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An AALU Washington Report

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TOPIC: Fundamentals of Tax-Qualified Plans – Participation and Coverage Standards: What Everyone Should Know

MARKET TREND: Retirement plans remain valuable employee benefits. Employers evaluating whether maintaining an ERISA-covered, tax-qualified plan is feasible must understand the fundamental rules for these plans. One of the most important questions is whether the employer can or is willing to satisfy the minimum participation and coverage requirements applicable to this type of plan.

SYNOPSIS: Under ERISA and the Internal Revenue Code ("Code"), an employer cannot require an employee to complete more than one-year of service before becoming eligible to participate in a pension plan, such as a 401(k) plan. An employer need not cover all employees who complete a year of service, but the classification of ineligible employees who may complete a year of service must not be based on the manner in which they perform service for the employer (e.g., full-time vs. part-time). Assuming that requirement is satisfied, a tax-qualification rule under the Code also requires that the plan not cover a disproportionate amount of the employer's highly compensated employees.

TAKE AWAYS: Although an employer considering implementing a tax-qualified retirement plan can exclude certain categories of employees from participation, it must be willing to offer that benefit to all otherwise eligible employees who have worked for the employer for at least a year – a longer service requirement generally is not permitted for qualified plans. In addition, if the employer is only interested in covering a portion of its employee population under the plan, the employer must be certain that the group it wishes to cover satisfies the nondiscriminatory coverage requirements imposed under the Code.

In addition to procedural rules governing employee benefit plan operations, ERISA defines a comprehensive set of rules governing the substance and content of these plans, including the standards for employee eligibility to participate in a pension plan. The Code includes several similar standards governing the nondiscriminatory participation and coverage of employees for a plan to qualify as a tax-qualified plan. The following summarizes these ERISA and Code participation and coverage standards so employers can ensure that their plans cover required employees.

WHAT ARE THE MINIMUM PARTICIPATION REQUIREMENTS

Rules. ERISA and the Code require that employee eligibility standards for a qualified plan include the following minimum participation requirements based on the employee's age and period of service, in addition to any other eligibility criteria (i.e., an otherwise eligible employee cannot be excluded from participation if he or she meets the following age and service requirements):

1. Minimum Age of 21: The plan must allow an otherwise eligible employee to participate if he or she has attained age 21 -- employees younger than this can be excluded from participation;[1] and

2. Year of Service: The plan must allow the participation of an otherwise eligible employee if he or she has at least one year of service, as discussed below (note that a plan can require an employee to complete two years of service to participate if the plan provides that the individual has a fully non-forfeitable interest in his or her accrued benefit under the plan upon completion of that service).

Note that these requirements are caps, not thresholds - an employer can allow employees who are younger or have less service to participate, if desired.

Exclusions. An employer's qualified plan also does not need to cover every employee that has reached age 21 and completed a year of service. Employers can exclude categories of employees from participation. For example, a plan may exclude from participation salaried employees, hourly employees, union employees, or employees of a certain division. Note, however, that employers cannot categorically exclude employees based on the manner in which they perform services, such as part-time, temporary, or seasonal employees, if they still meet the above minimum requirements. Under guidance issued by the IRS, such exclusion could have the effect of denying participation to an employee who completes a year of service.

Note on ERISA/Code Overlap. One may question why an ERISA issue like minimum participation would be impacted by IRS guidance. The reason deals with the tax treatment of the ERISA-governed plan. Other ERISA provisions require funding of participants' plan benefits in a trust with participants vesting in their benefits over a minimum, specified period. These requirements could result in current taxation of the participant on the plan benefit, unless the plan is a tax-qualified plan. Several rules for achieving tax-qualified status under the Code are identical to the rules under ERISA, including the minimum participation standards. ***While ERISA rules are typically under the DOL's jurisdiction, the Code provisions that govern tax-qualified plans are generally subject to IRS interpretation***.

WHAT IS A YEAR OF SERVICE

For purposes of the minimum participation requirements, a year of service is generally defined as a 12-consecutive-month period ("**computation period**") during which an employee completes at least 1,000 hours of service for the employer maintaining the plan. An hour of service is generally each hour for which the employee is paid, or entitled to payment by the employer, for (1) the performance of duties for the employer and (2) within certain limitations and subject to certain caps, on account of a period during which no duties are performed due to vacation, holiday, illness, incapacity, layoff, jury duty, military duty, or leave of absence.

Given the above, it is technically possible for even part-time, temporary, seasonal, or similar employees to complete more than 1,000 hours of service during a computation period to satisfy the one-year service requirement, which is why they cannot be categorically excluded from plan participation. Practically, however, requiring a complete year of service by these employees as a condition for participation will effectively exclude most of them from the plan (the employer would not have to impose a similar requirement on its full-time employees, unless desired).

The computation period for determining whether an individual has completed a year of service is initially the 12-consecutive month period beginning on the individual's date of hire. If the employee does not complete 1,000 hours of service during that period, the subsequent computation periods that are looked at to determine if the employee has satisfied the year of service requirement can be either the 12-consecutive-month periods that begin on an anniversary of the employee's date of hire or the fiscal year of the plan (*i.e.*, the plan year). Once an employee completes a year of service, however, he or she remains eligible to participate in the plan in all future years of employment with that employer, regardless of whether he or she ever completes another year of service.

WHAT ARE THE MINIMUM COVERAGE STANDARDS – CODE VS. ERISA

An employer may wish to limit plan participation to a subset of its entire employee population. For example, it may wish to provide pension benefits only to salaried employees and not to hourly-paid employees. As long as the employer does not require salaried employees to complete more than a year of service, the plan will satisfy the minimum participation rules discussed above. However, under a rule found in the Code <u>but not</u> in ERISA, the plan must also satisfy the minimum coverage requirement of Code § 410(b) to be a tax-qualified plan.

To satisfy this minimum coverage requirement, the plan must generally cover a percentage of the employer's non-highly compensated employees ("**NHCEs**") that represents at least 70% of the percentage of highly compensated employees (or "**HCEs**") that the plan covers. For this purpose, a HCE in 2016 is generally an employee who earned at least $120,000 in compensation in 2015.

> ***Example:*** Assume Employer X Co. want to create a tax-qualified plan for only salaried employees. X Co. has 100 HCEs and 90 of them are salaried employees, which means 90% of the HCE will be covered by the plan. The employer has 1,000 NHCEs. To pass the minimum coverage test for a qualified plan, 630 of X Co.'s NHCEs must be salaried employees (70% of 90% is 63%, and 63% of 1,000 is 630).[2] If X Co. has fewer than 630 NHCEs who are salaried employees, it generally could not maintain a plan covering just salaried employees as its only tax-qualified plan.

TAKE AWAYS

Although an employer considering implementing a tax-qualified retirement plan can exclude certain categories of employees from participation, it must be willing to offer that benefit to all otherwise eligible employees who have worked for the employer for at least a year – a longer service requirement is not permitted for qualified plans. In addition, if the employer is only interested in covering a portion of its employee population under the plan, the employer must be certain that the group it wishes to cover satisfies the nondiscriminatory coverage requirements imposed under the Code.

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NOTES

[1] Note that there is no maximum age limit for exclusion from participation -- i.e., an employee cannot be excluded after attaining a certain age, such as 85.

[2] There is another test that can be used to satisfy the minimum coverage requirement, which is known as the "average benefits test." However, as the average benefits test is rarely used to satisfy the minimum coverage requirements and involves a complex mathematical analysis, it is beyond the scope of this *Washington Report Marketplace*.