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IRS Proposes 401(k) Plan Regulations Implementing Long-Term Part-Time Employee Eligibility Requirements

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The day after Thanksgiving, while many us of were fortunate enough to be reaching for leftover pie, the IRS released proposed regulations implementing the requirement that 401(k) plan sponsors permit "long-term part-time employees" to make elective contributions to a 401(k) plan. These proposed regulations arrive just one month before the statutory requirements are set to take effect in 2024—meaning that plan sponsors need to quickly get familiar with the proposed rules. This is especially key as the proposed regulations, which would apply for plan years starting on or after January 1, 2024, do not seem to permit good-faith reliance on the statute instead of the proposed rules.

How did we get here?

Back in 2019, the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE 1.0) included a provision requiring 401(k) plan sponsors to treat employees who have at least 500 hours of service (but less than 1,000 hours) during each of three consecutive 12-month periods as eligible to make contributions to a 401(k) plan. At the end of 2022, Congress passed SECURE 2.0 Act of 2022, which included, among other items, a provision shortening the three consecutive 12-month eligibility periods for long-term part-time employees to ***two*** consecutive 12-month periods for plan years starting after December 31, 2024.

Who is a long-term part-time employee?

The proposed regulations define a “long-term part-time employee” as an employee eligible to participate in a 401(k) plan ***solely*** on account of (1) completing two consecutive 12-month periods during which the employee is credited with at least 500 hours of service (or for plan years starting before January 1, 2025, three consecutive 12-month periods) and (2) attaining age 21 by the close of the consecutive 12-month periods. Employees who are part-time but who become eligible to participate by meeting the plan’s generally applicable service requirement (*e.g.*, 1,000 hours of service in a 12-month period) would be excluded from the definition of long-term part-time employee.

Our 401(k) plan excludes hourly employees. Is that prohibited under the proposed rules?

Some 401(k) plans exclude certain job-based classifications (*e.g.*, hourly employees) from participation. In the preamble, the IRS confirmed that bona fide job-based eligibility conditions not based on age or service (or conditions that are proxies for imposing age or service requirements) continue to be permitted under the proposed rule. However, given the nuances in this area, it is worth analyzing whether any current plan exclusions have the effect of an impermissible service requirement under the long-term part-time rules.

Do the proposed rules require that we make matching or non-elective contributions with respect to long-term part-time employees?

No. The proposed regulations do not require that plan sponsors make matching contributions or non-elective contributions with respect to long-term part-time employees. However, long-term part-time employees who become ***former*** long-term part-time employees (see below) and who remain otherwise eligible to participate in the plan are not subject to this rule, meaning that employers will need to monitor employees who toggle between long-term part-time and former long-term part-time status.

How do we count the 12-month service periods for long-term part-time employees?

A long-term part-time employee is eligible to participate following the completion of the applicable consecutive periods (two 12-month periods, or, for plan years starting before January 1, 2025, three 12-month periods). Although the first 12-month period must be based on the employee's date of hire, subsequent 12-month periods may shift to the plan year (aligning with general service crediting principles). One question left unanswered in the proposed regulations is whether a plan may permit different approaches for different classes of employees (*e.g.*, switching to the plan year for full-time employees, but using anniversary years for long-term part-time employees).

Do we have to double-count hours during consecutive 12-month periods?

Possibly. If a plan shifts to the plan year for service counting after the year of hire, an employee's initial 12-month period and second 12-month period are treated as separate consecutive 12-month periods even if the same hours would be credited to both the initial 12-month period and the second 12-month period. Here's an example. Assume a part-time employee starts on December 1, 2023, and his employer sponsors a calendar-year 401(k) plan. The employee is credited with 600 hours of service during the 12-month period starting on December 1, 2023, and 600 hours of service during the 12-month period starting on January 1, 2024. Assuming the plan has monthly entry dates, the employee would be eligible to participate on January 1, 2025—even though the employee has not worked for two full consecutive 12-month periods.

How do long-term part-time employees earn credit for vesting?

Each 12-month period starting on or after January 1, 2021 during which a long-term part-time employee is credited with at least 500 hours of service is required to be credited as a year of vesting service. Plans are required to track vesting service for long-term part-time employees even though this may have no practical effect, as long-term part-time employees are not required to be eligible for match and profit-sharing contributions. However, vesting service could come into play for long-term part-time employees who become ***former*** long-term part-time employees, as explained below.

What happens to an employee's vesting service if an employee toggles between long-term part-time employee status and full-time employee status?

An employee who is eligible to participate in a plan as a long-term part-time employee will become a former long-term part-time employee as of the first day of the first plan year beginning after the plan year in which the employee satisfies the plan's default service requirement (*e.g.*, 1,000 hours of service). A former long-term part-time employee is required to be credited with the vesting service earned while a long-term part-time employee. Additionally—and perhaps most challenging for plan sponsors to implement—the proposed regulations require that a former long-term part-time employee who becomes a regular 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.

How long do we need to track eligibility service for long-term part-time employees?

For a long time.Once a long-term part-time employee becomes eligible to participate in a plan by virtue of completing the applicable service period, the employee's eligibility is "locked in." In other words, the plan cannot require the long-term part-time employee to complete another applicable service period to become eligible to participate after incurring a break in service (which is different from the break-in-service participation rules that apply for other employees).

Can we apply the same entry date for long-term part-time employees as we do for other employees who become eligible to participate?

Yes. The proposed rules confirm that a plan may apply the same entry date rules to long-term part-time employees as those that apply to other employees covered by the plan.

Our plan uses the elapsed time service crediting method. Do we have to worry about these long-term part-time employee rules?

Not really. Under the elapsed time method of crediting service, a plan takes into account the period of time that elapses while the employee is employed, regardless of the actual number of hours worked by the employee during the year. The IRS confirmed in the proposed rules that, for plans using the elapsed time method, an employee could not meet the definition of a long-term part-time employee, as the employee would not become eligible to participate solely on account of completing 500 hours of service during the applicable service period.

Do we have to include long-term part-time employees in testing?

No. Under the proposed rules, a plan sponsor may elect to exclude long-term part-time employees from top-heavy, coverage, and nondiscrimination testing. These exclusions apply only to employees who meet the definition of long-term part-time employees, however. If a plan chooses to make all employees immediately eligible for elective deferrals (with the result being there are not any long-term part-time employees), these testing exclusions would not apply.

What is the deadline for adopting plan amendments?

The general deadline for SECURE-related amendments is the last day of the first plan year beginning on or after January 1, 2025. In the proposed rules, the IRS confirmed that this deadline applies to plan amendments related to long-term part-time employee eligibility. Additionally, the IRS noted that the SECURE amendment deadline would also apply to amendments that provide broader eligibility to part-time employees (*e.g.*, a plan amendment providing that, effective January 1, 2024, all employees are immediately eligible to participate following hire).

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Next steps for plan sponsors?

The proposed rules include a significant level of detail and illustrate many of the operational challenges associated with administering the long-term part-time employee rules. Some plan sponsors may want to explore plan design changes that would permit them to comply with the long-term part-time employee requirements, but avoid some of the tricky service crediting and vesting requirements in the proposed rules. Given that the long-term part-time requirements take effect in 2024, plan sponsors should act quickly to evaluate next steps.

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