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Boomerang Employees: Rehires and Retirement Plans

A boomerang employee (as we will use that name in this article) is, quite simply, one who leaves and then comes back to work...a rehire. As is so often the case, the retirement plan rules related to rehires are quite different than those that apply to other areas of employment and benefits. Whether rehiring a former employee is a rare occurrence or part of your regular course of business, it is important to understand how these rules work.

First Things First

The first step in this analysis is to determine whether the worker is truly a rehire. You may be thinking that it is pretty obvious, but there can be some ambiguity about whether there was a termination in the first place. If there wasn't, there can be no rehire. Let's consider several scenarios.

Leave of Absence

There are many reasons an employee may take a leave of absence, and there are several other laws, including the Family and Medical Leave Act and the Uniformed Services Employment and Reemployment Rights Act, that may confer special employment rights on those who are covered. As a result and depending on the specifics, a leave of absence may not be a termination of employment; therefore, when the employee returns to work, he or she is not truly a rehire.

Inconsistent Work Schedule

Some employees may have inconsistent work schedules, working more hours one month and very few or no hours in another. This may be more prevalent in industries such as retail sales or hospitality. There are several other fairly common arrangements that fall into this category:

- "Per Diem" Employees: work a day here and there on an as-needed basis (often in health-care-related fields);
- Interns: consistently work during each school break but do not work at all while school is in session;
- Seasonal Employees: return to work at the same general time each year, e.g. grounds keepers at a golf course, but do not work in the off-season.

Are these employees terminated during each gap in their work schedule or are they continuously employed but not on the schedule? Again, answering that question is a critical first step in determining whether the rehire rules apply.

Transfers

Another variation is when an employee transfers from one division, location or subsidiary to another. When the transfer is within the same “employer,” it is not a termination and a rehire, it is continuous employment...even if the divisions or locations have separate payrolls or financial reporting structures. The same is true for transfers of employment classification such as a union employee who discontinues his or her union membership and is reclassified as a non-union employee.

You may be wondering why there are quotes around the word employer. The reason is that there are complex rules that require multiple companies with certain overlap in ownership or business operations to be treated as a single employer for retirement plan purposes. An employee who transfers from one such company to another within the same group is again treated as continuously employed.

Rules of the Road

Once the above determination has been made, there are two general rules we must review. They are known as the rule of parity and the one-year holdout rule.

Rule of Parity

The rule of parity establishes the requirements that allow an employee’s pre-termination service to be permanently disregarded upon rehire. In short, the employee in question must have been:

- A participant in the plan prior to termination;
- 0% vested at the time of termination; and
- Terminated long enough to incur five consecutive breaks in service.

All three requirements must be met. The first is straightforward; however, keep in mind that someone is a participant if they are eligible for the plan even if they have not chosen to contribute.

The vesting requirement is a bit trickier and depends on the employee’s actual account. Since salary deferrals must be fully vested at all times, any employee who has made 401(k) deferrals does not meet the vesting requirement. In other words, there are no circumstances that would allow the company to ignore pre-termination service regardless of how much time has passed between termination and rehire.

If the employee has never deferred or the plan doesn’t allow deferrals, we turn our attention to company contributions. It is obvious whether a person has vesting credit if a contribution has been made, but what about an employee who is vested but has no account balance? For example, how would we treat an employee who has worked for the company for two years and is 20% vested but the company has not made any contributions during that time frame? The employee is 20% vested in an account with nothing in it.

The rules are somewhat open to interpretation on this point but seem to suggest that such an employee would be treated as 0% vested in applying the rule of parity. Others argue that such an interpretation seems contrary to the intent of the law. Should this situation arise, it is a good idea to seek assistance from an experienced consultant and to make sure that whatever interpretation is adopted is applied consistently.

Breaks in Service

That brings us to five breaks in service. As a general rule, a break in service is a plan year during which an employee works fewer than 501 hours of service. A couple of quick examples may help here.

Arthur terminates employment on January 31, 2014, having worked 100 hours year to date. Assuming he isn't rehired before then, he would experience his first break in service at the end of 2014 and his fifth at the end of 2018.

Penelope terminates employment on May 31, 2014, having worked 800 hours year to date. Since she completed at least 501 hours of service prior to termination, she does not have a break in service for 2014. That means her first break is in 2015 and her fifth is in 2019.

For plans that use the elapsed time method of counting service, the fifth break in service occurs when the employee has been terminated for 60 consecutive months.

One-Year Holdout Rule

This rule is much simpler in many ways and allows a company to temporarily ignore a rehire's pre-termination service. Under the one-year holdout rule, once an employee incurs a single break in service, pre-termination service is ignored until he or she completes one year of service following rehire. Then all pre-break service is immediately reinstated retroactive to the date of rehire. A break in service is measured the same way as described above for the rule of parity, and a year of service generally means a 12-month period in which the employee works at least 1,000 hours.

Putting the Rules into Play

The above analysis is the hard part. If you've made it this far, putting those results into play is much easier. There are two main reasons that we care about all of these rules: to determine eligibility and vesting. Let's take a look at how the results apply to both of these important determinations.

Eligibility

An employee who didn't meet the plan eligibility requirements before terminating is the most straightforward—he or she must complete those requirements irrespective of breaks in service, etc. Someone who was a participant prior to termination rejoins the plan immediately on rehire unless either the rule of parity or one-year holdout rule applies.

A participant who satisfies all three requirements under the rule of parity is treated as a new hire as of the reemployment date and must satisfy the plan's eligibility requirements that are currently in place in the same manner as any other new employee. Keep in mind that it is somewhat unusual in a 401(k) plan for an individual to meet all of the rule of parity requirements, so proceed with caution and double-check your findings if it looks like a former participant will be treated as a new hire.

The one-year holdout rule can present some unique challenges since it provides retroactive credit for pre-termination service. Another example will help to illustrate.

Harold is a former participant who is rehired for 20 hours per week on December 1, 2013. Under the one-year holdout rule, he completes one year of service after his rehire on November 30, 2014, and his pre-termination service is reinstated retroactively to his rehire date, making him eligible for the plan in 2013.

If the company made a contribution for 2013, Harold is eligible to share in it even though the company could not have known it at the time they made the deposit. The company is obligated to make a 2013 contribution for Harold, but they would have to deduct it on their 2014 tax return.

Keep in mind, however, that other plan rules continue to apply. So, if the plan has a separate provision requiring a participant to work at least 1,000 hours in a plan year to share in a con-

tribution, Harold would not receive a 2013 contribution since he would have only completed 80 hours of service from the December 1st reentry date through the end of the year.

Another quirk of the one-year holdout rule is whether and how it can be applied to a 401(k) plan. A 401(k) plan, by its nature, requires a participant to make a deferral election before the pay becomes available. By the time a participant retroactively reenters the plan under the one-year holdout rule, he or she has already been paid for a year making it impossible to defer. That could be interpreted as a violation of the terms of the plan. As a result, it is unusual for 401(k) plans to apply the one-year holdout rule.

Vesting

Both the rule of parity and the one-year holdout rule are applied in a similar manner for vesting. There is, however, one very important difference related to the one-year holdout rule: the computation period for determining one year of service can be different for eligibility than for vesting. Specifically, it is counted from rehire date for eligibility, but the vesting computation period in many plans is always the plan year. So, using the above example, although Harold is rehired on December 1, 2013, he will not complete 1,000 hours by the end of the plan year (December 31, 2013) and would reset the clock on January 1, 2014. That means he would not be given retroactive credit for vesting until December 31, 2014, one month later than when his service was recognized for eligibility.

Conclusion

Dealing with boomerang employees can be challenging on many fronts. Establishing a procedure to review employment history will help meet those challenges with regard to the retirement plan. Both the rule of parity and one-year holdout rule are optional provisions, so it is critical to check your plan document. When questions arise, a call to an experienced TPA or consultant at the beginning will go a long way to preventing even more daunting challenges down the road.

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