employee benefits update

year end 2005

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When companies can't exclude classes of employees

Your company must structure its qualified retirement plan for the exclusive benefit of employees, and favoring highly compensated employees or key personnel over other employees is generally not allowed. Specialized testing, known as minimum coverage testing, ensures that plans comply. For a plan to meet these government regulations, it must pass one of the two coverage tests: the ratio percentage test or the average benefits test.

Who benefits under the plan

For either test, you must count all nonexcluded employees by determining who benefits under the plan. (For more on excluded employees, see "Employees you can exclude" on page 3.) Benefiting includes receiving an allocation of contribution or forfeitures, accruing a future benefit, and — even if the employee elects not to participate — being able to make an elective deferral under a 401(k) plan.

If the plan or component plan benefits only the nonhighly compensated employees, it is automatically deemed to pass the coverage test. And if the employer employs only highly compensated employees, the plan is deemed to pass.

Testing complexities

Contributions and benefits provided under all employer plans must satisfy coverage requirements, and you must separately test certain plan components. If your company provides both matching and profit-sharing contributions in a 401(k) plan, you must test these dollars separately for coverage. And salary deferrals must meet coverage rules without considering employer matching contributions.

The rules allow you to combine employee after-tax and employer matching contributions and test them apart from the other components. Similarly, you can combine profit sharing and forfeiture dollars together.

Coverage testing is complex where there are multiple companies in the same plan or multiple plans among a group of companies. Ownership is particularly important, as overlap in ownership among different businesses may result in a "controlled group." All members of a controlled group are treated as a single employer for testing purposes. In a plan sponsored by multiple employers (such as associations or employee leasing companies), the rules require separate testing for each company, even if employees are in the same plan. Each employer tested must pass the coverage test. It's possible to exclude a division of employees as long as the coverage testing passes when applied to the correct definition of employer and employee.

Ratio percentage test

Under the ratio percentage test, the percentage of nonhighly compensated employees who benefit under the plan must be at least 70% of the percentage of highly compensated employees who benefit. ("Benefit" in this context may have different meanings depending on what type of contribution is being tested.)

How do you get this figure? Begin by determining who among the employees are not excludible.

Once you've identified the proper employees, separate them into two groups: nonhighly compensated and highly compensated employees. Determine the number of employees in each group and calculate the ratio percentages as follows:

1. Divide the number of nonexcludible, nonhighly compensated employees who benefit by the total number of nonexcludible, nonhighly compensated employees.
2. Divide the number of nonexcludible, highly compensated employees who benefit by the total number of nonexcludible, highly compensated employees.

Generally, your consultant or third-party administrator runs the ratio percentage test as part of a compliance routine at the plan's year end. If the plan fails this testing, the employer should refer to the plan document and follow the plan's correction method.

In most situations, the employer may correct the coverage failure by adopting a corrective amendment up to 9½ months after the plan year's close. The amendment may expand the group of nonhighly compensated employees who benefit under the plan or increase the allocations or accruals for nonhighly compensated employees who benefit under the plan. If the failure involves 401(k) plan contributions, the employer must make a special contribution called a QNEC (qualified nonelective contribution) to nonhighly compensated employees.

Average benefits test

If the employer fails the ratio percentage test, the employer may run the average benefits test as an alternative to making a plan correction. The average benefits test contains two parts, both of which the employer must satisfy:

1. **Nondiscriminatory classification test.** A plan passes the nondiscriminatory classification test if classification of employees who benefit under the plan is both reasonable and nondiscriminatory. The threshold is lower than the 70% ratio and is determined by the number of nonhighly compensated employees. The more nonhighly compensated employees, the lower the threshold is.
2. **Average benefits percentage test.** The average benefits percentage test looks at all of the benefits provided under all of the employer's plans and combines the benefits for testing. The average benefits provided for the nonhighly compensated employees must be at least 70% of the average benefits of the highly compensated employees.

Employees you can exclude

When applying minimum coverage testing, a plan may exclude certain categories of employees *before* applying the test. Among those you can exclude are:

- Employees not meeting the plan's minimum age and service requirement (for example, that an employee must be age 21 and work one year to be eligible for the plan),
- Union employees,
- Nonresident aliens with no U.S. source income,
- Employees going into a separate line of business ("SLOBS"), and
- Employees not employed on the last day of the plan year with less than 500 hours of service during the year.

To be excluded, the employee must be in an excludible category for the entire testing period.

You can exclude union employees only if retirement benefits were the subject of good faith collective bargaining. No more than one-half of the members of the collective bargaining unit may be owners, officers or executives of the employers covered by the plan and no more than 2% of the employees covered by the agreement can be professional.

Passing the test

Minimum coverage testing ensures that retirement plans aren't discriminatory and don't favor highly compensated employees. Today's complex company designs — such as multiple-employer groups and single-employer groups with multiple plans — make determining if you meet coverage testing even harder. And because coverage testing isn't the only testing your plan is subject to, it's important to consult with a qualified benefit professional to determine if your company's plan is in compliance.

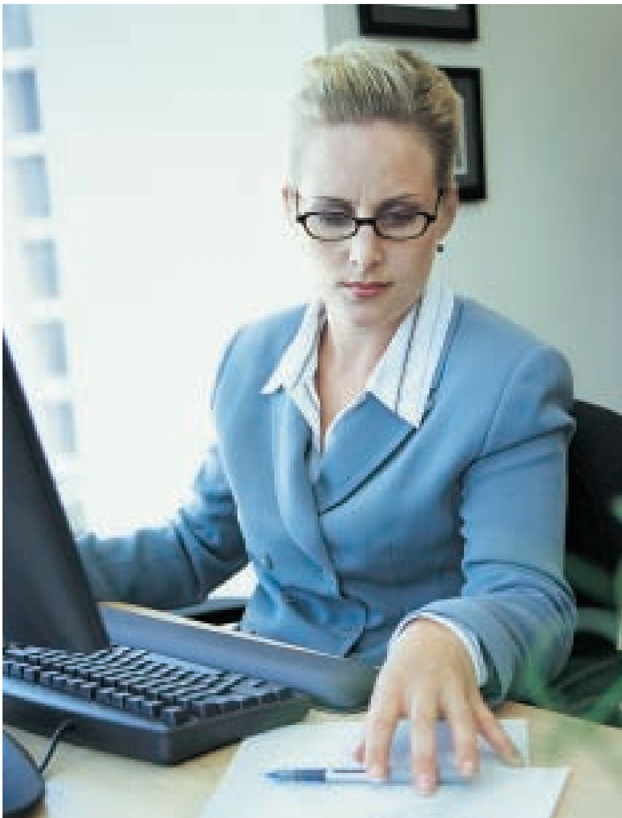
Individual life insurance policies in qualified plans

Most qualified plans don't allow for life insurance. But you may make an exception if a participant, for health reasons, has to pay exorbitant premiums. In this situation, a plan can purchase life insurance on a "guaranteed issue" basis — no questions asked. Although life insurance can be complex — and difficult to administer — here's a look at what you'll need to do if one of your plan participants needs this coverage.

The basics

First, your plan must allow for life insurance and the plan document must spell out any special limitations. A qualified plan's primary purpose is to provide "retirement" benefits, not "death" benefits. So the annual amount paid for insurance must be incidental, or secondary, in nature.

Because insurance must be an incidental benefit, if you have a defined benefit or defined contribution plan you're limited in the amount the plan can purchase. If the plan purchases ordinary life insurance, the aggregate premiums must be less than 50% of the aggregate contributions allocated to a participant's account. If the plan purchases term or universal life insurance, the aggregate premiums must be 25% or less of the aggregate contributions. When there's a combination of ordinary life and term insurance, the premium for the term insurance plus half of the ordinary life cannot exceed 25% in the aggregate.



Profit-sharing plans — including 401(k) plans — are much more liberal due to the nature of the plans. To pay the insurance premiums, the plan can use up to 100% of the *contributions* that have accumulated for at least two years, but the limits still apply to money that has accumulated for less than two years. And the plan can use the *entire account* if the individual has been a participant for more than five years. Plus, there are no limitations as to the amount of insurance the plan can purchase from rollover accounts or voluntary contribution accounts.

For example, Joe has been in the XYZ profit-sharing plan for three years. Contributions and forfeitures have been allocated to his account as follows: Year 1, $1,000; Year 2, $2,000; and Year 3, $3,000. The plan allows for life insurance, and during his third year of participation the plan purchases the maximum amount of term insurance with funds from his account. The plan administrator determines that it can use $3,750 from Joe's account to pay the premiums. That includes 25% of the allocations for Years 1 and 2 and 100% of the allocation from Year 3.

Premium payment options

When the insurance is issued, you must decide how to pay the premiums. There are two options:

1. **Pay the premiums directly from the plan to the insurance company.** The plan can then pass this expense to the insured participant. Your third-party administrator will simply reflect the premium as a directed expense and deduct it from the participant's account.

2. **The employer can pay the premiums.** The premiums paid to the insurance company represent a portion of the deductible employer contribution to the plan for the year. Your third-party administrator will report this as new money coming into the plan, as well as a directed expense from the participant's account. (For self-employed plans, the premium is neither deductible nor treated as a contribution to the plan.)

A qualified plan's primary purpose is to provide "retirement" benefits, not "death" benefits. So the annual amount paid for insurance must be incidental, or secondary, in nature.

Either way, give your third-party administrator copies of the premium statements, as well as information on the date and source of payment.

Administration of accounts

Each year, give your third-party administrator information from the insurance company with regard to any life insurance policies held by the plan. The insurance company should provide the cash surrender value of the policy as of the plan valuation date, which is typically the last day of the plan year. (Term insurance doesn't have cash value.) On a participant level, this information will be included in the participant's account balance as of the valuation date. On a plan level, the plan must report this information in its annual report on Form 5500, Schedule H – Financial Information (Schedule I for a small plan), as a plan asset.

The insurance company should also provide Schedule A information each year. This includes, among other things, any commissions paid to the insurance agent or broker and the amount of premiums paid for the given year. Also included is the policy's contract year. Often the policy's issue date doesn't coincide with the plan year, but the Department of Labor will allow reporting for the contract year which ends within the plan year.

Each year, the insurance company must provide information about the cost of current life insurance protection. This cost is more commonly referred to as the "PS-58 cost" and can't be more than the premium paid in a given year.

Generally, the benefits in a qualified plan are considered deferred benefits, meaning they accumulate in the plan until they're distributed and become taxable. But if a plan has life insurance, the participant is considered to receive a "current" benefit in the form of life insurance protection. The cost associated with this protection should be reported on the participant's tax return.

When a participant retires or terminates employment, you must decide what to do with the life insurance policy. The most common option is to surrender the policy. But if the participant wants to maintain the life insurance coverage, you can transfer the policy's ownership to the individual.

Proceed with caution

As you can see, administering a plan with life insurance is complex, but beneficial to the employees who need it. Be sure to understand all of the associated rules before adding life insurance to your plan.

Summary annual report 101

ERISA has many rules meant to protect retirement benefits. One such rule requires benefit plans subject to ERISA to distribute a summary annual report (SAR) to plan participants and beneficiaries. Because the SAR is required of almost all plans, let's take a closer look at it.

Who should receive a SAR?

Eligible qualified plan participants must receive the SAR, even if they don't have an account balance. Once an employee meets plan participation requirements, he or she is entitled to a SAR — whether or not the employee is actually contributing.

You don't have to provide a SAR to an individual who has terminated participation in the plan or who is no longer eligible to participate. But terminated participants who are eligible for benefits must receive a SAR.

Which plans must distribute a SAR?

All retirement plans and all tax-deferred annuity plans (unless exempt from ERISA) must distribute a SAR. But if an employer simply makes tax-deferred annuities available to its employees, the program may not be subject to ERISA — and thus not required to distribute a SAR — if participation is completely voluntary, the employer isn't participating in the plan and the employer isn't enforcing certain rights under the annuity contract.

Most welfare benefit plans must also distribute a SAR. Those that don't include:

- Plans that are totally unfunded — the benefits are paid from general assets,
- Insured plans for a select group of management or highly compensated employees, and
- Plans exempted from annual reporting requirements by Department of Labor (DOL) regulations.

The DOL exemption pertains to welfare benefit plans that had fewer than 100 participants at the beginning of the plan year and that are funded solely through employer assets, an insurance carrier or a combination of these funding methods.

What information must you include?

The SAR must include specific information, including:

- The financial institutions that hold plan assets,
- Participants' and beneficiaries' right to year-end statements,
- A notice that participants and beneficiaries may contact the Employee Benefits Security Administration if they are unable to examine or obtain certain documents, and
- For plans with more than 5% of its assets in nonqualifying assets, bonding information — including the name of the surety company issuing the required bond.

The regulations also require the SAR to include information about any insurance purchased with plan funds.

How can you distribute the SAR?

The plan administrator must use measures reasonably considered to ensure actual receipt of the material and a method or methods of delivery likely to result in full distribution to participants and beneficiaries. Personal delivery or the U.S. mail is acceptable.

You can send the SAR through U.S. mail by first-, second- or third-class mail. If you use second- or third-class mail, you must guarantee return and forwarding postage and request address correction. If the SAR is returned with an address correction, you must send it again by first-class mail or personally deliver it.

You can furnish the SAR as a special insert in a periodical distributed to employees — such as a company publication — if the distribution list for the periodical is comprehensive and up-to-date. A prominent notice on the front page must advise the reader that the publication contains an insert with important information about plan rights that should be read and retained for future reference.

If some participants and beneficiaries aren't on the distribution or mailing list, you can use the periodical only in conjunction with other distribution methods so that the combined methods are reasonably calculated to ensure the SAR's receipt. Intercompany mail delivery will generally meet the requirements. But random distribution — such as posting within the company lunchroom — isn't acceptable.

Ready to distribute your SAR?

A SAR provides useful information about your plan to all participants. And because it's required by law, be sure to follow the rules when preparing and distributing your SAR.

Automatic enrollment: A solution for inertia?

Traditionally, employers could withhold 401(k) plan contributions from compensation only with the participant's consent. But some plans choose "automatic enrollment" or "negative election" — where the employer automatically enrolls a participant.

If your plan document provides for automatic enrollment, you must withhold salary deferrals from pay and deposit them according to plan defaults, unless an eligible employee indicates in writing that he or she does *not* want to defer. You must give employees advance notice explaining the automatic compensation reduction procedures, their right to elect to not make contributions or to change their election, and the timing for doing so. You must allow employees to change their election at any time and notify them annually of the deferral percentage that is being used and their right to modify it.

One IRS ruling indicates that automatic enrollment for newly hired employees with a default percentage of 3% is acceptable. Another allows for automatic enrollment of current employees, and any salary deferral percentage is acceptable as long as it's within plan and law limits. Increases in the percentage can be built-in according to a specified schedule or occur on an event (such as a raise or bonus), as long as you inform participants and they can opt out.

Automatic enrollment increases plan participation, resulting in improved nondiscrimination testing results and increased retirement savings for employees. So what's the downside? One concern is the fiduciary liability associated with the choice of the investment default. Although employers tend to select low-risk investments, these aren't a safe harbor. And some states have garnishment laws that don't permit pay withholding without the employee's approval, although ERISA almost certainly pre-empts these state laws.

And participants may believe that plan defaults are the "correct" choice, when in fact they're often very conservative. The inertia that kept employees from deferring in the first place may keep them from making changes that might help them achieve their retirement goals.

Finally, increased participation can increase employer administrative costs, as well as employer contributions if the plan provides a match.

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