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Employee Benefit Plan Review

IRS Announces Transition Relief for 403(b) Plan Exclusions of Part-Time Employees

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The Internal Revenue Service (IRS) recently issued Notice 2018-95 providing transition relief for 403(b) plans that have improperly excluded part-time employees from making elective deferrals in violation of the universal availability rule.

The Universal Availability Rule

The universal availability rule is a nondiscrimination rule that applies to 403(b) plans. Under the universal availability rule, if a 403(b) plan permits *any employee* to make elective deferrals to the plan, it must permit *all employees* to make elective deferrals to the plan, with limited exceptions. One of the limited exceptions to this rule allows a 403(b) plan to exclude employees who normally work less than 20 hours per week if certain conditions are satisfied.

Treasury Regulation 1.403(b)-5(b)(4)(iii)(B), issued by the IRS on July 23, 2007, provides that in order for a 403(b) plan to exclude an employee who "normally works less than 20 hours per week" from making elective deferrals, the following requirements must be satisfied:

1. For a part-time employee to be excluded from the plan for the 12 month period following the employee's start date, the employer must reasonably expect the employee to work fewer than 1,000 hours.
2. For a part-time employee to be excluded from the plan any plan year after the initial 12-month period described in (i), the employee must actually have worked fewer than 1,000 hours in the preceding 12-month period.

Excluding a part-time employee from a 403(b) plan, therefore, requires employers to look forward, in the case of newly hired employees, and backward, in the case of employees thereafter.

Many employers have excluded part-time employees who should have been included in the 403(b) plan under the OIAI rule.

The IRS has further interpreted Treasury Regulation 1.403(b)-5(b)(4)(iii)(B) as providing that once an employee has become eligible to make elective deferrals to the 403(b) plan in a given year, the employee can no longer be excluded from making elective deferrals

under the 403(b) plan under the part-time exclusion. This is known as the "once-in-always-in" rule (OIAI).

Many Plans have Applied the Oiai Incorrectly

Many employers have excluded part-time employees who should have been included in the 403(b) plan under the OIAI rule. For example, consider an employee who is reasonably expected to work fewer than 1,000 hours in her first year of employment (2012), but who actually works the following hours:

Year	Hours Worked
2012	1,000
2013	900
2014	900
2015	900
2016	900
2017	1,000

The employee could properly be excluded from the 403(b) plan during 2012, because she is reasonably expected to work fewer than 1,000 hours during 2012, even though, as it turns out, she actually works 1,000 hours. However, the employee could not be properly excluded from the 403(b) plan for 2013, because she worked at least 1,000 hours during the preceding 12-month exclusion period. Moreover, under the OIAI rule, the employee cannot be excluded from the 403(b) plan under the part-time exclusion for any year after 2012.

However, many employers have administered their 403(b) plans in a way that would have excluded such an employee from making elective deferrals not only in 2012, but also in 2014 through 2017, because for each of these years, the employee failed to work at least 1,000 hours in the preceding 12-month period.

Transition Relief

In 2015, the IRS issued sample plan document provisions – referred to as listings of required modifications or LRMs – for 403(b) plans, which made clear that the IRS interpreted Treasury Regulation 1.403(b)-5(b)(4)(iii)(B) to include the OIAI rule. Since LRMs are directed to drafters of pre-approved plans, many employers sponsoring individually designed plans were still not aware of the IRS' interpretation.

The IRS issued Notice 2018-95 to provide transition relief for 403(b) plans that have not correctly applied the OIAI rule in determining whether or not their part-time employees can be properly excluded from the plan. The transition relief period begins with taxable years beginning after December 31, 2008, and, for plans with exclusion years based on the plan year, ends for all employees on the last day of the last exclusion year that ends before December 31, 2019. For example, for plans that use the calendar year as the plan year, the relief period ended on December 31, 2018. For plans with exclusion years based on employee anniversary years, the transition relief period ends, with respect to any employee, on the last day of that employee's last exclusion year that ends before December 31, 2019. For example, if Employee A started on June 1, 2015, and Employee B started on August 21, 2015, the relief period ends on May 31, 2019 for Employee A and on August 20, 2019 for Employee B.

The relief provided in Notice 2018-95 applies to both operational errors and plan document errors.

- *Operational Errors*: During the transition relief period, a plan will not be treated as failing to satisfy the conditions of the part-time employee exclusion merely for failing to apply the OIAI rule correctly.
- *Plan Document Errors*: Sponsors of individually designed plans have until March 31, 2020 to correct errors in their plan document regarding the OIAI rule. Pre-approved plans already contain the required language.

Notice 2018-95 also provides a "fresh-start opportunity" for exclusion years beginning on or after January 1, 2019. Beginning on January 1, 2019, a plan must comply with the OIAI rule in both form and operation. However, under the "fresh start" relief, plans can apply the OIAI rule as if the rule first became effective on January 1, 2018.

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