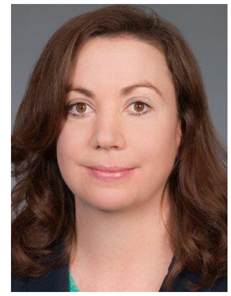
Anticipating New Rules On Part-Time Worker Retirement Plans

By **Amy Sheridan and David Guadagnoli** (August 6, 2024)



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In an effort to expand retirement savings opportunities for part-time employees, the Secure Act first added the concept of a long-term, part-time employee when it was enacted in 2019.

LTPT employees must be offered the opportunity to make elective deferral 401(k) contributions but need not receive employer contributions.

In 2022, the Secure 2.0 Act made various modifications to the concept, including expanding the LTPT requirements to certain 403(b) arrangements, and in late November 2023, long-awaited proposed regulations were issued.

As we await final regulations, we wanted to highlight a few of the thornier issues that the proposed LTPT regulations raise. Our focus here is on 401(k) plans, rather than 403(b) arrangements.

LTPT Defined

Employers sponsoring 401(k) plans must, generally beginning on or after Jan. 1, 2024, allow LTPT employees working between 500 and 1,000 hours of service for three consecutive years — two consecutive years for plan years beginning on or after Jan. 1, 2025 — to make elective deferral 401(k) contributions.

Employee Category Exclusions

For close to 20 years, little has changed in the way of eligibility exclusions involving certain categories of employees, such as temporary, casual or seasonal employees, or interns.

In general, provided the minimum coverage requirements can be satisfied under Internal Revenue Code Section 410(b), it is possible to exclude these employees from participation in a qualified plan.

The wrinkle has long been whether the Internal Revenue Service might view such exclusions as an end-run around the most often used maximum age and service eligibility requirements of 21 years old and one year of service — the latter generally consisting of a 12-month period in which the employee performs at least 1,000 hours of service.

Some, but not all, employers have added so-called backstop provisions that allow such employees to enter the plan upon satisfying the age and length of service requirement.

By our reading, the proposed LTPT regulations appear to have upped the ante a bit on certain categorical exclusions by explicitly providing that any elective deferral eligibility exclusion that is a proxy for imposing an age or service requirement is prohibited.

Establishing this rule in the form of a regulation strengthens the Internal Revenue Service's hand and may signal renewed scrutiny of category exclusions. At a minimum, the proposed LTPT regulations shift the risk-reward calculus on excluding categories of employees.

Pros and Cons of LTPT Status

What is striking to us in speaking with clients is that the best strategy for dealing with LTPT employees is not the same across clients and plans. Allowing LTPT employees to participate in the elective deferral contribution feature does have its advantages.

In addition to not having to make employer contributions — such as a match or profit sharing contribution — a plan sponsor can elect to disregard them for purposes of:

- The minimum coverage test;
- The actual deferral percentage and actual contribution percentage tests, or safe harbor provisions;
- Tests under Internal Revenue Code Section 401(a)(4), including benefits, rights and features testing; and
- Interestingly, catch-up contributions.

The election is all-or-nothing, meaning that either all LTPT employees must be included for all testing purposes or none of them are included for any applicable testing purposes.

In addition, if the election is made, the employer will also exclude LTPT employees from any top-heavy vesting and contribution provisions, although their balances will be taken into account in determining whether or not a plan is top-heavy.

One wrinkle introduced by the proposed LTPT regulations is the rejection of the use of the elapsed time method for determining eligibility, a method created to allow employers an alternative to tracking hours.

Instead, the proposed LTPT regulations require an employer to either actually count hours or use an equivalency method if a plan sponsor wants to take advantage of an individual's LTPT status.

And because only an employee who meets the definition of an LTPT employee is eligible to be excluded from employer contributions and for the various testing purposes described in the preceding paragraph, at least some employers who use the elapsed time method for plan purposes exclusively will need to invest in payroll or recordkeeping system changes if they want to take advantage of the benefits of the LTPT provisions.

LTPT Vesting

Perhaps the most significant disadvantage of LTPT status, however, are the special vesting rules introduced by the proposed LTPT regulations. An LTPT employee is entitled to credit for each year of vesting service for which the individual completes at least 500 hours of service.

The proposed LTPT regulations go a step further, however, by requiring a former LTPT employee to continue to receive vesting credit based on a 500-hour standard.

That is, even if an LTPT employee moves to a fully eligible plan participant category, the individual is permanently entitled to be credited vesting service for each year in which the employee completes 500 hours of service.

This means an LTPT or former LTPT employee will always be treated better for vesting purposes than an employee who was never treated as an LTPT employee. Not surprisingly, employer groups and recordkeepers have commented on this provision, noting in particular that it is not necessarily supported by the law.

Plan Design Considerations

The appropriate plan design for any particular client will depend on the plan's current design and the employee population. For example, a plan with generous eligibility and vesting provisions and employer contributions may benefit from allowing employees who meet the LTPT requirements into the plan as LTPTs.

This provides the employees with an elective deferral opportunity without the additional cost of employer contributions or adverse testing consequences — and if participants are otherwise fully vested, no special tracking would be required.

Another scenario involves an employer that might be reaching the limit on the number of employees that can be excluded under the minimum coverage requirements. Shifting to an LTPT employee approach may relieve the pressure at little incremental cost — aside from administrative hassles and the aforementioned vesting benefit.

Other employers may decide that the continued exclusion of interns, seasonal, casual or other types of temporary employees may simply no longer be worth the risk of a challenge and the new rules afford the opportunity to make a change.

Finally, some plan sponsors may simply find that letting all employees make elective deferrals after one year of service, or earlier, using the elapsed time method, or immediately, reduces the administrative burden of having to track LTPT hours, even if it results in the requirement to make employer contributions, the incremental cost of which may be mitigated by the plan's vesting schedule.

Next Steps

For plans utilizing a calendar year plan year, the earliest year an LTPT employee would be eligible to make elective deferrals is 2024, as a result of having had at least 500 hours in each of 2021, 2022 and 2023.

If a plan has not complied with the new law, self-correction is a viable option, as long as the error is caught early enough. Plan amendments relating to the LTPT changes, including design changes intended to avoid application of LTPT rules, will need to be made no later than the last day of the 2025 plan year. Hopefully final, and potentially revised, regulations will be issued well before then.

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