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Using Employee Classification Exclusions

Without targeted exclusions, many employers would be unable to offer a retirement plan at all, or only a very expensive one.

BY JAMES H. CULBRETH, JR.

For an employer with a diverse workforce (i.e., both manufacturing and distribution employees), covering all employees in its retirement plan may be too costly. Instead, an employer may want to create a retirement benefit structure that reflects market needs by offering retirement benefits to only some employees or at different levels to different groups of employees within the workforce.

While excluding some employee classifications or offering different benefit levels to groups within a single plan is difficult under the Internal Revenue Code and ERISA, without targeted exclusions, an employer may be unable to offer a retirement plan at all, or only a very expensive one. Fortunately, plan consultants are comfortable recommending actions based upon practical concerns in retirement plan design, such as making the plan broadly available or rewarding only those employees who are most productive.

Such decisions not limited to the prevailing format of participant salary deferrals and employer matching/profit sharing contributions, since allowing more employees to participate in the retirement plan can lower the salary deferral limits for highly compensated employees (HCEs) by expanding participation by employees who may not defer any, or significant, compensation. Permitting more lower-deferring, less-highly compensated employees in a salary deferral plan reduces both the plan's actual deferral percentage and cap on salary deferrals by HCEs, and broad participation increases employer matching and profit-sharing contributions since more employees qualify for them.

This article examines three ways to restrict participation in a retirement plan under ERISA and the Code: the "soft" exclusions and other design-based exclusions, controlled groups, and the QSLOB exemption.

DOCUMENT FLEXIBILITY

One of the first considerations is the document supporting the plan. Many prototype plans using adoption agreements limit exclusions for the desired employees or subsidiaries, or may not offer other limitations in the Adoption Agreement. Before moving beyond the "soft" exclusions described below, the first step is to determine that the document will permit the exclusions permitting the retirement plan goals. In such situations, an individually designed plan document may be more appropriate. For example, an individually designed plan

may be able to obtain a determination letter from the IRS on a classification that excludes part-time employees as a class *until they have attained 1,000 hours of service*, a useful provision if the employer typically hires part-timers to work less than 1,000 hours in a plan year.

EMPLOYEE CLASSIFICATIONS

Once it has been determined that the form of retirement plan supports flexibility for the employer, the employees must be identified. The common classification is a "common law employee" under Code Section 3401(d), defined as "the person for whom the individual performs service … as the employee of such person." The broad definition includes most employees and employment relationships, both salaried and hourly. This becomes murky with individuals whose taxable income is reported on a Form W-2 while working under an employment contract, as contrasted with individuals whose income as an independent contractor is reported on Form 1099 and not a Form W-2. As a result, the term "contract employee" can be confusing because an individual under an employment contract could either be a Form W-2 employee and eligible for the retirement plan or a person whose income is reported under a Form 1099 as a "contractor."

Further complicating the decisions are workers who are "leased" from an outside source with whom the plan sponsor arranges for the individuals to work alongside onsite employees. Leased employees under Code Section 414(n) may be excluded as a class from the leasing employer's retirement plan if it meets the requirements of Section 414(n).

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Another alternative is to affiliate with a professional employer organization (PEO) in which both the employer and the PEO have control over specific of an individual's work. PEOs are intended to offer a means to successfully exclude employees from the employer's benefit plans by jointly hiring the employees with the PEO. In such arrangements, the employer and the PEO retain specific aspects of their employment, with the PEO providing the retirement benefits. PEOs present their own challenges because these are contractual arrangements and the lines drawn between the roles of each employer must be precise in order to avoid the having the "co-employed" individuals eligible for benefits in both retirement plans.

THE 'SOFT' EXCLUSIONS

The simplest ways to exclude specific groups of employees are through the "soft exclusions" of requiring the employee to attain age 21 and requiring 1,000 hours of service in a plan year. Code Section 410 allows these limited age and year of service exclusions, and most pre-approved plan documents permit them. Neither soft exclusion is required, and an employer may admit employees into the retirement plan on the date of hire or before age 21.

The other soft exclusions include non-resident aliens and collectively bargained employees, along with leased employees as mentioned above. Excluding employees through the age and hours of service requirements reduces high-turnover employees (those who quit within the first year of service); the other three are identifiable groups.

Each soft exclusion must be elected by the employer under the plan document. The default under the Code and most prototype plan documents is including all employees, and only specific plan language can overcome this presumption.

Additionally, Code Section 403(b) permits colleges and universities to exclude student employees from 403(b) plans in recognition of the fact that students work for the school on a temporary basis with no intention of maintaining that relationship. This exclusion is not available to 401(k) plans.

EXCLUDING HCEs

One limited exclusion permits an employer to exclude HCEs from participating in its retirement plan. While collectively bargained employees can be excluded from a plan or the controlled group, maintaining a separate plan for hourly paid union employees and salaried employees generally will be tested as one plan for coverage and nondiscrimination

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purposes. Thus, excluding HCEs from a plan is a permissible strategy. However, HCEs generally expect some form of retirement compensation and may not be satisfied if they are excluded from the retirement plan. This strategy is further limited because the employer cannot sponsor another qualified plan that covers any HCE, or the plans will be tested together for coverage and non-discrimination using all the HCEs and non-HCEs in the workforce and result in the HCEs being able to defer less compensation and receive reduced employer contributions.

CONTROLLED GROUPS

A plan sponsor may exclude employees from its retirement plan by moving the employees to an entity related to the plan sponsor with less than 100% common ownership. "Controlled groups" under Code Section 414 (b) (and affiliated service groups under Section 414(m)) recognize that some employers move retirement plans and the related costs to subsidiaries controlled by the initial employer but operated under separate employer identification numbers and as separate entities. The controlled groups exist as brother/sister, parent/subsidiary, administrative service organizations, management service organizations, and hybrids of these. A full discussion of controlled groups is beyond the scope of this article, but if designed properly, a plan sponsor could give up as little as 21% of the ownership of the assets or the equities in another entity and avoid having a controlled group issue by moving the other entity outside of its controlled group.

Avoiding a controlled group requires careful planning because IRS and DOL audits request information on related entities, and overlooking a controlled group can create multiple problems. It can be expensive to correct the missed salary deferrals and matching contributions, depending on the size of the workforce, the payroll, and the time the controlled group employees were not permitted to participate in (or benefited at a reduced level from).

QUALIFIED SEPARATE LINES OF BUSINESS

The ability to establish a retirement plan within a single organization which benefits employee groups differently may be addressed through the qualified separate line of business (QSLOB) rules. Under Code Section 414(r), QSLOBs may provide such varied benefits, but only for employers demonstrating elements of a QSLOB.

In order to claim and operate different benefit structures for each QSLOB, an employer must demonstrate four factors covering size, financial, organizational and management concerns. The most difficult limitation for most employers is that at least 50 employees must be employed by the QSLOB; this keeps smaller employers from using a QSLOB to differentiate the retirement benefits available to groups. Under Section 414(r), an employer must notify the IRS before claiming the QSLOB status. Treasury regulations provide information on safe harbors for QSLOBs and offer qualifying employers detailed guidance for determining how to create and operate a QSLOB.

SUMMARY

An employer may exclude certain groups of individuals from participation and coverage by using the "soft" exclusions, after confirming that the proper elections are made in the plan document. An employer trying to use other design-based exclusions, such as excluding HCEs, should act strategically and not just tactically, since the implications of excluding some groups, or including some groups, may reach far beyond the simple benefits being provided. The general rule is to include any employee that works 1,000 hours of service and not rely upon any seasonal or part-time designation for those employees.

Lastly, an employer with a large workforce divided into different business segments with different accountability management and organization responsibilities could consider declaring that the retirement benefits for these groups qualify for the QSLOB exemption and need not be tested with the other employees covered under the plan. PC

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