401(k) plans are prohibited from discriminating in favor of highly compensated employees, which means that contributions must be available to a nondiscriminatory group within the meaning of Code Section 410(b).

The minimum coverage test compares the percentage of eligible highly compensated employees who are benefitting under the plan (i.e. eligible to make deferrals or receive contributions) to the percentage of eligible nonhighly compensated employees who are benefitting under the plan.[5]

The ratio obtained by dividing the average percentage of nonhighly compensated employees by the average eligible highly compensated employees who are benefitting needs to be greater than 70 percent to pass the coverage test.[6]

Employees who do not get a benefit because they do not meet a plan's allocation conditions (e.g., a requirement to complete 1,000 hours in a plan year or a requirement to be employed on the last day of the plan year) are counted in the test as not benefitting. For example, in year 1, Plan ABC benefits 75 percent of an employer's nonhighly compensated employees and 100 percent of the employer's highly compensated employees. ABC's ratio percentage for the year is 75 percent (75 percent/100 percent), which passes the minimum ratio percentage test. If in year 2, ABC benefits 40 percent of an employer's nonhighly compensated employees and 60 percent of the employer's highly compensated employees, then ABC's ratio percentage for the year would be only 66.67 percent (40 percent/60 percent), which would not pass the minimum ratio percentage test.[7]

If the plan does not pass the minimum ratio percentage test, then the plan must satisfy a more complicated average benefit test to determine that the actual amount of benefits allocated in the plan does not disproportionately favor the highly compensated employees.[8] The average benefits test must be satisfied with respect to each contribution source under the plan (i.e., pretax deferrals, matching contributions, profit sharing contributions).

Special Rules for Multiemployer Plans

The minimum coverage and nondiscrimination requirements do not apply to the portion of a multiemployer plan that benefits only "collectively bargained employees."[9] Coverage with respect to the collectively bargained employees in the 401(k) plan automatically passes the minimum coverage test.[10]

A multiemployer plan that benefits both noncollectively bargained and collectively bargained employees, however, must satisfy the requirements of Code Sections 401(a)(4) and 410(b) with respect to the noncollectively bargained employees. The Code requires a multiemployer plan that includes noncollectively bargained employees to apply the mandatory disaggregation rules, which provide that the plan will be treated as two separate plans (i.e., one benefiting collectively bargained employees and one benefiting noncollectively bargained employees).[11] Each employer participating in the plan must satisfy the minimum coverage and nondiscrimination requirements with respect to the employer's nonbargained employees. An IRS agent examining a plan may review employment and payroll records for evidence of contributions from sources other than employers subject to collective bargaining agreements (e.g., the union or benefit fund office) to determine if there are any noncollectively bargained employees.[12] It is helpful if collectively bargained employees are coded and identified as such for purposes of testing. Under the applicable rules, generally all employees of the particular employer being tested, whether or not covered by the plan, are included.[13]

Nondiscrimination Testing

A qualified 401(k) plan must satisfy the nondiscrimination requirements of Code Section 401(a)(4). This section provides that a plan will not maintain its qualified status unless the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees.[14] The purpose of the nondiscrimination rules is to ensure that the right to participate in the 401(k) plan is available to enough of the nonhighly compensated employees so that the benefits of the tax qualified plan do not favor the highly compensated employees. To satisfy these nondiscrimi-

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[5] Treas. Reg. § 1.410(b)-9 (ratio percentage definition).
[6] *See* I.R.C. § 410(b); Treas. Reg. § 1.410(b)-2(b)(2).
[7] Treas. Reg. § 1.410(b)-2(b)(2)(ii), Examples.
[8] Treas. Reg. § 1.410(b)-2(b)(3).
[9] *See* I.R.C. § 410(b)(3); Treas. Reg. § 1.410(b)-6(d)(1). The term "collectively bargained employee" means an employee who is included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, provided that there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers. Treas. Reg. § 1.410(b)-6(d)(2).
[10] *See* Treas. Reg. §§ 1.410(b)-2(b)(7); 1.401(a)(4)-1(c)(5). Under certain circumstances, however, collectively bargained employees may not be disregarded for purposes of testing if more than 2 percent of the employees covered under a collective bargaining agreement are professional employees. *See* Treas. Reg. § 1.410(b)-6(d)(2)(iii)(B)(1).
[11] *See* Treas. Reg. § 1.410(b)-7(c)(4)(ii)(B).
[12] Internal Revenue Manual, Part 4 Examining Process, Chapter 72 Employee Plans Technical Guidelines, Section 4.72.14.5.6.
[13] A collectively bargained employee is an "excludable employee" with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees. *See* Treas. Reg. § 1.410(b)-6(d)(1); IRS Announcement 96-25, § 340.
[14] I.R.C. § 401(a)(4).

nation rules, the plan can satisfy an objective nondiscrimination test or a "safe harbor."

The objective test for determining whether elective deferrals are nondiscriminatory is the actual deferral percentage ("ADP") test.[15] The objective test for determining whether matching contributions and after-tax contributions are nondiscriminatory is the actual contribution percentage ("ACP") test.[16] These tests, which are discussed below, generally compare the level of contributions made on behalf of highly compensated employees with the level of contributions made on behalf of nonhighly compensated employees.

Special issues arise when testing multiemployer plans.

ADP Testing

General Rules

To perform the ADP test, first, the actual deferral ratio ("ADR") for each employee eligible to defer at any time during the plan year must be computed,[17] which is determined by dividing the employee's elective deferrals, including any Roth contributions but excluding catch-up contributions, by the employee's compensation for the entire plan year.[18] If the employee did not elect to defer any contributions, then such employee has an ADR of zero. Next, the average deferral percentage must be determined for each of the groups of highly compensated employees and nonhighly compensated employees.[19] This average is determined by adding the ADRs of each employee in the group and dividing by the total number of employees in that group (the ADP).[20] To pass the ADP test, the ADP for the highly compensated group cannot exceed the greater of (a) the basic limit, which is 1.25 times the ADP of the nonhighly compensated group or (b) the alternative limit, which is the lesser of (i) 2 plus the percentage points of the ADP of the nonhighly compensated group or (ii) two times the ADP of the nonhighly compensated group.[21] For example, if the ADP of the nonhighly compensated group is 1.80 percent, then the maximum ADP for the highly compensated group is 3.60 percent.

As an alternative to ADP testing, plans are able to automatically satisfy the ADP test by using a design-based safe harbor. One safe harbor plan design requires certain notices and a minimum contribution to employees that is immediately and fully vested.[22] Another safe harbor design applies to certain automatic enrollment plan designs.[23]

Special Rules for Multiemployer Plans

When conducting the ADP test of a multiemployer plan, the composition of the plan matters. Under Code Section 413(b), a plan maintained pursuant to a collective bargaining agreement that includes only collectively bargained employees may be treated as a single plan and the ADP test therefore may be conducted on either a plan wide basis or an employer by employer basis.[24] If the multiemployer plan includes both collectively bargained employees and noncollectively bargained employees, then the plan is disaggregated into two separate plans.[25]

If the multiemployer plan includes more than one collective bargaining unit, the plan is treated as comprising separate plans for each unit and the ADP testing is then generally applied separately with respect to each collective bargaining unit.[26] The plan, however, has the option of treating two or more separate collective bargaining units as a single collective bargaining unit, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year.[27] Thus, the plan may test all of the bargaining units as separate plans, or to simplify the test, all of the units may be aggregated and the ADP testing can be conducted on a plan wide basis as a single plan.

ACP Testing

General Rules

To perform the ACP test, first, the actual contribution ratio ("ACR") for an employee who met the plan's requirements to receive a matching contribution for the plan year or who was eligible during the plan year to make voluntary after-tax contributions (other than Roth contributions) must be computed.[28] If an employee does not elect to make elective deferrals into the plan and therefore does not receive matching contributions, the employee is still considered to be eligible employee for the ACP test.[29]

The ACR is determined by dividing the sum of employee's matching and after-tax contributions deferrals, by the employee's compensation for the entire plan year.[30] If the employee did not elect to defer any matching or voluntary contributions, then such employee has an ACR of zero. Next, the average contribution percentage must be determined for each of the groups of highly compensated employees and nonhighly compensated employees. This average is determined by adding the ACRs of each employee in the group and dividing by the total number of employees in that group (the "ACP").[31]

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[15] I.R.C. § 401(k)(3).
[16] I.R.C. § 401(m).
[17] Treas. Reg. § 1.401(k)-6 (eligible employee definition).
[18] I.R.C. § 401(k)(3)(B); Treas. Reg. § 1.401(k)-1(f)(4); 1.414(v)-1(d)(2).
[19] Treas. Reg. § 1.401(k)-2(a)(2).
[20] Treas. Reg. § 1.401(k)-2(a)(3).
[21] I.R.C. § 401(k)(3)(A).
[22] I.R.C. § 401(k)(12); Treas. Reg. § 1.401(k)-3.
[23] I.R.C. § 401(k)(13); Treas. Reg. § 1.401(k)-3.
[24] I.R.C. § 413(b); Treas. Reg. § 1.401(k)-1(b)(4)(v)(C).
[25] Treas. Reg. § 1.401(k)-1(b)(4)(v).
[26] Treas Reg. § 1.401(k)-1(b)(4)(v)(B).
[27] *Id.*
[28] Treas. Reg. § 1.401(m)-1(a)(3).
[29] I.R.C. § 401(m)(5); Treas. Reg. § 1.401(m)-5 (eligible employee definition);
[30] I.R.C. § 401(m)(3).
[31] Treas. Reg. § 1.401(m)-2(a)(2) and (3).

To pass the ACP test, the ACP for the highly compensated group cannot exceed the greater of (a) 1.25 times the ACP of the nonhighly compensated group or (b) the lesser of, (i) 2 plus the percentage points of the ACP of the nonhighly compensated group or (ii) two times the ACP of the nonhighly compensated group.[32]

Special Rules for Multiemployer Plans

For purposes of ACP testing, a multiemployer 401(k) plan is treated as automatically satisfying the requirements of the ACP test for the portion of the plan that covers collectively bargained employees.[33] A multiemployer 401(k) plan generally must conduct only the ADP test (i.e., testing with respect to employee elective contributions) for the collectively bargained employees.

With respect to any noncollectively bargained employees included in the plan, however, multiemployer plans must satisfy the ACP test. To conduct the ACP test, the plan must be disaggregated and treated as two plans benefiting collectively bargained and noncollectively bargained employees.[34] Thus, in terms of testing, the plan can ignore the collectively bargained employees and test the noncollectively bargained employees on an employer-by-employer basis.[35]

Testing for Profit Sharing Contributions

General Rules

Profit sharing contributions and other non-elective employer contributions are generally subject to nondiscrimination testing under Code Section 401(a)(4). A plan can satisfy a design based safe harbor, if for example, the plan has an allocation formula that is uniform; that is, the same percentage of compensation (e.g., 10 percent of compensation for all participants) or the same dollar amount (e.g., $25 for each participant) is allocated to each participant in the plan.[36]

If the plan was not designed to satisfy a safe harbor formula, then the plan must satisfy the general test for nondiscrimination in amount of benefits under Code Section 401(a)(4) on a contribution basis or an equivalent benefits basis. In brief, the general test breaks down the plan into rate groups and tests the rate groups separately for nondiscrimination. A rate group consists of a highly compensated employee who receives a certain allocation and every other participant who has an equal or greater allocation.[37] Participants may be included in more than one rate group. Highly compensated employees with the same allocation rates will have identical rate groups. Each rate group must satisfy the minimum coverage tests, described earlier.[38] If all of the rate groups satisfy minimum coverage, then the plan will satisfy the general test for nondiscrimination.

Special Rules for Multiemployer Plans

Multiemployer 401(k) plans with only collectively bargained employees do not have to run the nondiscrimination tests under Code Section 401(a)(4).[39] If a plan benefits collectively bargained and non-collectively bargained employees, the portion of the plan that benefits noncollectively bargained employees must satisfy the requirement under 401(a)(4) that the amount of profit sharing contributions is nondiscriminatory.[40]

Nondiscriminatory Benefits, Rights and Features

To satisfy 401(a)(4), all benefits, rights and features provided under a 401(k) plan must be made available in a nondiscriminatory manner.[41] A benefit, right or feature is considered to be nondiscriminatory if it meets a current availability requirement and an effective availability requirement.[42] Benefits, rights and features include optional forms of benefits (e.g., different payment schedules, timing of payments, early retirement benefits, or forms of distribution),[43] ancillary benefits (e.g., social security supplements or death benefits),[44] and other rights and features available under the plan (e.g., plan loans, right to direct investments, right to make after-tax contributions, right to make rollovers).[45] Benefits, rights and features should be tested when different rules apply to certain groups of participants (e.g., the rate of matching contribution varies, the type of benefits available vary or the ability to make certain contributions varies).

Substantiation of Data

Because of the significant number of employers that may participate in a multiemployer plan, the administrator of the plan may not have direct access to employer-specific data that is needed for nondiscrimination testing. Completing the nondiscrimination testing on a multiemployer plan can be costly and time-consuming. The Internal Revenue Service has provided methods for multiemployer plans to substantiate compliance with the nondiscrimination requirements under the Code, pursuant to Revenue Procedure 93-42.[46]

According to Revenue Procedure 93-42, if precise data is not available at a reasonable expense, the plan may use "substantiation quality data" if (1) this is the best data available at a reasonable expense, and (2) the plan concludes that relying on this data to pass the nondiscrimination testing establishes a high likelihood that the

[32] I.R.C. § 401(m)(3)(A); Treas. Reg. § 1.401(m)-2.
[33] Treas. Reg. § 1.401(m)-1(b)(2).
[34] Treas. Reg. §§ 1.401(m)-1(b)(4) and 1.410(b)-7(c)(4)(ii)(B).
[35] Treas. Reg. § 1.401(k)-1(b)(4)(v)(C).
[36] Treas. Reg. § 1.401(a)(4)-2(b).
[37] Treas. Reg. § 1.401(a)(4)-2(c)(1).
[38] Treas. Reg. § 1.401(a)(4)-2(c)(3).
[39] Treas. Reg. § 1.401(a)(4)-1(c)(5).
[40] Treas. Reg. § 1.401(a)(4)-2.
[41] Treas. Reg. § 1.401(a)(4)-4(a)
[42] Treas. Reg. § 1.401(a)(4)-4(b)-(c).
[43] Treas. Reg. § 1.401(a)(4)-4(e)(1).
[44] Treas. Reg. § 1.401(a)(4)-4(e)(2).
[45] Treas. Reg. § 1.401(a)(4)-4(e)(3).
[46] Rev. Proc. 93-42, 1993-2 C.B. 540.

plan would pass such testing using precise data.[47] Testing may be performed using procedures such as single day snapshot testing, simplified identification of highly compensated employees, and a three-year testing cycle.[48] Because a multiemployer plan must satisfy the nondiscrimination requirements on the basis of each disaggregated population of employees who benefit under the plan and who are not treated as collectively bargained employees, if the multiemployer plan fails to satisfy the nondiscrimination requirements, it will result in disqualification of the plan for all participating employers.[49]

For ADP testing purposes, the plan administrator of a multiemployer plan may rely on appropriate information provided by a participating employer as to its highly compensated employees and nonhighly compensated employees, as long as it is reasonable for the plan administrator to rely on that information.[50]

Noncompliance and Disqualification Issues

If the plan fails coverage or one of the discrimination tests, there are a number of methods to correct the failure. For example, if the plan fails the ADP test, the excess contributions can either be recharacterized, refunded or the employer can make additional contributions that cause the ADP test to be satisfied.[51] Similar corrective methods are available to correct a failed ACP test.[52] The most common method to fix a failed ADP or ACP test is to refund excess amounts to highly compensated employees within 2 ½ months after the close of the plan year being tested. If the tests are not corrected within strict time frames, the plan may still be able to correct on a voluntary basis by filing with the IRS through its voluntary correction program.

The failure by one employer maintaining the plan (or by the plan itself) to satisfy and/or correct a failed requirement will result in the disqualification of the plan for all contributing employers.[53] Disqualification of the plan causes numerous adverse consequences: (1) the trust income becomes taxable and the trust must file Form 1041 to pay income tax on the earnings;[54] (2) employers lose the tax deductions for contributions that are not vested;[55] (3) employers are penalized for failing to withhold payroll and income taxes timely;[56] (4) participants in the plan are subject to payroll and income taxes on the portion of their account balances that are vested[57] (but this only applies to highly compensated employees if the disqualification is due to a 410(b) coverage failure);[58] participants cannot take a distribution while they remain employed (unless the plan permits in-service distributions) and employees will be taxed on future amounts as they become vested, rather than being able to defer income tax until the amounts are distributed from the plan;[59] and (5) participants may lose the ability roll over their plan distributions to an IRA or another employer plan.[60] If a plan loses its tax-exempt status, there are methods to correct the failure and apply to the Internal Revenue Service to re-qualify the plan.

The Commissioner of the IRS has the authority to retain the qualified status of a multiemployer plan for innocent employers. In accordance with the revenue procedure, the Commissioner may exercise this authority if (1) the plan administrator has followed guidelines that are reasonably designed to obtain from each participating employer the appropriate information substantiating that the disaggregated portion of the plan satisfies the nondiscrimination requirements, and (2) that it is reasonable for the plan administrator to rely on that information. The appropriate information does not have to be actual data; however, the information must be based on the employer's substantiation data.[61]

In sum, there are many issues involved in establishing and maintaining a multiemployer 401(k) qualified plan that complies with the myriad of nondiscrimination rules. Decisions regarding nondiscrimination testing, however, should be made carefully and always be reviewed by the trustees and legal counsel.

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[47] *Id.* at § 2.01.
[48] *Id.* at §§ 3, 4, and 5.
[49] *Id.* at § 6.02.
[50] *Id.* at § 6.03.
[51] Treas. Reg. § 1.401(k)-2(b)(1).
[52] Treas. Reg. § 1.401(m)-2(b)(1).
[53] See Treas. Reg. § 1.413-1(a)(3)(ii).
[54] I.R.C § 501(a); Rev Rul. 74-299.
[55] I.R.C § 404(a)(5); Treas. Reg. § 1.404(a)-1.
[56] I.R.C. § 3401(d)(1).
[57] I.R.C § 402(b)(1); Treas. Reg. §§ 1.402(b)-1(a) & 1.402(b)-1(b).
[58] I.R.C. § 402(b)(4)(B); Treas. Reg. § 1.402(b)-1.
[59] Treas. Reg. § 1.402(b)-1(b).
[60] Treas. Reg. § 1.402(a)-1(a)(2). The Circuits are split over whether distributions from a disqualified plan are eligible for rollover treatment. The Fifth, Sixth and Seventh Circuits have held that the qualified status of the plan at the time of the distribution should determine whether amounts distributed from the plan are entitled to favorable tax treatment under I.R.C. § 402. *Fazi v. Comr.*, 102 T.C. 695, 18 EBC 1643 (1994); *Woodson v. Comr.*, 73 T.C. 779 (1980), rev'd 651 F.2d 1094, 2 EBC 1652 (5th Cir. 1981); *Baetens v. Comr.*, 82 T.C. 152, 5 EBC 1804 (1984), rev'd 777 F.2d 1160, 6 EBC 2583 (6th Cir. 1985) and *Benbow v. Comr.*, 82 T.C. 941, 5 EBC 1714 (1984), rev'd 774 F.2d 740, 6 EBC 2379 (7th Cir. 1985). In contrast, the Second Circuit and the Tax Court have followed a bifurcated approach and held that the qualified status of the plan at the time of contribution (not distribution) should determine whether the amounts distributed from the plan are entitled to favorable tax treatment under I.R.C. § 402, such that contributions made when the plan was not qualified are not eligible for rollover but contributions made when the plan was qualified are eligible for rollover. *Greenwald v. Comr.*, 44 T.C. 137 (1965), rev'd 366 F.2d 538, 1 EBC 1089 (2nd Cir. 1966).
[61] *Id.*