

Troutman Pepper Podcast: Long-Term Part-Time Employee Eligibility Rules Now in Effect

Speakers: Emily Zimmer and Constance Brewster

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Constance Brewster:

Hi, everyone. Welcome to another special edition podcast, where we're diving into the intricacies of SECURE Act, more commonly known as SECURE 1.0 and its successor, SECURE 2.0. I'm Constance Brewster, and today, I'm joined by my colleague, Emily Zimmer. We're both partners in the Employee Benefits and Executive Compensation practice group here at Troutman Pepper.

Emily Zimmer:

Thanks for that introduction, Constance. SECURE 1.0, which came into effect in 2021 introduced a significant change for part-time employees. It required plans to allow employees who work at least 500, but less than 1000 hours in three consecutive 12-month periods to make elective deferrals to their 401(k) plans. These workers are referred to as long-term part-time employees.

Constance Brewster:

And 2024 is a crucial year, and it's the first year that long-term, part-time employees can become eligible to participate under SECURE 1.0. But the story doesn't end there, SECURE 2.0 has further modified these rules, reducing the service requirement for the long-term part-time employees to just two consecutive 12-month periods starting January 1, 2025.

Emily Zimmer:

That's right. Proposed regulations have been issued, which answer many questions about how these rules are applied. Such as what 12-month periods count, how different methods for counting service apply to the rules, and the requirements that apply to an employee who becomes eligible solely as a long-term part-time employee. In today's episode, we'll highlight the key features of these new rules under the proposed regulations and discuss the next steps that company's sponsored 401(k) plan should be taking now.

Constance Brewster:

Whether you're an employer, an employee, or just someone interested in the world of retirement planning, stay tuned as we unravel the complexities of SECURE 2.0. Let's get started.

Emily Zimmer:

As background, tax qualified 401(k) plans must satisfy certain minimum age and service eligibility requirements under the Internal Revenue Code. Prior to the SECURE Act, a 401(k) plan was not permitted to require — as a condition of participation — that employee complete a period of service extending beyond the later of the attainment of age 21 or 1000 hours of service during the 12-month determination period. Plans can exclude certain objective classes of employees from participation, but the excluded class cannot be a disguised service-based exclusion that violates the minimum thousand-hour or age 21 rules. For example, exclusion on part-time employees as a service-based exclusion to comply with the tax rules. Plans that exclude part-time employees must allow them to participate if they meet the thousand-hour rule.

Constance Brewster:

To expand the population of workers eligible to save for retirement, SECURE 1.0 added a new minimum eligibility rule requiring that 401(k) plans permit employees who work at least 500 hours for each of the three prior consecutive 12-month periods. Which we like to refer to as the look-back period. To make elective deferrals under such plans even if they did not have at least 1000 hours of service in a 12-month period. Secure 2.0 modified this rule by reducing the three-year look-back period to a two-year look-back period for plan years beginning on or after January 1, 2025. Making it easier for an employee to become eligible to participate. Employees who become eligible to participate in 401(k) elective deferrals by virtue of satisfying these rules are referred to as long-term part-time employees.

Emily Zimmer:

A key takeaway is that employers need to be able to administer the SECURE 1.0 rules for 2024, and then be ready to shift to the more generous SECURE 2.0 rules starting in 2025. Of this background, let's walk through some common questions about the long-term part-time employee rules.

Constance, are any groups of employees not covered by the long-term part-time employee eligibility rules?

Constance Brewster:

Yes. Certain employees covered by collective bargaining agreements. And then also employees who are non-resident aliens with no US source income are excluded from these rules.

Emily Zimmer:

Can a 401(k) plan have more generous eligibility requirements?

Constance Brewster:

Absolutely. These rules are minimum eligibility requirements. Plans can by design have more generous eligibility provisions than what the code and regulations require. In fact, some employers allow all employees to participate in the plan immediately, or after a short waiting period without any minimum hours or service requirements. These employers don't have to worry about these new long-term part-time employee eligibility rules.

Emily Zimmer:

What are the 12-month periods that apply for the long-term part-time employee eligibility?

Constance Brewster:

Well as discussed, these rules count hours in consecutive 12-month periods. The first 12-month period begins on the employee's hire date, and then the next 12-month period begins on the anniversary of the hire date. Unless the plan provides that the period shifts to the first plan year that begins after the employee's hire date. This shift to the plan year can result in some overlap in service. For example, for an employee hired on October 1, 2023, the first 12-month period runs from October 1st, 2023 to September 30th of 2024. The next 12-month period for a calendar year plan runs from January 1st to December 31st, 2024. The overlap is the time from January 1 to September 30, 2024, which is included in both 12-month periods. So if the employee worked 500 hours in both of these 12-month periods, he must be treated as an eligible long-term part-time employee, and given an opportunity to make 401(k) deferrals in 2025, even though he'd only completed 15 months of employment.

Emily Zimmer:

Now, not all plans use actual hours of service or an hour's equivalence fee to determine eligibility. What if a 401(k) plan uses elapsed time?

Constance Brewster:

Great question. So under the elapsed time approach, service for eligibility is based on the beginning and end dates of employment without regard to hours worked. Since hours are not counted under elapsed time, the long-term part-time rules do not apply to plans that use elapsed time. Instead, the plan's regular eligibility rules would apply.

Emily Zimmer:

Can a 40(k) plan still exclude certain groups of employees not based on service?

Constance Brewster:

Yes. So long as the excluded class is based on a reasonable classification that is not based on age or service. So for example, a plan can exclude employees working at a particular location. However, if the employee transfers from an excluded location to a location that's not excluded from the plan and had previously met the long-term part-time employee hours requirement. That employee must be immediately eligible to participate as a long-term part-time employee. In other words, service while in an excluded classification still counts for determining long-term part-time employee eligibility status if the employee later moves into a non-excluded category.

Emily Zimmer:

Can a 401(k) plan exclude part-time or temporary employees?

Constance Brewster:

Well, these exclusions look more like service-based exclusions. The plan would need to include a safety valve feature, that allows the employee to participate if either the employee works at least 1000 hours in eligibility computation period, or, if earlier the employee qualifies as a long-term part-time employee by working at least 500 hours, but less than 1000 hours in the relevant either two or three consecutive 12-month eligibility computation periods.

Emily Zimmer:

Well, with these technical rules, this administrative burden may warrant having more generous eligibility provisions to avoid these long-term part-time rules. So once an employee becomes a long-term part-time employee, when does he enter the plan?

Constance Brewster:

It depends on the plan terms. Plans must specify the entry date for employees who first meet the plan's eligibility requirements. That cannot be later than six months after meeting the plan's eligibility requirement, or the start of the next plan year if earlier. Many 401(k) plans apply earlier entry dates. For example, 30 days, 60 days after meeting eligibility requirements. It is important to also note that if a long-term part-time employee terminates employment and is later rehired, the employee generally must be allowed back into the 401(k) plan as a long-term part-time employee immediately. Generally, once eligible always eligible. Emily, what if a long-term part-time employee later works 1000 hours?

Emily Zimmer:

An employee who becomes eligible solely as a long-term part-time employee may later meet the plan's regular eligibility requirements. In which case, the employee will cease to be treated as a long-term part-time employee. As we'll discuss in a moment, status as a long-term part-time employee or a regular employee matters for various purposes. Including eligibility for employer contributions and treatment for purposes of qualified plan non-discrimination testing.

For example, suppose a plan requires 1000 hours of service as its regular eligibility requirement. If an employee has 500 hours of service and two consecutive 12-month periods in 2024 and 2025, the employee must be treated as eligible as a long-term part-time employee beginning in 2026, under the SECURE 2.0 requirements. But if that employee then works 1000 hours in 2026, the employer will become eligible in 2027 under the plan's regular eligibility rules, and would no longer be treated as a long-term part-time employee.

Constance Brewster:

Do long-term part-time employees receive matching or other employer contributions?

Emily Zimmer:

They don't have to. That's because an employee who's eligible to make elective deferrals in a 401(k) plan solely as a long-term part-time employee may be excluded from eligibility for employer contributions. This exclusion may apply to non-elective employer contributions and matching contributions, as well as safe harbor matching or non-elective employer contributions for a safe harbor plan.

It's worth noting, however, that excluding long-term part-time employees from eligibility for employer contributions is a choice. This choice applies only if the employee is eligible to participate in the plan, solely by reason of the long-term part-time employee eligibility rules. Any election to exclude long-term part-time employees from employer contributions should be reflected in an amendment to the plan document. And the treatment of long-term part-time employees under a safe harbor plan may also need to be reflected in the applicable safe harbor notice.

Constance Brewster:

What about non-discrimination testing Do long-term part-time employees count for this testing?

Emily Zimmer:

Well, the answer to that question is, again, they don't have to. The 401(k) plan can elect to exclude employees who participate in the plan solely by reason of the long-term part-time employee eligibility rules. That exclusion can be from various non-discrimination testing requirements, such as the ADP/ACP tests for non-safe harbor 401(k) plans, and the minimum coverage test under Section 410(b).

Any election to exclude long-term part-time employees from testing must be reflected in the plan document. In addition, if a long-term part-time employee is excluded from one of the above tests, they must be excluded from all such non-discrimination tests. Long-term part-time employees are still counted in determining whether the plan is considered top-heavy under Section 416. But if the plan otherwise excludes long-term part-time employees from non-discrimination testing, then those employees do not have to actually receive top-heavy contributions if the plan ends up being top-heavy.

Constance Brewster:

So we know that long-term part-time employees must be eligible to make 401(k) deferrals. But can they make catch-up contributions? What about Roth contributions?

Emily Zimmer:

That's up to the plan sponsor. Long-term part-time employees can be eligible to make catch-up contributions or Roth contributions under a 401(k) plan that generally offers those types of contributions to participants. But if the plan elects to exclude long-term part-time employees from non-discrimination testing, the plan can choose to not offer capital contributions or Roth contributions to those long-term part-time employees. Again, such an exclusion can apply only to employees who participate in the plan solely by reason of the long-term part-time employee eligibility rules.

Constance Brewster:

Do special vesting rules apply for these long-term part-time employees.

Emily Zimmer:

Yes, they do. Vesting service for long-term part-time employees may be counted on the 401(k) plan's usual vesting computation period. Typically, the plan year. They must provide that one year of service for any such year is going to be earned when the long-term part-time employee has at least 500 hours of service. That's opposed to the normal 1000 hours of service requirement that typically applies to employees. However, this special rule only applies to service starting in 2021.

It's important to note that this friendly lower vesting service rule continues to apply. Even if the employee ceases to be a long-term part-time employee. Such as if the long-term part-time employee later satisfies the plan's regular eligibility rules and moves to being a regular employee. In that case, vesting service while participating as a regular employee would still be based on the 500-hours requirement, even if other regular employees have to work at least 1000 hours to receive a year of vesting service.

We expect this will likely add significant complexity to 401(k) plan administration for plans that utilize the hours counting service crediting method for vesting service. Interestingly, vesting service for long-term part-time employees may not ever actually matter. For example, if a long-term part-time employee is not eligible for employer contributions, and never becomes a regular employee, or if all employer contributions are always 100% vested, such as in a safe harbor 401(k) plan. But employers with employer contributions that are subject to a vesting schedule will need to work closely with their 401(k) plan record keeper to make sure that the special vesting service rule is properly implemented and tracked.

Constance Brewster:

Do these rules also apply to 403(b) plans?

Emily Zimmer:

Not yet. For now, the proposed regulations solely address 401(k) plans. But SECURE 2.0 does apply the long-term part-time employee eligibility rules to 403(b) plans starting in 2025. We hope the IRS will provide additional guidance before then.

Constance Brewster:

When do 401(k) plans have to be amended to reflect these rules?

Emily Zimmer:

That is by the end of 2026. This deadline applies to all amendments to reflect these new long-term part-time employee rules, including any amendments to reflect elective features of the new rules. However, plans must begin operating consistently with the new rules, including any elections made starting this year in 2024.

Constance Brewster:

This is a lot of technical rules. What should employers be doing new?

Emily Zimmer:

Employers should be working with their legal and other advisors along with their 401(k)-plan record keeper, to ensure that their 401(k) plans are now operationally compliant with the long-term part-time employee rules reflected in the proposed regulations. The potential impact will depend greatly on each employer's business model, demographics, and workforce dynamics. Some employers may consider adopting more generous eligibility rules, or move to an elapsed time service counting method to largely avoid the long-term part-time employee special rules. Others may need to adapt to those new rules and ensure that service is being properly tracked. Those employers will also need to make decisions permitted by the new rules, such as whether to exclude long-term part-time employees from non-discrimination testing.

Finally, employers should monitor to see when final regulations are adopted and see if there are any changes in those final regulations. Of course, be prepared to adopt plan amendments by the end of 2026. I think this is a perfect point to end our episode, it's clear that these acts have brought significant changes to retirement planning, and that there's a lot for employers and employees to consider. Companies sponsoring 401(k) plans need to take steps now to ensure they're in line with these new requirements.

Constance Brewster:

We hope this discussion has provided you with valuable insights and practical takeaways. We recently published a companion article that delves into these regulations in more detail that we will link in the podcast description. If you have any questions or need further clarification on any of these topics that we discussed today, please do not hesitate to reach out to either of us directly.

Emily Zimmer:

In closing, don't forget that we are hosting our annual webinar in September of this year, where we'll provide a comprehensive look at the future landscape of Employee Benefits and Executive Compensation. Thank you for listening.

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