Flashpoint: The Ins and Outs of 403(b) Deferrals – The IRS Solves the Problem

The IRS has provided important transition relief for many 403(b) plans struggling with an apparent change in IRS positions on a critical issue: how should 403(b) plans treat part-time employees who sometimes work more than 20 hours a week and sometimes work fewer? Recently issued Notice 2018-95 clarifies that what the IRS is calling "the once-in-always-in rule" (to which the Notice attaches the unpronounceable acronym "OIAI") applies for all years beginning in 2019. While many plans may have used a different approach in the past, the Notice provides important relief for prior years, but most plans must start to follow the guidance January 1, 2019.

The Issue and the Law

The issue relates to the distinctive "universal availability" requirement for 403(b) deferrals. Simply stated, Internal Revenue Code (the "Code") Section 403(b) requires that, if any employee can make pre-tax salary deferrals to a 403(b) plan, every employee – with very few exceptions – must be able to defer. One of the most important of these exceptions is the rule allowing plans to exclude "employees who normally work less than 20 hours per week." [Code §403(b)(12)]

The 403(b) regulations, which became effective in 2009, changed the 20 hours/week requirement to 1,000 hours/year. Under those regulations, a 403(b) plan can exclude an employee from deferring during his or her first 12 months of employment if the employer reasonably expects the employee to work fewer than 1,000 hours during those 12 months. For subsequent plan years, the regulations apply the exclusion as follows:

> For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period. [Treas. Reg. §1.403(b)-5(b)(4)(iii)(B)(2).]

Many practitioners interpreted this regulation as suggesting that an employee's ability to defer was a year-by-year determination. If an employee worked at least 1,000 hours in 2012, she would be able to defer in 2013. But if she didn't work 1,000 hours in 2013, she would be barred from deferring in 2014. We can call this the "in-and-out rule."

In 2015, the IRS provided model plan language that rejected the in-and-out rule in favor of the OIAI approach. Under this latter rule, once an employee is allowed to defer, the plan could never again exclude the employee from deferring under the 20-hour rule. The good thing about this interpretation is it is consistent with ERISA. 403(b) plans subject to ERISA are barred from applying the in-and-out rule. 403(b) preapproved plans all contain language adopting the OIAI rule.

The Need

That's all well and good; however, there are many 403(b) plans – particularly public school, church, and deferral-only plans – that have operated for years in good faith under the in-and-out rule. Most 403(b) plans are now being restated onto preapproved documents, with a retroactive effective date of 2010. The plan language contradicts the plans' operations for nearly a decade, thereby running the risk that the IRS would consider those operations as failures to comply with Section 403(b) – a potentially very costly result.

Document vendors and professional associations, such as the American Retirement Association, urged the IRS to provide relief for plans that have operated in good faith. The guidance gives them everything they asked for.

The Solution

Notice 2018-95 addresses this issue in several ways.

1. Most importantly, during the "relief period," a 403(b) plan will not be in operational failure if it consistently applied the in-and-out rule. The relief period runs from January 1, 2009, until the end of the last "exclusion period" *ending before* December 31, 2019. For most plans, an exclusion period is the plan year. If the plan year is the calendar year, the relief period ends December 31, 2018. If the plan applies the 20-hour exclusion on anniversaries of hire date, the exclusion period is determined separately for each employee based on the employment year.
2. A preapproved plan already should have a provision implementing the OIAI rule and need not adopt an interim amendment to address the Notice 2018-95 relief.
3. An individually designed 403(b) plan has until March 31, 2020, the end of the remedial amendment period, to amend the plan to conform to the OIAI rule. The plan document likely should note the date it starts to apply the OIAI rule.
4. A plan that has been using the in-and-out rule has a 'fresh start" opportunity under the Notice. It can apply the OIAI rule for 2019, ignoring exclusion periods starting before January 1, 2018.

Example. Anytown High School offers a 403(b) plan to its employees. Until now, the plan has consistently used the in-and-out rule. The plan has a calendar plan year and applies the 20-hour rule on the basis of the plan year. The plan was restated onto a preapproved plan document in 2017. The school hired Alan and Becky in 2015 as part-time custodians, and reasonably concluded neither would work 1,000 hours in the first employment year. Neither did. However, in 2016, Becky had 1,000 hours, and so the plan let her defer in 2017. Becky did not work 1,000 hours in 2017, and so she could not defer in 2018, thanks to the in-and-out rule.

Alan worked 1,000 hours in 2018. Under either the in-and-out rule or the OIAI rule, Alan must be allowed to defer in 2019, and, thanks to the OIAI rule, he must be allowed to defer in all future years, regardless of his hours worked. Becky, however, need not be allowed to defer in 2019,

because the fresh start rule allows the plan to disregard her 1,000-hour year in 2016. The plan is not in operational failure and need not adopt an interim amendment.

The Moral

Once-in-always-in is the rule for 403(b) plans, beginning in 2019, and plans should change their administrative practices accordingly. Few plans will require a plan amendment to implement this change, because most plans use preapproved documents. 403(b) vendors, TPAs, and others working with 403(b) plans should become familiar with the current IRS interpretation and the relief the IRS has provided.

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