Verrill

Retirement Plans: What Categories of Employees may be Excluded?

by Lisa S. Boehm on March 28, 2024

We are often asked about the permissibility of excluding certain categories of employees from participating in an employer's tax-qualified retirement plan.[1] This post provides a high-level summary of what is and is not permitted.

- *Excludable by Statute*. Certain categories of employees, by statute, may be excluded from participating in an employer's tax-qualified retirement plan. Examples include collectively bargained employees, provided retirement benefits were the subject of good faith bargaining between employee representatives and the employer, and nonresident aliens with no U.S.-source earned income.

  The exclusion for nonresident aliens is especially helpful for U.S. companies that are members of a controlled group of corporations that includes foreign corporations because, under the controlled group rules, all employees of all controlled group members are treated as employed by a single employer. Without this exclusion, it might not be possible for that U.S. company to offer a retirement plan to its employees because the plan would not cover enough nonhighly compensated employees, taking into account the employees of all controlled group members.

- *Excludable Without Any Fail-Safe Provision*. A tax-qualified retirement plan may exclude other categories of employees without any "fail-safe" provision if the exclusion is not service-based. An exclusion is not service-based if it is based on job function or some other common factor that is not tied to service. Examples include employees who are warehouse employees, employees in Division X of the employer, employees in the Kansas City, Missouri office, and retail employees other than those employed in retail stores in New Hampshire.

  A "fail-safe" provision is a plan provision stating that the plan will not exclude an employee in the excluded category who has attained age 21 and completed either one 1 year of service (as defined in the statute) or, in the case of elective deferrals to a 401(k) plan, the alternative SECURE 2.0 long-term, part-time employee ("LTPT") service requirement.

- *Excludable With Fail-Safe Provision*. If the excluded category is tied to service, the exclusion will not be permissible unless the plan includes a fail-safe provision. Examples include exclusions for employees expected to work less than X hours per week (think

[1] A tax-qualified retirement plan is a plan that meets the requirements of Section 401(a) of the Internal Revenue Code of 1986, as amended ("Code"). Examples include 401(k) plans, profit sharing plans, and defined benefit pension plans.

part-time employees), employees expected to work for a certain period of time (think seasonal employees or temporary employees), and employees expected to work as needed (think per diems). The reason is that the IRS considers any exclusion that is tied to service to be a minimum service requirement, and tax-qualified retirement plans generally may not, except as explained in the first and second bullet points, exclude employees who are at least 21 years old and have completed one year of service (or, in the case of 401(k) elective deferrals, the alternative LTPT service requirement).

Even if the excluded category does not specifically refer to service, the IRS nevertheless may view it as a service-based exclusion if, in the context of the employer's job categories, there is no common factor (*e.g.*, job function or location) for the excluded category apart from service.

Finally, the ability to exclude categories of employees beyond those described in the first bullet point will always be subject to the plan satisfying the minimum coverage requirements of Code Section 410(b) after giving effect to the exclusion.

Please contact a member of our Employee Benefits & Executive Compensation Group if you have any questions about excluding certain employee categories from participating in a tax-qualified retirement plan.

Lisa S. Boehm
Partner
T (207) 253 4904
email