

# Benefit Insights



A non-technical review of qualified retirement plan legislative and administrative issues

August 2006

## Retirement Plan Coverage for Part-Time Employees

A major business trend in the American workplace is the hiring of part-time, seasonal or temporary employees (collectively referred to in this newsletter as “part-time employees”). Employers believe the advantages to using this alternative workforce include lower wages and significant savings in terms of not providing employee benefits to these individuals.

Unfortunately, many plan sponsors are under the misconception that all part-time employees can be excluded from participation in their qualified retirement plans when, in fact, the Internal Revenue Code does not permit part-time employees to be excluded as a class.

A qualified plan may be drafted to require that an employee work a minimum number of hours to enter the plan, but the maximum number of hours that can be required in a twelve-month period is 1,000. This maximum translates into approximately 20 hours a week, making many part-

time employees eligible for plan participation.

A bulletin issued by the IRS on February 14, 2006 indicates that it will be scrutinizing plans that attempt to exclude employees who have satisfied the 1,000-hour requirement by designating them as a certain class of employees who are excluded from coverage. Improper exclusion of employees can trigger expensive make-up payments or possible plan disqualification.

This newsletter will describe the minimum coverage requirements, the new IRS guidance and outline the correction methods for making improperly excluded employees whole.

### Minimum Coverage Requirements

Qualified plans are permitted to require an employee to satisfy minimum age and service requirements in order to become a participant in the plan. The maximum permissible service requirement for salary deferrals is one year of service, generally defined as the twelve-month period, beginning on the employee’s date of hire, during which the employee has worked at least 1,000 hours.

If the 1,000-hour requirement has not been met at the end of the initial twelve-month period,

many plan documents will switch to the plan year for measuring future service computation periods. Up to two years of service may be required for employer contributions to the plan, but employees must then become 100% vested immediately upon plan entry.

*EXAMPLE:* The Acme Company requires one year of service with 1,000 hours to become eligible to participate in its 401(k) plan. Employees become participants the first day of the month following completion of the service requirement. Ken is hired part-time on June 13, 2004. As of June 12, 2005 he has had 930 hours. He has not met the plan's service requirement.

Future service computation periods are measured based on the plan year. The next computation period begins on January 1, 2005 and extends through December 31, 2005. During this period Ken has 1,050 hours of service. He has now satisfied the service requirement and will enter the plan effective January 1, 2006.

### **Excluding Classes of Employees**

Plan documents usually exclude union and nonresident alien employees. Other classifications may be excluded on a discretionary basis if based on objective business criteria, such as hourly employees or a specific division of the company. However, it is not permissible to exclude part-time employees as a job classification. As long as a part-time employee meets the 1,000-hour requirement, it is irrelevant for qualified plan purposes that the employee is employed on a less than full-time basis.

If the plan excludes classifications of employees, it will be required to pass nondiscrimination testing to ensure that the plan is not discriminating in favor of highly compensated employees. In general, employees in the highly compensated group include more than 5% owners and employees who earn over an indexed limit (\$100,000 for 2006).

## **Effect of Short Service Requirement**

In order to attract qualified employees in today's competitive job marketplace, an increasing number of 401(k) plan sponsors are utilizing less than the traditional one year of service requirement. Some are offering immediate entry, at least for the salary deferral portion of the plan. A shorter service requirement or immediate participation could potentially cause all part-time employees to become plan participants. Generally most employers want to avoid including part-time employees in their plans because:

- These employees generally have little interest in participating in the plan but are still required to receive enrollment materials and a summary plan description on a timely basis once they have met the plan's eligibility requirements.
- If the plan is top heavy (a plan where the key employees' account balances make up 60% or more of the total plan assets), minimum contributions of up to 3% of compensation may be required for active participants, whether or not they have elected to make salary deferrals and regardless of the number of hours worked during the plan year.
- Increased administrative expenses.

## **Plan Participation Does Not Guarantee Employer Contributions**

Just because an employee has satisfied the plan's eligibility requirements and has become a participant in the plan does not automatically mean that he is entitled to receive an employer contribution unless the plan is top heavy. The plan may require a minimum number of hours of service during the plan year (1,000 is the maximum) and/or employment on the last day of the plan year to receive an allocation of the employer contribution.

*EXAMPLE:* The Crane Company requires one year of service with 1,000 hours to become eligible to participate in its profit sharing plan. Employees

become participants the first day of the month following completion of the service requirement. In order to share in the profit sharing contribution, the participant is required to work 1,000 hours during the plan year. Barbie was hired part-time on April 16, 2004. As of April 15, 2005 she had 1,020 hours and became a participant on May 1, 2005. For the plan year January 1, 2005 through December 31, 2005 she worked 975 hours. Since she had less than 1,000 hours during the plan year, she is not eligible to share in the profit sharing contribution. However, if this plan were top heavy, she would be entitled to a top heavy minimum contribution.

A plan that requires active participants to have a minimum number of hours of service during the plan year or terminated participants to have more than 500 hours of service in order to be eligible to share in the employer's contribution will be subject to nondiscrimination testing.

## New IRS Guidance

The IRS has long taken the position that employers cannot omit groups of part-time employees from plan participation simply because they work less than full time. In a bulletin issued in February 2006 the IRS indicated that document specialists will be requesting that plan administrators remove or clarify plan language if the plan provision could result in exclusion by reason of a minimum service requirement of an employee who has completed a year of service.

The IRS guidance included an example of how an employer might design the plan to exclude part-time employees but still satisfy the participation rules. The plan could provide immediate eligibility for full-time employees but require one year of service for employees who are scheduled to work less than 1,000 hours during the year as long as the plan includes fail-safe language that

says such employees will become participants if they actually work more than 1,000 hours during the computation period.

The bulletin warns that plans with improperly drafted clauses excluding part-time employees may be subject to disqualification regardless of whether the plan has a determination letter. If the plan received the determination letter after June 30, 2001, the plan sponsor cannot rely on the letter to protect the plan regarding this issue. If the determination letter is dated before July 1, 2001, then the letter should protect the plan from retroactive disqualification.

## Making Participants Whole

Qualified plans that have improperly excluded part-time employees from participation are required to make these individuals whole. Failure to make the necessary corrections can result in severe monetary penalties and possible plan disqualification if discovered on plan audit.

The IRS has recently updated its Voluntary Correction Program (VCP) which includes new guidance for correcting the failure to include an eligible employee in a 401(k) plan. With regard to the 401(k) deferral, the employer is required to make a Qualified Nonelective Contribution (QNEC) in the amount of 50% of the "missed deferral."

The "missed deferral" is calculated by taking the average deferral percentage of the excluded employee's group (either highly compensated or non-highly compensated) times the employee's compensation during the period of the exclusion.

If the plan provides for matching contributions, the employee is required to receive a QNEC equal to the matching contribution the employee would have received on the missed deferral. The plan's matching percentage is multiplied by the missed deferral amount.

QNECS must be 100% immediately vested and are subject to withdrawal restrictions. The corrective contributions must be adjusted for earnings.

*EXAMPLE:* Alex is a part-time, non-highly compensated employee who was improperly excluded from his employer's 401(k) plan and should have become a participant effective January 1, 2005. The average deferral percentage of the non-highly compensated group was 4.20% for the plan year ending December 31, 2005. Alex earned \$15,000 during 2005.

His missed deferral is calculated by multiplying his compensation (\$15,000) times the non-highly compensated group's average deferral percentage (4.20%) which equals \$630. To make Alex whole, his employer makes a QNEC in the amount of 50% of the missed deferral amount, or \$315. Since the plan provides for a 25% matching contribution, Alex will also receive a QNEC in the

amount of \$157.50 (25% times the \$630 missed deferral). These corrective contributions will also be adjusted for earnings.

## Conclusion

Plan sponsors should carefully examine their plan document language to determine if an amendment is necessary to ensure that employees working 1,000 or more hours during the computation period are eligible for plan participation. Administrative practices should be reviewed carefully to determine if part-time employees have been improperly excluded. If so, the plan sponsor should consider using the IRS VCP to correct the failure and make the participants whole to avoid stiff penalties or possible plan disqualification.

Complete census data, including part-time employees, should always be provided to the plan's third party administrator to ensure that the plan is being administered properly.

The information contained in this newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is provided with the understanding that our company is not engaged in rendering legal or tax advice. Legal or tax questions should always be referred to a qualified tax advisor such as an attorney or CPA.

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