



# Management Alert



## Tax-Exempt Employers: IRS Issues Relief from Confusing 403(b) Eligibility Requirement Applicable to Part-Time Employees

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On December 4, 2018, the Internal Revenue Service issued Notice 2018-95 (the “Notice”), which clarifies the application of the Internal Revenue Code (the “Code”) Section 403(b) plan “universal availability” rule to part-time employees normally working fewer than 20 hours a week. The IRS established relief for 403(b) plans that have not properly applied the universal availability rule to such part-time workers any time after 2008 and before 2019. The need for this rule highlights an important distinction between 403(b) plans and 401(k) plans, relieves 403(b) plans from liability (to the IRS) for prior failures to have properly covered part-time workers, and allows for a “fresh-start” following the end of the relief period.

### 403(b) Plans and the Universal Availability Requirement

In offering employees an individual account-type tax-preferred retirement plan, tax-exempt employers have the option to establish either a 401(k) plan or a 403(b) plan.<sup>1</sup> One important distinction between 401(k) plans and 403(b) plans is how the two types of plans are tested for nondiscrimination with respect to employee salary deferral contributions. 401(k) plans are subject to the “average deferral percentage” (or “ADP”) test, while 403(b) plans are not. A consequence of an ADP test failure can be having to return employee salary deferrals to certain highly compensated employees, or the employer-sponsor having to make additional contributions to the accounts of certain non-highly compensated employees.<sup>2</sup>

Rather than being subject to the ADP test and the possible consequences of a testing failure, Code Section 403(b) provides an alternative for tax-exempt employers. Instead of having to satisfy the ADP test, Code Section 403(b) applies the “universal availability” requirement to employee salary deferral contributions. Generally speaking, this requirement is self-explanatory—if the plan permits any employee to make salary deferral contributions, every employee must be permitted to make such contributions.<sup>3</sup> However, the Code provides for limited exceptions to this requirement. One such exception is for employees who normally work fewer than 20 hours per week. Treasury regulations explain that an employee is considered to normally work fewer than 20 hours a week if: (1) the employee is reasonably expected to work fewer than 1,000 hours in the 12-month period following the commencement of employment (this is referred to as the “first year exclusion condition”); and (2) for *each* plan year ending after that initial 12-month period the employee worked fewer than 1,000 hours in the immediately preceding 12-month period (generally referred to as the “preceding year exclusion condition”).

1. Taxable entities are prohibited from establishing a 403(b) plan.

2. These corrective contributions are referred to as “qualified non-elective contributions” or “QNECs”, and must be fully vested upon contribution.

3. The universal availability requirement does not apply to employer contributions (i.e., match or non-elective contributions).

Following these rules, many tax-exempt employers exclude a worker expected to work fewer than 1,000 hours in his or her first year of employment from 403(b) plan participation. After the conclusion of that first year of employment, many employers typically only permit such a part-time employee to make salary deferrals contributions in a subsequent plan year only if they had worked 1,000 hours or more in the immediately preceding year.

In 2013 and again in 2015, the IRS issued model language for pre-approved 403(b) plans, making it clear that this treatment of part-time employees is improper. Rather, the exclusion is to be applied such that once a part-time employee works 1,000 hours in a year, they must be permitted to make salary deferral contributions not only in the next year but *each* year thereafter. This has become known as the “once-in, always-in” (or “OIAI”) rule.

Having only clarified this application of the part-time employee exclusion to the universal availability rule in 2015, and then only in guidance that applied to pre-approved plans, many employers did not take notice and continued to operate their plans as they had been—incorrectly excluding certain part-time employees who had once worked 1,000 or more hours in any prior year. In order to rectify this problem, the IRS issued the Notice providing for relief for 403(b) plans that were improperly administered or drafted in this regard.

## OIAI Relief

### Operational Relief

Under the Notice, 403(b) plans that had improperly excluded part-time employees under the mistaken interpretation of the exception to the universal availability rule will not be considered as having failed to satisfy the universal availability requirement, provided that such plans were consistently administered under the first year and preceding year exclusion conditions. In other words, an employer may have interpreted the exclusion incorrectly but the employer applied that incorrect interpretation consistently from year-to-year and part-time employee to part-time employee.

This relief is extended for the period starting with the first tax year beginning after December 31, 2008, (the general effective date of the Code Section 403(b) final regulations), and through the last exclusion year that ends before December 31, 2019. Thus, for plans that use the calendar year as the exclusion year, the relief period ends December 31, 2018. Accordingly, such plans must act immediately to rectify any improper part-time employee exclusion and extend the opportunity for previously improperly excluded part-timers to make salary deferral contributions starting January 1, 2019.<sup>4</sup>

### Plan Document Relief

Having been approved by the IRS, pre-approved Section 403(b) plans should already include language that incorporates the OIAI exclusion condition retroactive back to when Section 403(b) regulations became effective in 2009. However, if an employer using a pre-approved 403(b) plan document did not correctly implement the OIAI exclusion condition, the plan has an operational error (i.e., a discrepancy in the plan’s operation and in the plan’s language). This Notice provides relief from this operation error, and no plan amendment is required.

Individually designed plans that do not properly reflect the OIAI rule will have until March 31, 2020, (i.e., the generally applicable remedial amendment period for individually designed 403(b) plans), to amend the plan (retroactive to as far back as 2009 as may be necessary) to properly reflect the OIAI rule.

## Fresh-Start Opportunity After Relief Period Ends

The Notice also provides a “fresh-start” opportunity for 403(b) plans that were not in operational compliance with the OIAI requirement. Starting with exclusion years beginning on or after January 1, 2019, these plans will not be treated as having been out of compliance with the part-time employee exclusion rule provided the plan properly applies the rule as if it were first effective on January 1, 2018. Accordingly, if a part-time employee hired before 2018 did not work 1,000 hours or more in 2018, he or she does not need to be offered the opportunity to make salary deferral contributions in 2019 (assuming such

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4. Plans that use the calendar year as the “exclusion year” will necessarily have an overlap of the first calendar exclusion year and the first 12 months of employment. So long as the plan has treated these overlaps consistently, the relief granted under the Notice applies.

employee hasn't already been extended this opportunity). This fresh-start opportunity does not require an amendment to the plan document.

## Immediate Action Steps

Tax-exempt employers who exclude part-time employees from making salary deferral contributions to their 403(b) plans should immediately review their plan administrative practices and determine whether the exclusion was properly applied in the past years. Regardless, starting next month, these plans will need to ensure that part-time employees who worked 1,000 hours or more in 2018 are extended the opportunity to contribute starting in 2019.

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