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Part-Time Employees in 401(k) Plans

More and more businesses are hiring 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 401(k) plan sponsors are under the misconception that all part-time employees can automatically be excluded from participation in their plans when, in fact, the Internal Revenue Code does not permit a plan to include a blanket exclusion of part-time employees.

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 an average of a little over 19 hours a week, making many part-time employees eligible for plan participation.

This newsletter will describe the minimum service requirements for 401(k) plans and the effects of improperly excluding part-time employees.

Minimum Age and Service 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 non-safe harbor 401(k) plans, but employees must then become 100% vested immediately upon plan entry.

The plan is also permitted to set a minimum age requirement. The maximum permissible is age 21.

Entry Date

Once employees have met the age and service requirements for the plan, they will enter the plan on the entry date specified in the plan document. Common entry dates for 401(k) plans are the first pay period after meeting the eligibility requirements or the first day of the month

or quarter after the requirements have been met (in general, semi-annual entry is the maximum permissible).

Example: Eagle Company requires one year of service with 1,000 hours to become eligible to participate in its 401(k) plan. Employees enter the plan the first day of the month following completion of the service requirement. Ken is hired part-time on June 13, 2014. As of June 12, 2015 he has had 930 hours of service. He has not met the plan's service requirement.

The plan document requires that future service computation periods be measured based on the plan year. The next computation period begins on January 1, 2015 and extends through December 31, 2015. During this period Ken has 1,050 hours of service. He has now satisfied the service requirement and will be eligible to enter the plan effective January 1, 2016.

Effect of a Short Service Requirement

In order to attract qualified employees, an increasing number of 401(k) plan sponsors are utilizing less than the maximum 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; and
- Increased administrative expenses.

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 because this exclusion may result in the plan violating the maximum service requirement.

IRS auditors have been directed to carefully scrutinize plans that attempt to exclude employees who have satisfied the 1,000-hour requirement by disguising them as a certain class of employees who are excluded from coverage.

Even when a plan properly excludes certain classifications of employees, it is required to pass additional tests to ensure the exclusion does not discriminate in favor of highly compensated employees (HCEs). In general, an HCE is anyone who directly or indirectly owns more than 5% of the plan sponsor or who earns more than an indexed dollar amount during the immediately preceding year (\$120,000 for 2016).

Excluding Part-Time Employees with a Fail Safe Provision

There is a way for the plan to allow full-time employees immediate entry and minimize part-time employee eligibility. The IRS has provided clear guidance and examples of how a plan document may be designed to exclude part-time employees without violating the 1,000-hour service requirement.

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 a computation period.

Service Requirements for Employer Contributions

Just because a part-time employee has satisfied the plan's age and service requirements and has become a participant in the plan does not automatically mean that he or she 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: Dove Company's 401(k) plan eligibility requirement is one year of service with 1,000 hours. Employees become eligible to make deferrals and receive matching contributions the first day of the month following completion of the service requirement. In order to share in the matching contribution, the participant is required to work 1,000 hours during the plan year.

Barbie was hired part-time on April 16, 2014. As of April 15, 2015 she had 1,020 hours, became a participant on May 1, 2015 and began making deferrals to the plan. For the plan year January 1, 2015 through December 31, 2015 she worked 975 hours. Since she had less than 1,000 hours during the plan year, she is not eligible to share in the matching 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 (matching and/or profit sharing) will be subject to nondiscrimination testing.

Impact on ADP and ACP Tests

The Average Deferral Percentage (ADP) test is performed on employee deferrals while the Average Contribution Percentage (ACP) test is performed on matching and/or voluntary after-tax contributions (other than Roth deferrals). The percentages for each employee within the HCE and non-HCE (NHCE) groups are totaled and averaged to get the ADP and ACP for each group. The averages for the HCE group may not exceed a specific ratio of the average for the NHCE group.

In performing the ADP test, all active and terminated employees eligible to defer at any time during the plan year are included, whether or not they actually made a deferral. In general, the ACP test includes all active and terminated employees who met the plan's requirements to receive a match regardless of whether they actually made a deferral and received a match.

Plans that do not pass the test(s) must take some action, such as corrective distributions or additional employer contributions. Corrective distributions generally must be made within 2½ months after the end of the plan year to avoid a 10% excise tax. Improperly excluding part-time employees who have satisfied the eligibility requirements will cause these tests to be performed incorrectly, possibly resulting in corrective action not being taken on time for failed tests.

Making Excluded 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 recently updated its pre-approved correction program for a failure to include an eligible employee in a 401(k) plan. In a nutshell, if the participant in question is properly enrolled no later than three months following the initial failure, then no corrective contribution is required for the missed deferral opportunity. However, matching contributions (if applicable), including earnings, are required as well as a notice to affected participants.

If the failure is discovered beyond three months but less than two years (the end of the self-correction period) after the failure, a qualified nonelective contribution will be required for the missed deferral opportunity. The percentage of compensation to be contributed for the missed deferral opportunity is calculated by multiplying the average deferral percentage of the excluded employee's group (either HCE or NHCE) by 25%. Matching contributions (if applicable), earnings on the corrective contributions and a notice to affected participants are also required.

Conclusion

A plan sponsor should never automatically assume that part-time employees are not eligible to participate in its 401(k) plan. Plan document provisions should be reviewed and administrative practices put in place to ensure part-time employees who meet the minimum service requirement are timely enrolled in the plan.

If it is discovered that part-time employees have been improperly excluded, the plan sponsor should consider using the IRS pre-approved program to correct the failure and make the participants whole to avoid stiff penalties or possible plan disqualification.

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