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Publications

IRS Issues Long-Term, Part-Time Employee Proposed Regulations

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On November 24, 2023, the IRS issued a Notice of Proposed Rulemaking, which provides long-awaited proposed regulations regarding the "long-term, part-time employees" rules under the SECURE Act of 2019 ("SECURE 1.0") and the SECURE 2.0 Act of 2022 ("SECURE 2.0").

The proposed regulations provide a number of helpful answers that may reduce the implementation burdens for some employers. But there are also a number of nuances that are likely to be challenging to implement by the January 1, 2024 statutory effective date of SECURE 1.0, and the January 1, 2025 effective date of SECURE 2.0.

Background

SECURE 1.0 generally requires that employees who are age 21 and complete 500 hours in three consecutive 12-month periods ("long-term, part-time employees") cannot be excluded from eligibility to make employee deferrals based on a more stringent service condition in a plan that includes a cash or deferred arrangement (CODA) under Section 401(k) of the Internal Revenue Code. It further provides that plans that also make employer contributions on behalf of long-term, part-time employees must count prior years with 500 hours of service for vesting purposes. Long-term, part-time employees who are eligible to participate solely because of the new rules may be excluded from nondiscrimination and coverage testing and top-heavy vesting and benefit requirements. The SECURE 1.0 rules do not apply to certain employees covered by a collective bargaining agreement or non-resident aliens with no US-source income and are effective for plan years beginning on or after January 1, 2024. In Notice 2020-68, the IRS clarified that, under SECURE 1.0, all 12-month periods prior to January 1, 2021 are excluded only for eligibility purposes.

SECURE 2.0 reduced the consecutive 12-month periods of service required to be a long-term, part-time employee from three to two, effective for plan years beginning on or after January 1, 2025, and extended the application of the long-term, part-time rules to ERISA-covered 403(b) plans.

SECURE 2.0 also made technical corrections to the long-term, part-time rules, including clarifying that (1) long-term, part-time employees may be excluded from a plan's safe harbor provisions, and (2) all periods of service prior to 2021 are excluded for both eligibility and vesting. Further, SECURE 2.0 clarified that the vesting rules that apply to a long-term, part-time employee continue to apply even if the employee later satisfies the regular service requirements.

Compliance with the mandatory long-term, part-time rules has proven to be fraught with complexity. Although plan amendments, including accelerated eligibility, are not required until the end of the 2025 plan year, plan operations must be compliant by January 1, 2024. For this reason, some plan sponsors may wish to provide for immediate eligibility for all employees to avoid the long-term, part-time rules altogether. However, if they do so, they should consider the potential implications for the plan's nondiscrimination and top-heavy testing (since none of the relief available under the new rules will apply).

Proposed Regulations

The proposed regulations provide important guidance with regard to these rules and include numerous instructive examples. We address the questions vexing plan sponsors here in a question and answer format.

Who is a Long-Term, Part-Time Employee?

An employee is a long-term, part-time employee only if the employee becomes eligible to participate in the CODA solely as a result of satisfying the age 21 and 500 hour/consecutive 12-months service requirement. The employee does not participate solely as a result of satisfying the long-term, part-time service requirements if the employee satisfies other service requirements under the plan (e.g., immediate eligibility or completion of one year of service).

Do the Long-Term, Part-Time Rules Apply in Elapsed Time Plans?

No. As hours of service are not calculated in elapsed time plans, such a plan must permit an otherwise eligible employee who is classified as a part-time employee to participate after a one-year period of service. None of the long-term, part-time relief is available to plans that use the elapsed time method of crediting service.

Can the Plan Use the DOL Equivalency Method of Counting Hours?

The number of hours (500) required cannot be changed, but a plan may use any of the permissible equivalency methods under DOL regulations as long as it is set forth in the plan document. (There is no special equivalency rule applicable to long-term, part-time employees.)

Note: An employee who satisfies a plan's 1,000-hour eligibility requirement as a result of the equivalency method is not a long-term, part-time employee. For example, an employee who works one hour per month for six months in a plan that provides 190 hours of service for each month in which an employee performs one hour of service, is credited with 1,140 hours of service and would not be a long-term, part-time employee.

What are the Required Entry Dates for Long-Term, Part-Time Employee Participation?

A plan may use the same entry dates for long-term, part-time employees as apply to other eligible employees. That is, participation must be no later than the earlier of the first day of the first plan year beginning after the date the employee satisfies the eligibility requirements or the date 6 months after satisfying the eligibility requirements.

Note: An employee who would have been eligible to participate as a long-term, part-time employee if it were not for an eligibility condition (other than age and service) must be immediately eligible to participate upon satisfying the condition.

How Does a Plan Determine the 12-month Periods?

A plan must count all 12-month periods beginning the later of the employee's hire date or January 1, 2021, including periods in which the employee was in an ineligible classification. While a plan must start counting from the employee's hire date, the computation period can switch from anniversary year to plan year if provided under the plan terms.

Note: If the plan switches its computation period from anniversary year to plan year, as little as 13 months of service may result in two consecutive years of service. For example, an employee hired on December 1, 2023 who completes 600 hours of service by December 1, 2024 and 600 hours from January 1, 2024 through December 31, 2024, would be eligible to participate in 2025 as a long-term, part-time employee.

As the 12-month periods with 500 hours of service must be consecutive, if an employee works more than 500 hours in the first year but less than 500 hours the next year, the employee does not satisfy the requirements and the counting starts over. However, once a long-term, part-time employee, always a long-term, part-time employee, even if the employee works less than 500 hours in subsequent years and even if the participant terminates and is later re-hired without satisfying 1,000 hours.

Note: Plan language that provides, effective January 1, 2024, for eligibility on completion of 500 hours of service in the applicable 12-month periods will violate the long-term, part-time rules. Instead, the plan must provide for eligibility on completion of the earlier of: (1) one year of service with 1,000 hours, or (2) 500 hours of service in each of the applicable 12-month periods.

Can Employees be Excluded from Participation Based on Other Classifications?

Yes. Employees who would otherwise be eligible to participate in the CODA as long-term, part-time employees may be excluded from the CODA, but only if the reasonable classification is not based on age or service. However, any eligibility conditions imposed on a classification (e.g., temporary employee) cannot exceed the earlier of the 500 hour/two years of service or 1,000 hours/one year of service condition. (For example, a plan cannot provide that temporary employees are ineligible to participate unless and until they are credited with 1,000 hours of service.) Furthermore, employees excluded from the CODA based on a classification must be included in nondiscrimination and coverage testing and top-heavy benefits and vesting.

How is Vesting of Employer Contributions Calculated for Long-Term, Part-Time Employees?

Each 12-month period of 500 hours of service on or after January 1, 2021 must be counted for vesting purposes, whether or not the employee received an employer contribution during that period, unless otherwise excluded under the Internal Revenue Code, for example, breaks in service and deemed distributions. Notably, the plan may use the plan's regular vesting computation period for long-term, part-time employees – plan year, calendar year or other consecutive 12-month period designated by the plan – even if different from the eligibility computation period.

What Happens if a Long-Term, Part-Time Employee Later Completes One Year of Service or Becomes an Ineligible Employee (Other Than For Age or Service)?

A long-term, part-time employee becomes a "former long-term, part-time employee" on the first day of the first plan year beginning after the earlier of the year in which the employee (1) completes 1,000 hours of service in a 12-month period or (2) becomes an ineligible employee. At that time, the long-term, part-time employee exclusion from nondiscrimination, coverage, top-heavy and employer contribution requirements no longer applies to that employee. However, the vesting rules for long-term, part-time employees continue to apply.

Long-term, part-time employees who become former long-term, part-time employees as a result of becoming ineligible employees (other than for age or service – e.g., non-union to union employee status) will return to long-term, part-time employee status as of the first day of the first plan year in which they again become eligible. The return will occur retroactive to the first day of the plan year in

which a former long-term, part-time employee becomes eligible if it occurs in the same year the employee becomes ineligible. However, this rule does not apply if the employee is a former long-term, part-time employee because the employee met the 1,000 hour/one year of service requirement.

How do the Long-Term, Part-Time Rules Apply to Safe Harbor Plans?

Long-term, part-time employees may be excluded from receiving safe harbor contributions and for purposes of determining if a plan satisfies the safe harbor plan contribution and top-heavy benefit requirements.

Note: An employer's election to exclude long-term, part-time employees from safe harbor contributions and top-heavy benefit requirements must be set forth in the plan document.

How are Long-Term, Part-Time Employees Treated for Nondiscrimination and Coverage Testing Purposes?

Long-term, part-time employees may be excluded from nondiscrimination and coverage testing purposes for all employer contributions (including additional contributions that are not safe harbor contributions) but if they are excluded they must be excluded from *all* nondiscrimination and coverage tests. If included, the long-term, part-time employees are generally considered "otherwise excludable employees" for coverage testing purposes.

Note: The plan must include language that enables the exclusion of long-term, part-time employees from all nondiscrimination and coverage testing.

How do the Long-Term, Part-Time Rules Apply to Top-Heavy Plan Determinations?

The plan terms may provide that all long-term, part-time employees are excluded from receiving top-heavy benefits and from top-heavy plan vesting.

Note: The IRS did not extend the relief from counting long-term, part-time employees in determining whether or not the plan itself is top-heavy. However, a plan will not be considered top-heavy if the only reason for being top-heavy is because of the election not to make employer contributions (matching or nonelective) or to make employer contributions that do not satisfy the safe harbor requirements.

Are Plans Required to Permit Long-Term, Part-Time Employees to Make Catch-up and Designated Roth Contributions?

Generally, plans that offer catch-up and Roth contributions permit long-term, part-time employees to make those contributions. However, if the plan excludes long-term, part-time employees from nondiscrimination and coverage testing, it may exclude long-term, part-time employees from catch-up and/or Roth contributions.

Do Long-Term, Part-Time Employees Need to be Counted for Purposes of 5500 Reporting?

Generally, yes, if they have an account balance as of the first day of the plan year. The Notice of Proposed Rulemaking refers to recent changes made by the DOL to the Form 5500 instructions, which provide that only participants with an account balance are counted for purposes of the small plan audit waiver of annual examination and report of an independent qualified public accountant.

Are There Any Special Rules for 403(b) Plans?

No rules for 403(b) plans were addressed in these proposed regulations. In the absence of such rules, ERISA-covered 403(b) plans should expect that similar rules will apply (to the extent applicable in the 403(b) context) when SECURE 2.0 comes into effect.

Next Steps

The Notice of Proposed Rulemaking provides necessary guidance to plan sponsors and providers. While the proposed regulations may be relied upon until finalized, the Treasury and IRS have requested comments by January 25, 2024, especially with respect to governmental plans and non-electing church plans. A hearing is scheduled for March 15, 2024.

In the meantime, although amendments are not required at this time, in order to comply operationally with the proposed regulations, plan sponsors and providers should review their long-term, part-time employee processes, including a review of exclusions (and ensure proper monitoring in the event there is a change to eligibility), and determine if any changes to plan operations or communications (e.g., safe harbor notices) are necessary.

If you have any questions or would like to submit any comments, please contact your regular Groom attorney.