



Electronic Dispatch

Employee Benefits Law Action Memo

April 2006

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INTERNAL REVENUE SERVICE REVISITS RETIREMENT PLAN EXCLUSION OF PART-TIME EMPLOYEES

In a recent Employee Plans Determinations Quality Assurance Bulletin ("Bulletin"), the Internal Revenue Service ("IRS") summarized the Internal Revenue Code and Treasury Regulation provisions that may prevent a retirement plan from being designed and operated to exclude part-time, seasonal or temporary employees. The Bulletin also directs IRS employee plans specialists to begin requesting plan sponsors to remove or clarify plan language, if the language includes a provision that defines a plan exclusion by reference to service and the plan provision could result in the exclusion, by reason of a minimum service requirement, of an employee who has completed more than one year of service.

Applicable Law

Generally, a retirement plan intended to satisfy the tax-qualification rules of the Internal Revenue Code ("Code") can be designed to include or exclude employees based upon objective business criteria such as payroll status (salaried vs. hourly), work location or union membership. Eligibility provisions that are based, directly or indirectly, on an employee's age or service, however, are subject to limitations. Code Section 410(a) generally provides that a plan will not be tax-qualified if the plan requires, as a condition of participation, that an employee complete a period of service extending beyond the later of the date the employee attains age 21 or the date the employee completes one year of service (two years of service in the case of a plan that provides for full and immediate vesting). Because most plans define a year of service as the completion of at least 1,000 hours of service in a 12-month period, the Code Section 410(a) limitation on service generally means that a plan is prohibited from excluding employees on the basis of service, if the service requirement is greater than 1,000 hours in a year. For example, a plan could not exclude employees on the basis of service, if the service requirement is 1,500 hours of service in a year. (For plans that credit time other than on the basis of actual hours worked, the service maximum may be less than 1,000 hours.)

Treasury Regulations under Code Section 410(a) provide that plan provisions that exclude a group of employees may be treated as imposing age and/or service conditions, even though the provisions do not specifically refer to age or service. Whether such provisions have the effect of indirectly imposing a service requirement in excess of that permitted by Code Section 410(a) generally will depend on an examination of all the facts and circumstances. However, a plan provision will be treated as violating Code Section 410(a) if 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.

IRS Guidance

In guidance published by the IRS in 1994, the IRS indicated that it would ask plan sponsors to clarify or correct plan language if the plan language defined an exclusion by reference to an employee's service. The IRS indicated that this was an issue typically encountered in audits of plans that attempted to exclude part-time or seasonal employees. The IRS observed that part-time or seasonal employees are commonly defined as employees who are expected to work less than 1,000 hours of service during a year or employees who do not customarily work more than 20 hours per week. According to the IRS, these are service requirements that could result in the exclusion of an employee from a plan, even though the employee completes more than 1,000 hours of service in a year.

According to the February 14, 2006 Bulletin, effective with the February 1, 2006 opening of the IRS determination letter program for plan amendments required by the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), IRS specialists will again be requesting plan sponsors to remove or clarify plan language, if the plan language defines a plan exclusion by reference to an employee's service and that plan language could result in the exclusion, by reason of the service requirement, of an employee who has completed a year of service. While plan specialists will closely scrutinize any exclusion, those expressly based upon service will have to be removed or



clarified to ensure that the plan does not require service in excess of 1,000 hours in a year. If a plan defines an exclusion without reference to service, the exclusion generally will not be challenged.

The Bulletin includes the following example to demonstrate how plan exclusions will be reviewed:

Two plans, Plan A and Plan B, both provide for one year of service as a condition of participation. Both plans also provide that employees classified as part-time or seasonal employees shall not be eligible to participate in the plan.

Plan A defines a part-time or seasonal employee as an employee who works less than 1,000 hours of service in an eligibility computation period. Plan B defines a part-time or seasonal employee as an employee who is scheduled to work less than 1,000 hours of service in a year.

Plan A should not be challenged. Although Plan A provides an exclusion classification that references service, the plan provision is not imposing a service requirement in violation of [Code Section] 410(a)(1). Any employee that works 1,000 hours or more in an eligibility computation period would not meet the definition of a part-time or seasonal employee and thus would be eligible to participate.

Plan B should be challenged as the plan includes a provision that could impose a service requirement in violation of [Code Section] 410(a)(1). The plan language provides that a part time or seasonal employee is one who "is scheduled" to work less than 1,000 hours of service. The plan provision could result in the improper exclusion of an employee who worked more than his "scheduled" hours of service.

Plan B would have to be amended to define the exclusion classification in such a way as to avoid imposing an indirect service requirement in violation of [Code Section] 410(a)(1). Plan B could also be amended to include "fail-safe" language which provides that, notwithstanding any exclusion classifications, any employee that completes at least 1,000 hours of service in an eligibility computation period will be an eligible employee.

Recommended Action

Plan sponsors should review their plans to ensure that any plan exclusions related directly or indirectly to service do not, directly or indirectly, require service in excess of 1,000 hours of service in a year (two years, if the plan provides for full vesting). Including a "fail-safe" provision, like the one described in the example above, is another means to ensure compliance with the Code's minimum participation requirements.

As a reminder, the EGTRRA determination letter program opened on February 1, 2006 for individually-designed plans sponsored by employers that have a federal employer identification number that ends in one (1) or six (6). For more information on the new five-year determination letter cycle, please see the September 2005 Bond, Schoeneck & King *Employee Benefits Law Action Memo*.

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