

Retirement Planning Opportunities

Which Employees Can You Exclude in a Profit Sharing Plan?

Is Your Client's Profit Sharing Plan Too Expensive?

Your clients may want to have a profit sharing plan but, if there are too many employees in the business, the plan may be too expensive. Let's look at some of the employees you can exclude to lower the plan costs.

Which Employees Can You Exclude?

Business owners can exclude any employees who are not at least age 21. If they include a service requirement of at least one year in the eligibility requirements, they can also exclude any employees who earn less than 1,000 hours in a 12-month period.

Business owners can increase this service requirement to two years of service, but, if they do, they will have to give their employees full and immediate vesting.

Finally, business owners can exclude union employees as long as the retirement benefits were the subject of good faith bargaining.

Coverage Tests

The business owners can exclude other employees as long as they still satisfy one of two coverage tests: either the ratio percentage test or the average benefits test.

The average benefits is very complex and beyond the scope of this newsletter. Fortunately, the ratio percentage test is simpler.

Ratio Percentage Test

The ratio percentage test is also known as the 70% test. It states that the percentage of non-highly compensated employees (NHCE) that must benefit from the plan must be at least 70% of the percentage of highly compensated employees (HCE) that benefit.

Highly Compensated Employees

Employees are considered highly compensated if they owned 5% of the business in the current or previous year or they earned \$105,000* in the previous year. Some family members of the 5% owners (spouses, children, parents, etc.) will also be considered highly compensated employees even though they may not earn much.

Simple Example

Let's look at a simple example of a ratio percentage test. Let's say your client's business has 100 employees: 10 5% business owners and 90 non-highly compensated employees. All 10 business owners want to participate in the plan. How many non-highly compensated employees must also be included in the profit sharing plan?

**100 Employees:
10 HCE owners & 90 NHCE**

All 10 owners participate

**% of HCE benefiting = 100%
% of NHCE who must benefit =
100% x 70% = 70%
70% x 90 = 63
63 NHCE must benefit**

Since all ten or 100% of the highly compensated employees will benefit in the plan, then 70% of the non-highly compensated employees must also benefit. 70% of the 90 non-highly compensated employees is 63 so 63 non-highly compensated employees must benefit. That means the plan must include 73 employees: 63 rank and file employees plus the 10 business owners.

More Interesting Example

To make things more interesting, let's assume we have the same

business, but only one of the business owners wants to participate. How many of the non-highly compensated employees must also benefit from the profit sharing plan?

**100 Employees:
10 HCE owners & 90 NHCE**

Only 1 owner participates

**% of HCE benefiting = 10%
% of NHCE who must benefit =
10% x 70% = 7%
7% x 90 = 7
7 NHCE must benefit**

Since only one or 10% of the highly compensated employees benefit, the number of non-highly compensated employees that must benefit is 70% of 10% or 7%. 7% of the 90 non-highly compensated employees is 7 so just 7 of the non-highly compensated employees must benefit from the profit sharing plan. Consequently the business owner could actually have a plan that included just himself and 7 rank and file employees.

Cautionary Notes

Defined benefit plans must satisfy an additional participation rule.

Additionally, any employees excluded from the plan must be excluded on a nondiscriminatory basis. This usually means the exclusions must be based on legitimate job classifications.

Please feel free to contact me if you want to discuss the ratio percentage test or any specific cases.

* This is the limit for 2008. It is indexed for inflation and may increase in the future.