How Does the 20-Hour Rule Work for 403(b) Plans?

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New guidance from the IRS impacts the application of the 20-hour rule to 403(b) plans. Here's an overview.

What's the 20-hour rule all about? Unlike qualified plans—including 401(k) plans—where typically an employer would set out eligibility requirements for both elective contributions by employees and employer contributions, 403(b) plans may not have a year-of-service requirement for eligibility for elective deferrals.

Generally, eligibility for an employee to defer into their employer's 403(b) plan account is immediate, and the employer is required to offer this to all employees with very few exceptions. For years after 2008, an employee must be provided the opportunity to make elective deferrals into the 403(b) unless the employee:

- "generally" works fewer than 20 hours per week;
- participates in another deferral plan (another 403(b), 401(k), or governmental 457(b));
- is a nonresident alien (NRA); or
- is a student performing certain services (e.g., on a work study program).

On March 28, 2013, the IRS issued their long awaited Revenue Procedure 2013-22, providing guidance on the new 403(b) pre-approved plans and on the same day issued sample plan language for drafters to use in the form of "Listings of Required Modifications" (LRMs). These new LRMs provide a little more guidance in how the 20-hour rule works in subsequent years.

The new LRMs go on to describe this rule as follows:

> "An Employee normally works fewer than 20 hours per week if, for the 12-month period beginning on the date the Employee's employment commenced, the *Employer reasonably expects the Employee to work fewer than 1,000 hours* of service (as defined under section 410(a)(3)(C) of the Internal Revenue Code) in such period, and for each Plan Year ending after the close of that

12-month period, the Employee has worked fewer than 1,000 hours of service in the preceding 12-month period. *Under this provision, an Employee who works 1,000 or more hours of service in the 12-month period beginning on the date the Employee's employment commenced or in a Plan Year ending after the close of that 12-month period shall then be eligible to participate in the Plan."* (Emphasis added.)

This refers to a rule that will only apply to 403(b) plans. Once you are eligible to defer, you are always eligible. In other words, there will not be a continuing eligibility requirement after the 1,000 hours is met.

Below is a series of questions and answers that should help you and your employees understand who is eligible to defer into the employer's 403(b) plan.

What's the big picture that the 20-hour rule fits into?

The big picture is the concept of Universal Availability. The Universal Availability Rule states that to the extent an institution permits one employee to make salary deferral contributions to a 403(b) plan, it must allow all employees an "effective opportunity" to participate in the 403(b) plan. Remember that the 20-hour rule is only applicable to salary deferrals under the 403(b) plan, not employer contributions.

Are there exceptions to the Universal Availability Rule?

Yes. Generally, employers have been able to exclude certain groups of employees from participating in its 403(b) plan without violating the rule: nonresident aliens with no U.S.-source income; employees eligible to make elective deferrals to another 403(b), 401(k) or governmental 457(b) plan of the same employer; employees whose contributions to the plan would be $200 or less annually; student employees exempt from FICA taxation; and employees who "normally work" fewer than 20 hours a week.

For the last two of these exclusions to apply, all employees covered by that exclusion must be prohibited from participating in the plan by the plan's terms.

Practice Pointer: Remember to review the plan document. Remember that the terms "part-time" and "full time" employees have nothing to do with the 20-hour rule.

How is the 20-hour rule exception applied?

The 20-hour rule, which is addressed under the 403(b) regulations as the 1,000-hour rule, states that an employer may exclude an employee from participating in the 403(b) plan during his or her first 12 months of employment if the employer 'reasonably' expects the employee to work fewer than 1,000 hours during that period.

Practice Pointer: The initial eligibility computation period always begins on the date of hire. However, please pay attention to the plan language as to when the second 12-month eligibility computation begins, if applicable. Some plans may select anniversaries of the date of hire, while others may revert back to the beginning of the plan year (which is usually the calendar year)

What happens if in a subsequent year, the employee works fewer than 1,000 hours?

In subsequent years, the employee can be excluded from the 403(b) plan only if he or she did in fact work fewer than 1,000 hours during the prior 12-month period. Employers sponsoring 403(b) plans subject to ERISA, however, can exclude employees from participating in the 403(b) plan only if they actually work fewer than 1,000 hours that year.

What happens if the employee works more than 1,000 hours in the first year, but fewer in the next?

Generally, once employees become eligible by satisfying the 20-hour rule or the 1,000-hour rule, they will remain eligible unless they fall under an exclusion specified in the plan document. This operates differently than under a qualified plan.

For example: Jane was hired by the Big Diehl School District on Sept. 1, 2012 as a substitute teacher. The employer determines that Jane will not work more than 1,000 hours during her first year of employment. On Dec. 1, 2012, Jane took a permanent substitute position to fill in for a teacher who goes on maternity leave. During her first year of employment (9-1-2012 to 8-31-2013) she works more than 1,000 hours. Jane is hired as a full-time teacher on Sept. 1, 2013. Since she did in fact work more than 1,000 hours in the previous year, she is eligible immediately to defer from her salary into the 403(b). As long as Jane works for the Big Diehl School District she will be eligible to defer from her salary regardless of how many hours she works in the future.

Practice Pointer: Remember, this is not necessarily the case for employer contributions. There can be an ongoing eligibility requirement for employer contributions. Read the plan document to determine how eligibility works with respect to employer contributions. Even though IRS speakers have weighed in on this question over the last few years, be prepared for sample IRS language to explain this as we get closer to preparing prototype documents, which we hope will provide more guidance in this area.

What if the employer expected the employee to work fewer than 1,000 hours, but the employee in fact worked more, but was not permitted to participate in the plan?

As long as the employer anticipated that he or she would not work 1,000 hours or more than 20 hours per week, then nothing was done incorrectly. However after the employer "looks back" and determines that he or she did in fact work more than 1,000 hours, then he or she must be eligible to participate in Year 2 and all subsequent years regardless of the number of hours worked. b

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