

THE RISKS OF EXCLUDING PART-TIME AND SEASONAL WORKERS FROM QUALIFIED RETIREMENT PLANS

As more and more businesses are using part-time workers to address their hiring needs, it is important that employers consider how such workers affect their qualified retirement plans. In particular, employers and their service providers need to be very mindful of IRS guidance on the exclusion from qualified retirement plans of employees classified by the employer as part-time, seasonal, or temporary.

Earlier this year, the IRS issued a Quality Assurance Bulletin (QAB) to its employee plan agents regarding qualified retirement plans excluding part-time employees. In the QAB, the Service indicated that, effective with the opening of the EGTRRA Pre-Approved and Determination Letter Programs, agents will begin requesting that plan administrators remove or clarify language if a plan includes a provision that defines an exclusion classification by service and the plan provision could result in the exclusion, by reason of a minimum service requirement, of an employee who has completed a year of service. In particular, any plan containing a part-time, seasonal, temporary, or any other classification of employees will be scrutinized.¹

The emphasis by the IRS on class exclusions is not new. In 1994, the Service issued a Field Directive indicating that a plan may not exclude any part-time employee where it is possible for that employee to complete one year of service. Such exclusion, although not directly referring to age or service, may result in imposing a service requirement not consistent with § 410(a)(1) or § 410(b) of the Code. Section 410(a)(1) of the Code imposes certain minimum participation standards on qualified retirement plans. If a plan requires, as a condition of participation, that an employee complete a period of service with the employer extending beyond the later of the date on which the employee attains age 21 or completes one year of service,² then the plan will not be considered a qualified plan.

For example, a calendar-year plan requires one year of service and excludes part-time or seasonal employees if their employment is not for more than 20 hours per week or five months in any plan year.³ Joe, whose date of hire is January 1st, is classified as a part-time employee and consistently works 20 hours per week. Code Section 410(a) defines a year of service as a 12-month period during which the employee has not less than 1,000 hours of

service.

Joe, by consistently working 20 hours per week from January through the end of December works 1,040 hours per year. Because the part-time/seasonal plan definition requires employees to work more than 20 hours per week, the exclusion has the effect of requiring more than one year (1,000 hours) of service. The plan could not maintain its qualified status despite the fact that the plan could satisfy the coverage requirements under 410(b) after excluding all part-time and seasonal employees.

The IRS's Position Develops

Although the IRS treated part-time and other class exclusions with suspicion, its position as stated in a Technical Advice Memorandum (TAM) issued in 2000 was not to reject or require clarification of plan provisions that may impose impermissible age or service requirements at the time a determination letter was requested. Rather, the approach was to identify impermissible age and service conditions during the plan audit process. This was, however, after some determination letters were issued containing a caveat that the letter could not be relied on with respect to whether a plan's exclusion classifications, if any, violate the minimum age or service requirements of Section 410 by indirectly imposing any impermissible age or service requirements.

In 2001, the IRS revised Publication 794, which explains the limitations and scope of determination letters. Publication 794 indicates that a determination letter cannot be relied upon for purposes of § 410(a)(1). Thereafter, the IRS ceased issuing determination letters with the caveat included. In the QAB issued earlier this year, the IRS cautioned that an employer who received a determination letter on or after July 1, 2001 (after the release of revised Publication 794) cannot rely on its determination letter to protect the plan from retroactive disqualification if the plan contains an impermissible age or service requirement. Employers receiving determination letters before July 1, 2001, whose plans contain impermissible age or service provisions, may be able to rely on their determination letters, but only if the determination letters do not contain the caveat regarding non-reliance with respect to class exclusions.

Employers with plans containing part-time or other class exclusions need to review their plans to determine if the plan language provides a fail-safe in the event a part-time employee completes 1,000 hours of service in an eligibility computation period. Such a provision would act to allow those part-time employees into the plan, despite the part-time classification. If an employer's plan does not have a fail-safe provision, the employer should consult its attorney regarding using the IRS Voluntary Correction Program (VCP) to correct the document failure. Employers should also consult their attorneys if, despite a fail-safe provision in the plan, part-time workers who complete 1,000 hours of service have been excluded from participation.

Costly Correction

It can be costly for employers to correct this kind of plan defect. The correction method required under VCP is for the employer to include the improperly excluded employees into the plan and make contributions (plus attributable earnings) on behalf of those employees for the plan years in which they were improperly excluded. In the case of a 401(k) plan, the required contribution for each improperly excluded employee would be an amount equal to the average deferral percentage of the employee's testing group for non-discrimination testing purposes (highly or non-highly) plus a matching contribution (if the employer made a match) and attributable earnings on the deferral and match amounts, for each plan year in which the employee was excluded.⁴ This puts each employee in the same position he or she would have been in had he or she not been excluded from the plan. Despite the costs of voluntary correction, going through the correction program is much more cost effective than having the plan defect discovered during an IRS audit because the IRS would impose a sanction in addition to requiring the employer to provide contributions and earnings for the excluded employees.

The 1,000 Hour Exception

Employers can continue to use certain class exclusions as long as the plan also provides that employees working at least 1,000 hours will be eligible to participate. For example, a plan requires one year of service for participation and excludes part-time or seasonal employees. The plan further defines a part-time or seasonal employee as one who works less than 1,000 hours of service in an eligibility computation period. The QAB indicates that this is an acceptable class exclusion. Likewise, the QAB states that a plan provision that requires one year of service for participation and excludes hourly paid employees (those employees defined by the plan as receiving an hourly wage for their services) would not be challenged by the IRS because the plan is not excluding the hourly paid employees based on an age or service requirement.

Careful plan design can allow employers to accomplish their objectives while not running afoul of IRS guidance.

Notes 1. Employee Plans Determinations Quality Assurance Bulletin, Part-Time Employees Revisited, FY-2006 No.3, February 14, 2006. 2. Two years of service under § 410(a) (1) (B) (i). 3. QAB noted in endnote 1 above, citing Treasury Regulation § 1.410(a) (3) (e) (2), Example 3. 4. See Revenue Procedure 2003-44.