JOHNSTON ALLISONHORD

May 09, 2024

WORKER CLASSIFICATION REGULATION UPDATES

Until recently, plan sponsors could exclude an employee from being eligible to participate in a 401(k) plan by limiting the hours an employee worked or characterizing employees as independent contractors. Both methods are now under increased scrutiny under new legislative and regulatory changes regarding worker classification. Traditionally, employees could be excluded from a 401(k) plan if they worked fewer than 1,000 hours in twelve months and were under 21 years old. Under the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE 1.0) and SECURE 2.0 passed in 2022, fewer working hours are needed for a plan to be required to include long-term part-time ("LTPT") employees.

Under new Department of Labor (DOL) regulations that became effective on March 11, 2024, the DOL departs from the 2021 *core factors* analysis and begins a more intrusive *economic realities* analysis to determine worker classification. Employers should carefully review their contracts with independent contractors to ensure that the DOL will not reclassify independent contractors as employees.

Long-Term Part-Time Employees

Before the SECURE Act, plan sponsors could exclude an employee from being eligible to participate in a 401(k) plan unless they worked 1,000 hours in twelve months and were at least 21 years old by the end of such period. Absent an explicit definition, a long-term, part-time employee was presumed to be an employee that fell under this hour and age threshold.

The SECURE Act expanded eligibility to employees with less than 1,000 hours if they worked at least 500 hours per year in three consecutive twelve-month periods and were at least 21 years old by the end of the consecutive twelve-month testing periods. If so, those employees must gain eligibility for plan years beginning on or after January 1, 2024.

SECURE 2.0 went into effect for plan years beginning on or after January 1, 2025 and reduced the requirement from three years to 500 hours per year in two consecutive twelve-month periods where the employee is at least 21 years of age at the end of the consecutive twelve-month testing periods.

Worker Classification

Under the Fair Labor Standards Act of 1938 ("FLSA"), the definition of worker is vague. In *US v. Silk*, the Supreme Court incorporated five primary factors to determine whether a worker is an independent contractor or employee known as the *economic realities test* for worker classification. Subsequent

case law added a sixth factor to the *economic realities test*, which weighed the following factors equally:

- The degree of control a company has over a worker
- The worker's investment in the facilities and equipment used
- The permanency of the relationship between worker and employer
- The worker's opportunities for profit or loss depending on the worker's skill
- The degree of skill required for the task employed
- The degree to which a worker's services are integral to the company's business

In 2021, a new DOL rule interpreting what constituted a worker under the FLSA went into effect emphasizing two *core factors* (the degree of control a company has over a worker and the worker's opportunities for profit or loss depending on the worker's skill) to be given more weight than the others in determining whether a worker was an employee or independent contractor under the six-part *economic realities* test. The DOL proposed a new rule in October of 2022 that returns to the analysis incorporating all six factors equally that went into effect on March 11, 2024.

The IRS utilizes a three-prong test (a compression of twenty factors) for determining worker classification. The factors focus on the behavioral, financial, and type of relationship an employer has with a worker to classify a worker as an independent contractor or an employee. The IRS's test determines plan qualification and employment taxes. The DOL's test determines federal labor law violations. However, we think the test factors from the IRS and DOL can be instructive in many areas of employment law and employee benefits partially due to referrals between the two agencies. In 2022, the DOL and IRS renewed a memorandum of understanding between the agencies that sought to expedite referrals from the DOL to the IRS where the DOL suspects that workers have been improperly classified as independent contractors by an employer.

Changes Employers Should Make

Under the new requirements, in is more difficult to avoid including employees in employee benefit plans by limiting a worker's hours or classifying a worker as an independent contractor. Plan sponsors should carefully review their relationships with independent contractors to ensure that they will not be reclassified as employees eligible for benefits. Plan sponsors should also review hours for current part-time employees to ensure that the new LTPT requirements are met. Going forward, plan sponsors should have appropriate procedures in place for new workers to

- Properly classify them as contractors or employees

- Accurately track hours for employee eligibility

JAH Can Help

Johnston Allison Hord's experienced **employee benefits attorneys** are staying apprised of all development regarding worker classification regulation updates and can advise your business through future developments. Complete our **General Contact Form** if you have any questions.
