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Employee Benefit Plan Review

What Plan Sponsors Need to Know About Proposed IRS Regulations for Long-Term, Part-Time Employees

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The Internal Revenue Service (IRS) has issued a Notice of Proposed Rulemaking addressing the "long-term, part-time employees" rules enacted under the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE 1.0) and the SECURE 2.0 Act of 2022 (SECURE 2.0). The proposed regulations provide helpful clarity for plan sponsors required to implement these new rules.

Background

Historically, employees could not be excluded from participating in a 401(k) plan beyond age 21 or after completing 1,000 hours of service during a 12-month period (year of service).

SECURE 1.0 expanded eligibility by requiring that employees who perform 500 hours of service during a consecutive three-year period (long-term, part-time employees) must also be permitted to participate in an employer's 401(k) plan (including catch up and Roth elective contributions) beginning on or after January 1, 2021. The IRS clarified that these requirements do not apply to certain classifications of employees, such as those employees covered by a collective bargaining agreement and non-resident aliens who receive no U.S.-source income. The IRS also confirmed that an individual who otherwise would be eligible to participate as a long-term, part-time employee may be excluded from participating if they are a member of a job classification that is not based on age and service and is specifically excluded from participating under the terms of the plan.

SECURE 2.0 expanded the eligibility requirement even further by reducing, from three years to two, the maximum number of years an employer may require a long-term, part-time employee to work before they are eligible to contribute to a retirement plan. SECURE 2.0 also extended the long-term, part-time coverage rules to ERISA-governed 403(b) plans.

While the Proposed Regulations do not address ERISA-governed 403(b) plans, plan sponsors should expect that similar rules will apply in the 403(b) context, although there are some unique issues due to the universal availability rule that applies to 403(b) plans that need some clarification.

The Proposed Regulations also do not address grandfathered governmental 401(k) plans or church 401(k) plans. The long-term,

part-time employee rules present some unique concerns for these plans, since they have historically been exempt from the minimum service and vesting rules. The IRS received over 19,000 comments by the deadline of January 26, 2024.

The Proposed Regulations provide the following key clarifications when implementing the rules for long-term, part-time employees.

Determining the 12-Month Measuring Period

The 12-month measuring period to determine whether an employee is a long-term, part-time employee begins on the later of the employee's hire date or January 1, 2021. The Proposed Regulations clarify that a 12-month period beginning before, or any hours of service earned prior to, January 1, 2021, shall not be counted for eligibility and vesting.

After an employee's initial 12-month measuring period for which an employee is credited with at least 500 hours of service, the plan can elect to switch from anniversary year to plan year, if provided under the plan terms. However, this means that an employee's initial 12-month measuring period and second 12-month period may overlap and run concurrently during such time period of the overlap and result in an employee meeting the requirements of a long-term, part-time employee earlier. For example, an employee hired on December 1, 2024, and who completes 700 hours of service by December 1, 2025, and completes 700 hours from January 1, 2025 through December 31, 2025, would be eligible to participate in 2026 as a long-term, part-time employee.

Further, the 12-month counting periods with 500 hours of service must be consecutive, such that if the employee works less than 500 hours in year two, the employee will not satisfy the counting rules and the counting must start over. However, after the long-term, part-time employee satisfies the counting rules, they remain a long-term, part-time employee even if they then work less than 500 hours in later years or terminate employment and are later rehired without satisfying the historic 1,000 hours requirement.

Elapsed Time Method

The long-term, part-time employee rules will not apply to plans that use an elapsed time method of crediting service. Since hours are not actually counted under the elapsed time method, an eligible employee who is classified as a "part-time employee" must be allowed to participate after completing a one-year period of service, without regard to hours worked.

Equivalency Method

A plan may use an equivalency method to determine whether an employee is credited with at least 500 hours of service during a 12-month period (e.g., 190 hours for each month an employee would be required to be credited with at least one month of service). The Proposed Regulations clarify that the required 500 hours of service cannot be reduced or changed. However, a plan may use any permissible equivalency method, as long as the method is described in the plan documents.

Entry Date

Long-term, part-time employees remain subject to the same entry date rules as other eligible employees under the plan. Specifically, participation must be no later than the earlier of (i) the first day of the first plan year beginning after the date the employee satisfies the eligibility requirements, or (ii) the date that is six months after satisfying the eligibility requirements.

Vesting

Each 12-month period during which the long-term, part-time employee is credited with at least 500 hours of service must be counted for vesting purposes, whether or not the employee was eligible for an employer contribution during that period. The Proposed Regulations clarify that while the vesting computation period for long-term, part-time employees may be based on a calendar year, plan year, or another 12-consecutive month period as designated by the plan, the plan may also elect to align the vesting schedule with that of other employees.

Break in Service

A long-term, part-time employee that is participating in a plan will not experience a break in service if the employee is credited with fewer than 500 hours of service during a 12-month period and may continue to make elective contributions to a plan. During such period, though, the long-term, part-time employee is not required to be credited with a year of vesting service.

Former Long-Term, Part-Time Employee

- If an employee becomes eligible to participate in a plan because the employee met the long-term, part-time requirements, but is later credited with 1,000 hours of service, or completes the plan's regular eligibility requirements, the employee would then be considered a "former long-term, part-time employee." The Proposed Regulations require that a former long-term, part-time employee continues to vest on a 500 hours of service vesting schedule, even though a 1,000 hours of service vesting schedule may apply to other regular employees. A former long-term, part-time employee will no longer be excluded from the nondiscrimination, minimum coverage, safe harbor, top-heavy, and employer contribution requirements (see below for more details).
- An employee who becomes a former long-term, part-time

employee for failure to meet the plan's eligibility requirements (other than age or service) will return to status as a long-term, part-time employee as of the first day of the plan year during which the employee again satisfies those conditions. Further, if conditions are again satisfied during the same plan year, the employee will be considered a long-term, part-time employee for that entire plan year. On the other hand, a former long-term, part-time employee who meets the age and 1,000 hour/one year service requirements and then subsequently fails to meet those requirements will not revert back to long-term, part-time employee status.

Nondiscrimination Testing

A plan (except for a SIMPLE 401(k) plan) may exclude long-term, part-time employees for purposes of all nondiscrimination and minimum coverage requirements. Neither employee elective contributions nor nonelective employer contributions made on behalf of long-term, part-time employees are required to be included for testing purposes. Note also that if the plan excludes long-term, part-time employees from nondiscrimination and coverage testing, it may also exclude them from catch-up and Roth contributions. However, a former long-term, part time employee (e.g., credited with at least 1,000 hours during a 12-month period) may not be excluded from the nondiscrimination and coverage tests.

Safe-Harbor Plan and Top-Heavy Requirements

A safe harbor plan must be amended to exclude long-term, part-time employees from receiving safe harbor contributions. Additionally, the terms of the plan must be amended to exclude these employees from the application of the top-heavy vesting and benefit requirements of IRC 416(b) and (c). It is important to note that the election to exclude long-term, part-time employees from top-heavy vesting and benefit requirements is a separate election from the election to exclude for purposes of nondiscrimination testing.

Employer Contributions

While SECURE 2.0 does not require an employer to make employer contributions on behalf of long-term, part-time employees, an employer that does elect to make nonelective or matching contributions to long-term, part-time employees will not hinder its ability to exclude such employees from nondiscrimination and coverage testing, top-heavy vesting, and certain other benefit requirements. However, any employer contributions made to a safe harbor plan will not be considered safe harbor contributions if long-term, part-time employees are excluded from testing.

Form 5500 Reporting for Long-Term, Part-Time Employees

The IRS reiterated that Form 5500 reporting requirements fall under the regulatory and interpretive authority of the Department of Labor and is outside the scope of the Proposed Regulations. However, in accordance with recent changes to the Form 5500 instructions, a plan is required to account for participants with an account balance at the beginning of a plan year.

Plan Amendment Deadlines

The deadline for plan sponsors (other than for governmental or collectively bargained plans) to adopt plan amendments for any required changes pursuant to SECURE 2.0 is December 31, 2025. However, the Proposed Rules require plans to be in operational compliance by January 1, 2024, which presents administrative challenges for many plan sponsors. For this reason, some plan sponsors may wish to provide immediate eligibility for all employees to avoid the long-term, part time rules altogether. However, before doing so, plan sponsors should consider the possible implications for the plan's nondiscrimination testing and top-heavy testing, since none of the relief available under the new rules will then apply. Governmental plans have an extended deadline to amend their plans by December 31, 2027.

Next Steps

To prepare for these changes, employers should take the following next steps:

- Consider any necessary plan design changes to address the Proposed Rules;
- Consult with the plan administrator and recordkeeper to confirm any required administrative system updates;
- Review and confirm operational systems for tracking employee hours and vesting periods;
- Review service provider contracts for any updates due to the Proposed Rules; and
- Consult with benefits counsel to discuss any questions regarding implementation and required plan amendments.

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