A Trap for the Unwary Employer: Failure to Cover Part-Time and Temporary Employees Under a 401(k) Plan

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Background. Clients often ask us whether certain groups of employees, such as part-time or temporary employees, must be covered under their 401(k) plan. (Exclusion of leased employees (employees who perform services for a company pursuant to an agreement with a leasing organization) and so-called "independent contractors" present separate, complex issues and will be covered in future memos.) While tax-qualified plans are not required to cover all of a company's employees, care must be taken when crafting plan exclusions, as the Internal Revenue Code rules governing employee participation are quite complex.

Mistakenly excluding a group of employees from a plan can pose a serious problem, as the client must make corrective contributions to the plan on behalf of those employees or risk plan disqualification and significant tax consequences. Unfortunately, it is very common for employers to misunderstand or inadvertently misapply the employee participation rules.

For example, many employers think of part-time and temporary employees as individuals who are not "regular" employees and therefore can be excluded from company benefits. This is understandable -- in fact, an employer's health and welfare plan may **require** the exclusion of part-timers and temps. An employer who mistakenly extends coverage to such individuals is likely to face the wrath of the insurance carrier if the error is discovered. An employer who is required to exclude part-timers and temps from its medical coverage may reasonably believe that it is also required (or at least allowed) to exclude them from its 401(k) plan.

Check the Plan Document. An employer should always check the terms of its 401(k) plan document (i) before deciding to exclude a group of employees from participation, or (ii) when auditing its plan operations to make sure the coverage rules are being applied correctly. Prototype plan documents and adoption agreements almost never exclude employees using terminology such as "part-time" or "temporary." While plan documents may occasionally be modified to contain service-related exclusions that the plan document provider has deemed acceptable, most plan providers are becoming increasingly conservative about including any exclusion that could be interpreted as service-based, even if there is authority that the exclusion is acceptable.

Excluding Some Employees from Plan Participation is Permissible.

–*Some service exclusions are permitted under the Code*. To a limited extent, the Code permits employers to elect to design their 401(k) plans to exclude employees from participation based on service. For example, an employer can require employees to work up to 1,000 hours of service in a year before they are allowed to begin participation in its 401(k) plan.

–*Some exclusions based on job classification are permitted*. Similarly, an employer can design its 401(k) plan to exclude specific groups of employees from participation based on their job classification, so long as the exclusion is reasonable and the 401(k) plan still passes all applicable coverage tests. Regulations generally provide that the exclusion of a class of employees will be "reasonable" if it is based on objective business criteria, such as (i) specified job categories (i.e., as administrative vs. production), (ii) the nature of compensation (salaried vs. hourly employees), (iii) geographic location (such as Peoria office employees vs. Stockton office employees), or (iv) similar bona fide business criteria.

–*However, excluding employees based on a* ***service-related*** *job classification can be hazardous.* A problem arises when an employer attempts to draft its plan to exclude a class of employees using job classifications such as "part time employees," "temporary employees," "seasonal employees," "casual employees," etc. Such job classifications, while quite common in the workplace, are ultimately based on service. While an employer may believe that drafting a plan to exclude part-timers or temporary employees from a 401(k) plan is reasonable – i.e., constitutes a valid plan exclusion based on a reasonable job classification -- the regulations and the Internal Revenue Service take the position that applicable law already provides employers with a method for excluding employees based on service, which employers can choose to make use of, or forego (the maximum one-year, 1000-hour exclusion discussed above). If an employer chooses not to draft its plan to include the statutory service-based exclusion, it cannot then turn around and exclude employees by using a job classification that is based on service.

–*Excluding employees based on an intentionally disguised service-related job classification can be really hazardous*. Employers should never intentionally draft a plan participation exclusion that does not specifically refer to service, but has the effect of imposing a service requirement. For example, suppose an employer permits employees in Division 1 to participate in its plan, but not employees in Division 2. If an employee must be employed in Division 2 for two years before he or she can move to Division 1, then the exclusion is really a service-based exclusion, disguised as a geographical or structural exclusion.

Examples of classifications that work and don't work.

(1) The plan excludes part-time employees, and a "part-time employee" is defined as an employee who has not yet completed a year of service (1,000 hours in a year) within the meaning of the Code's minimum service rules. Theoretically this definition should work, as it tracks the provisions of the Code's minimum service rules.

(2) The plan excludes part-time employees, but a "part-time employee" is defined as an employee regularly scheduled to work 20 hours or fewer a week. This definition is not advisable, because in operation the plan could impermissibly exclude someone who worked 1,040 hours in a year and therefore satisfied the Code's minimum service requirement.

(3) The plan excludes part-time employees, with the exception that "any employee who completes a year of service as defined by Code Section 410(a) will become eligible to participate." Theoretically, this definition should work, since it does not appear to violate the minimum coverage rules. However, recently a major 401(k) prototype provider rejected this very language when approached on behalf of a client.

There are probably two reasons for the rejection. First of all, IRS reviewers and auditors are directed to carefully scrutinize any plan provisions that may contain an "indirect service requirement." Second, IRS determination letters no longer address whether a plan exclusion provision (questionable or not) actually violates the minimum service requirements. As a consequence, many 401(k) plan providers simply choose not to implement such exclusions on behalf of employers, even when they should likely be permissible.

(4) The plan excludes "night watchmen" and "custodians." At first glance, these job classifications seem to be reasonable and not to be service-based. However, if all night watchmen and custodians just happen to be part-time employees, these classifications may be suspect. If most night watchmen and custodians are part time, but some regularly earn more than 1,000 hours of service in a year, the exclusion might be even more suspect, and might be declared in violation of the Code if the plan were audited.

(5) The plan excludes "regular employees." If the plan is ever audited, such a definition is asking for trouble, because it is vague and could be easily abused by an employer seeking to circumvent the minimum coverage rules.

What Should Employers Do?

(1) Employers should examine their 401(k) plan document and adoption agreement. They should determine which categories of employees are validly excluded under the terms of these documents, and then conduct an audit of actual 401(k) plan operational practices to verify that the exclusions are being correctly implemented.

(2) If the plan has been impermissibly excluding part-time or temporary employees in operation, the employer should review all service records pertaining to such individuals and –working with the plan's administrator and recordkeeper –make a corrective contribution to the 401(k) plan on their behalf.

Example. Suppose that a part-time employee was erroneously excluded from an employer's plan for a period of one year. To avoid possible disqualification upon audit, the employer will have to make a corrective contribution to the 401(k) plan to make the employee whole for the lost opportunity to make salary deferral contributions. In this example, the employee earned $40,000 compensation, so he or she is considered a "non-highly compensated" employee under the Code. The employer should take the "average deferral percentage" ("ADP") for non-highly compensated employees covered by the plan and multiply that percentage by the employee's salary. Assuming that the most recent ADP for non-highly compensated employees was 5%, the result would be $2,000. Then, following IRS guidelines, the employer should contribute 50% of that amount, or $1,000, to the plan on behalf of the employee. Interest and earnings on the $1,000 amount should also be contributed to the plan, as well as a separate contribution for missed employer matching contributions, if applicable. With the assistance of counsel, the employer should determine whether an actual filing with the IRS is required, or whether the exclusion of eligible employees is eligible for "self-correction" without a filing under applicable IRS rules.

(3) Policies and procedures should be implemented to ensure that eligible employees are not excluded from the plan in the future.

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