Do All Employees Have To Be Included In a Qualified Plan?

This is a very common question that employers ask when considering whether to implement a qualified retirement plan for their business. As a business owner, you may want to set up a qualified plan, but the cost of providing retirement benefits to all your employees could be expensive. There are a few simple ways to cut the cost of providing these benefits to all your employees as long as you know and follow the rules.

When setting up a qualified plan, it is generally a common practice to build in eligibility requirements that the employees must satisfy before becoming eligible to participate in a plan. Setting eligibility requirements help to prevent businesses with high employee turnover from providing benefits, and incurring additional administrative expenses, for transient employees who do not stay with the employer for a substantial period of time.

A qualified plan may be set up with a minimum age requirement. For instance, employers may exclude any employee who is not at least age 21. It's important to note that there is no maximum age limit for participating in a qualified plan. The plan may also include a service requirement which is generally capped at 1 year of service. A year of service is usually defined as a consecutive twelve month period in which an employee works at least 1,000 hours. For plans other than 401(k) plans, a maximum service requirement of 2 years is permissible. However, if this option is selected, the plan must provide for 100% immediate vesting upon plan participation. Employers must also recognize that they are considered employees too for plan purposes so they should be careful not to select a requirement that would negatively impact themselves.

In addition to the eligibility requirements mentioned above, there are certain blanket exclusions that Employers may take advantage of. Part-time employees who work less than 1,000 hours in a consecutive twelve month period may be excluded from participating in a qualified plan. Employers may also exclude union employees as long as retirement benefits were the subject of good faith bargaining.

It is also important to understand that all qualified retirement plans must satisfy certain coverage and participation tests in order for plans to maintain their tax qualified status. Coverage tests include the "average benefits test" and the "ratio percentage test." Employers may exclude some employees as long as the plan passes one of the two coverage tests. The "average benefits test" is extremely complex to explain and understand and is beyond the scope of this article. This test is only used when the plan does not pass the ratio percentage test.

The "ratio percentage test," or the 70% test, as it is commonly known, states that the percentage of non-highly compensated employees (NHCE's) that benefit under the plan must be at least 70% of the percentage of highly compensated employees (HCE's) that benefit under the plan. The definition of a highly compensated employee is: a 5% or more owner, an officer earning more than $120,000 (for 2015, as indexed) in the previous year, and family members, including lineal ascendants and descendants, of a highly compensated employee. Anyone who is does not meet this definition is considered an NHCE.

Retirement Planning

The following examples show how the ratio percentage test works:

EXAMPLE 1:

There are 12 employees in the Company, 2 HCE's, 10 NHCE's
Both HCE's participate in the plan so the percentage of HCE's participating is 100%.

100% x 70% = 70%
70% x 10 NHCE's = 7 NHCE's.

7 NHCE's must benefit under the plan, 3 NHCE's may be excluded

EXAMPLE 2:

There are 12 employees in the Company, 2 HCE's, 10 NHCE's. But now only 1 HCE participates in the plan so the percentage of HCE's participating is 50%.

50% x 70% = 35%
35% x 10 NHCE's is 3.5.

4 NHCE's must benefit under the plan, 6 NHCE's may be excluded.

If any employees are to be excluded from or 'carved out' of a qualified plan, it must be done on a nondiscriminatory basis. This means the exclusion must be based on a bona fide job classification which should be addressed in the plan's organizational documents.

Defined benefit plans must also satisfy an additional participation rule. The rule is that a plan must cover the lesser of a) 50 employees, or b) the greater of 40% of the employees or 2 employees (if there is only one employee, then that employee).

Make sure that the eligibility and coverage requirements in the qualified plan that you establish for your business complies with these rules.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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