



## MARCH 2017 | NRS NEWSLETTER

### CONSIDERABLE FLEXIBILITY IS AVAILABLE WHEN DETERMINING A RETIREMENT PLAN'S COVERAGE GROUP

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One of the most important elements for an employer to consider when designing an employee retirement plan is determining which employees or employee groups will be covered by the plan. The decision process is complicated by the dictates of federal tax law which contain strict limits concerning who and how many employees may be excluded from the plan. This determination becomes especially challenging in situations where an employer sponsors more than one retirement plan for a given group of employees.

#### *Including and Excluding Employees*

To begin with, employers are permitted to establish minimum age and service conditions so that particularly young or recently hired employees may be excluded from the plan. This avoids inclusion of a group that frequently represents a high turnover group and targets young employees who may not value retirement plans as much as more seasoned workers. Employees may be excluded if they are under age 21. They may also be excluded if they have completed less than a Year of Service. (Generally, a Year of Service is defined to be the first year of employment in which the employee completes 1,000 or more hours of service.)

Tax laws also allow the following employee groups to be excluded from a tax qualified retirement plan:

- Former employees who are not employed on the last day of the plan year and who have completed less than 501 hours of service.
- Employees covered by a collective bargaining agreement where retirement benefits are a subject of good faith bargaining.
- Non-resident aliens, including those who work in Puerto Rico or United States possessions. (This does not include any "undocumented workers" living and working in the U.S.)

Many retirement plans are designed so that all employees not in the above groups and who meet the age and service requirements for a retirement plan are eligible to participate. However, there are many employers where additional exclusions are desirable and/or necessary for various



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business purposes. Some common examples are plans that include only employees employed at a geographic location, only salaried employees, only hourly employees, etc. Fortunately, the tax laws concerning coverage are flexible enough to accommodate these employers in most cases. However, plans that exclude employee groups and/or specifically identified employees must conduct annual mathematical tests to be certain that the covered group does not unduly favor business owners and highly compensated employees.

### Numeric Coverage Tests

Internal Revenue Code section 410(b) requires all qualified retirement plans to annually pass either the Ratio Test or the Average Benefits Test. Failure to do so results in plan disqualification unless the failure is corrected by suitable amendments to the plan. The tests involve Highly Compensated Employees (“HCEs”), a defined term (see our April 2016 newsletter on our website). The remaining employees are referred to as Non-Highly Compensated Employees (“NHCEs”).

The Ratio Test is deemed passed if the NHCE coverage ratio divided by the HCE coverage ratio equals or exceeds 70%. The NHCE coverage ratio equals the number of NHCEs who benefit from the plan during the plan year divided by the total number of NHCEs employed by the employer. The HCE coverage ratio is computed in the same way by examining only the HCEs. Employees (both NHCE and HCE) who failed the plan age or service requirements, who terminated employment with less than 501 hours of service, who are represented by a union, and non-resident aliens are ignored for testing purposes. For example, suppose an employer employs two HCEs and six NHCEs who meet a retirement plan’s age and service requirements and who are not in any of the four employee groups listed immediately above. If in a particular plan year both HCEs and three of the NHCEs are benefitting, the Ratio Test would equal 50% and the test would fail. Suppose instead that one of the two HCEs did not benefit during the plan year being examined. In that case, the Ratio Test equals 100% and passes easily ( $3/6 \div 1/2 = 100\%$ ). By the way, if the plan in question has a 401(k) feature, any participant who is offered the opportunity to defer compensation is considered to be “benefiting”.

The Average Benefits Test consists of two parts: the Nondiscriminatory Classification Test and the Average Benefits Percentage Test. A plan that cannot pass the Ratio Test must pass both components of the Average Benefits Test. The Nondiscriminatory Classification Test uses the same NHCE and HCE ratios that are used for the Ratio Test, but the “pass mark” is much lower.



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Instead of 70%, the pass mark can be as low as 20% or as high as 50%, depending upon the percentage of the work force classified as NHCEs. The higher the NHCE concentration, the lower the pass mark. The Average Benefits Percentage Test involves calculating each individual's benefit percentage, which is defined as the participant's benefit from *all* the employer's retirement plans divided by the participant's compensation. The average percentage is computed for NHCEs and for HCEs. The ratio of the NHCE average benefit percentage to the HCE average benefit is then determined and the plan passes the Average Benefits Percentage Test if that ratio equals 70% or more.

### *Plans Can be Aggregated When Testing*

Employers that sponsor two or more retirement plans have the option to aggregate two or more plans when conducting coverage tests. This is particularly helpful for employers who sponsor both a 401(k)/profit sharing plan and a cash balance pension plan. Likewise, a plan that covers only salaried employees can be aggregated with a plan that covers only hourly employees. Obviously, aggregating plans makes it easier to pass coverage tests, so what's the catch? The answer is that the aggregated plans must also be tested for nondiscrimination as if they were a single plan.

Coverage testing can be an interesting challenge, but many employers find that the ability to design separate plans for different groups or being able to exclude specified employment groups or named individuals is well worth the effort and expense of annual testing.

Please note, an exception does exist for Section 403(b) retirement plans such that deferral contributions under such 403(b) plans are not subject to the Section 410(b) coverage rules outlined above.

NRS can assist interested employers in the process of retirement plan design, as well as perform annual testing for the plan or plans.



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### REMINDERS FOR MARCH

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**March 15 – Minimum funding requirements** for defined benefit, money purchase, and target benefit pension plan years ended 6/30/16 must be met by March 15 to avoid excise taxes. An electronic transfer must be completed or a check mailed by this date.

**March 15** – Retirement plan employer contributions are due to be deducted on employer tax returns due to be filed March 15, 2017.

**March 15 – Form 5500 Series/8955-SSA** – Forms that are on extension are due for the Plan Year ending 5/31/2016.

**March 15** – Calendar year 401(k) plans must process corrective distributions for failed nondiscrimination tests to avoid a 10% excise tax. (Certain automatic enrollment plans have until June 30.)

**March 31 – Form 5500 Series/8955-SSA** – Forms are due for the Plan Year ending 8/31/16 that are not on extension.

**March 31** – Deadline for the calendar year end, defined benefit pension plan to prepare the funding adequacy related AFTAP calculation to avoid a presumed 10% funding adjustment.



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### HOW ARE WE DOING? PLEASE COMPLETE THE NRS CLIENT SATISFACTION SURVEY!

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We are grateful and thankful for the strong response to our Client Satisfaction Survey! In an effort to maintain high level client satisfaction, we need client feedback! The content of these replies will be sent directly to Executive Management. This survey takes less than 2 minutes to complete. To access the Client Satisfaction Survey, [please click here](#).

As always, NRS truly values your continued business!

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