

Internal Revenue Service

Tax Exempt and  
Government Entities

Employee Plans Division

## 403(b) Tax-Sheltered Annuity

for

# Participant



### Be Aware of Common Mistakes

As a 403(b) plan participant, you need to pay attention to the operation of your 403(b) tax-sheltered annuity so that you can:

- be compliant with the law,
- maximize your retirement benefits, and
- avoid additional taxes and penalties.

403(b)  
Tax-Sheltered  
Annuity

# for Participant

A 403(b) tax-sheltered annuity (TSA) plan is a retirement plan offered by public schools and certain tax-exempt organizations. An individual's 403(b) annuity can be obtained only under an employer's TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and non-elective employer contributions.

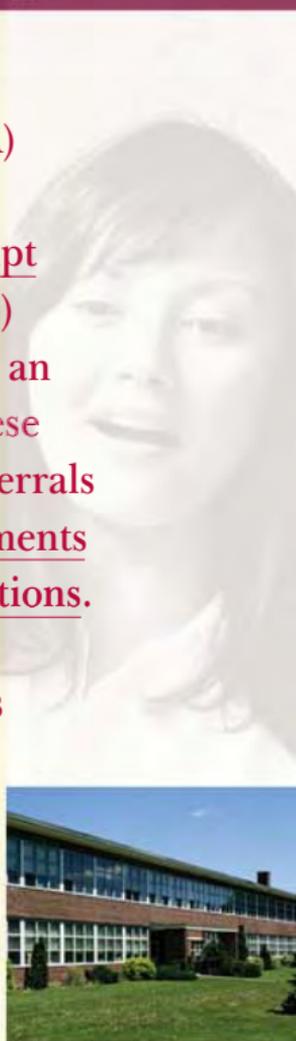
There are significant tax advantages for you, as a participant, in a 403(b) tax-sheltered annuity:

- ❑ your contributions to a 403(b) annuity are tax deferred,
- ❑ earnings on your retirement money are tax deferred, and
- ❑ you can carry your annuity with you when you change employers or retire.

Read on to learn about specific 403(b) topics where mistakes are common, and learn about Internal Revenue Service (IRS) products, services, and assistance to help you keep your 403(b) tax-sheltered annuity healthy.

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Note: Underlined topics identify electronic links for detailed information on that topic. For those reading a print version of this product, you can access an electronic version on-line at [www.irs.gov/ep](http://www.irs.gov/ep) to link to your topic of interest.



# 403(b) Tax-Sheltered Annuity

It is important to know the tax rules applicable to a 403(b) annuity to: 1) help you comply with the tax law; and 2) help you get the maximum 403(b) benefit.

In a national sample of audited 403(b) plans, the IRS found recurring mistakes in the following areas:

**Maximum Elective Deferrals.** The aggregate annual elective deferral limit per individual includes contributions to your 403(b) annuities (even if held under different employers), 401(k) plans, SIMPLE IRA plans, and SARSEP plans. Amounts contributed in excess of noted limits may be subject to additional taxes and penalties that may affect both the participant and the sponsor/employer. See the chart to the right for 403(b) provisions and requirements to maximize your retirement contributions.

**Catch-Up Contributions.** Plans may permit one or both of the following catch-up provisions. *Note: Catch-up contributions must be applied first to the years-of-service catch-up limits (for employees with 15 years of service) before being applied to the age-50 catch-up.*

**Years of service catch-up**—This catch-up is available through certain employers. Refer to the chart to the right to determine if, and how much of, this catch-up is available for you. The \$15,000 overall limit may have been exhausted through general contributions made during the first 15 years of service.



# — COMMON MISTAKES

**Age-50 catch-up**— This catch-up is available for any participant who has attained age 50 or more by December 31st. See the chart to the right for amounts. This catch-up cannot exceed your includible compensation.

**Distributions and Rollovers.** New laws permit you to roll over (tax free) all or any part of your otherwise taxable eligible distribution from a 403(b) annuity into another 403(b) annuity, a 457(b) plan, a traditional IRA, or other eligible retirement plan. Likewise, if permitted by the 403(b) annuity, you may roll over your otherwise taxable distributions from another retirement plan into this 403(b) annuity. Refer to the chart to the right for the specific times/occasions when annuity distributions may be available. You should check your 403(b) annuity or consult your employer for other distribution options available to you, such as early retirement.

**Loan Limitations.** Earlier access to your contributions may be available through loans if offered under the 403(b) annuity. See the chart to the right for conditions. If any of these provisions are not adhered to, there is a deemed distribution that is subject to federal income tax. Additional taxes may apply if these distributions occur before age 59½. Loan defaults may violate distribution requirements.

**Hardship Requirements.** Hardship distributions may be permitted under a 403(b) annuity. Hardships must be the result of an immediate and heavy financial need. Failure to meet these criteria can jeopardize the status of the TSA. Hardship distributions may not be rolled over into another retirement plan or IRA.

As a participant, you need to be aware of these common mistakes. Notify your sponsor/ employer to correct mistakes timely to avoid additional taxes and penalties that may affect both you and your sponsor/employer.



# Tax-Sheltered Annuity

# Provisions and Requirements

## Plan Provisions

## 403(b) Requirements

### Eligible Participants

common-law employees of public school systems and 501(c)(3) organizations

### General Contribution Limits

**elective deferrals**  
■ \$14,000 (2005); \$15,000 (2006); indexed thereafter (plus catch-ups)

**employer and employee contributions:**  
■ limited to the lesser of \$42,000 (2005); \$44,000 (2006) or 100% of includible compensation (elective deferrals and nonelective contributions)

### Year of Service Catch-Up Contributions

- certain employers
- employee must have 15 years of service
- limited to least of:
  - \$3,000
  - \$15,000 less previously excluded special catch-ups
  - \$5,000 multiplied by years of service minus previously excluded deferrals

### Age-50 Catch-Up Contributions

additional \$4,000 (2005);  
\$5,000 (2006)

### Loans

- if the TSA so provides
- \$50,000 aggregate limit of all loans at any time
- payments at least quarterly
- term not to exceed 5 years (except for purchase of principal residence)
- must bear reasonable rate of interest

### Timing of Distributions

- generally,
- death
  - age 59½
  - severance from employment
  - disability
  - later of age 70½ or retirement

### Other Distributions

- hardship
- qualified domestic relations order

### Rollovers

- to and from other retirement plans and to IRAs
- must satisfy eligible distribution requirements

### Trustee-to- Trustee Transfer

- while in service, employee can purchase certain permissive service credit in government defined benefit plans
- 403(b) to another 403(b)— in-service



# Customer Assistance

The following publications cover 403(b) tax-sheltered annuities and correction programs:

- Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations*
- Publication 575, *Pension and Annuity Income*
- Publication 590, *Individual Retirement Arrangements (IRAs)*
- Publication 4050, *Retirement Plan Correction Programs* CD-ROM
- Publication 4224, *Retirement Plan Correction Programs* pamphlet

Download these publications at [www.irs.gov/ep](http://www.irs.gov/ep), or order a free copy through the IRS by dialing (800) 829-3676.

For assistance or information on retirement plan tax-related issues:

[www.irs.gov/ep](http://www.irs.gov/ep)

See PLAN PARTICIPANT/EMPLOYEE

(877) 829-5500

Tax Exempt and Government Entities  
Customer Account Services



**IRS**

Department of the Treasury  
Internal Revenue Service

Publication 4482 (10-05)  
Catalog Number 47242K

## **Public Schools/Certain Tax Exempt Organizations:**

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

You cannot set up your own 403(b) account. Only employers can set up 403(b) accounts. A self-employed minister cannot set up a 403(b) account for his or her benefit. If you are a self-employed minister, only the organization (denomination) with which you are associated can set up an account for your benefit.

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.2 (03-01-2005)

### **Eligibility**

(1) Unlike a qualified plan, only certain tax-exempt employers and certain ministers are eligible to maintain a 403(b) plan on behalf of eligible employees. The three key issues here are whether the:

- a. employer is eligible to maintain a 403(b) plan for participating employees,
- b. participants in a 403(b) plan perform services for the employer as employees, and
- c. self-employed and certain other ministers are described in *IRC section 414(e)(5)(A)*.

Employee status under *IRC section 403(b)* is generally determined by employee status for federal employment tax purposes under common law principles. See the 20 steps for determining employee status in *Rev. Rul. 87-41, 1987-1 C.B. 296*.

4.72.13.6.1 (03-01-2005)

### **Universal Availability Requirements for Salary Reduction Contributions**

(1) Salary reduction contributions are tested separately from non-salary reduction contributions for nondiscrimination. (*IRC section 403(2)(12)(A)(ii)*).

- a. The nondiscrimination requirement for salary reduction contributions is satisfied only if the plan in operation allows each employee to elect to defer more than \$200 annually. Unlike a qualified CODA, nondiscrimination with respect to salary reduction contributions is not satisfied through compliance with the ADP test.
- b. The test for salary reduction contributions focuses on eligibility and generally requires universal eligibility. However, there is no requirement that the opportunity to make salary reduction contributions be available; but once that opportunity is available to any employee, it must be available to all **nonexcludable employees** to satisfy nondiscrimination.
- c. Until future guidance is issued, both public education institutions and 501(c)(3) organizations **MUST** currently operate their 403(b) plans in accordance with a good faith/reasonable interpretation of the nondiscrimination requirement for salary reduction contributions. No plan provisions are currently required, but faulty plan language may indicate an operational violation.
- d. Additional catch-up contributions under *IRC section 414(v)* must be universally available to employees if these are made available to any employee.

(2) Excludable employees may be disregarded in applying the nondiscrimination test for salary reduction contributions. These include:

- a. nonresident aliens with no U.S. source income,
- b. employees who normally work less than 20 hours per week,
- c. collectively-bargained employees,
- d. students performing certain services,
- e. employees whose maximum salary reduction contributions under the plan would be no greater than \$200,
- f. participants in an eligible 457 plan, a qualified CODA, or other salary reduction 403(b) plan, and

**Note: Unlike a qualified plan, a 403(b) plan is not permitted to have any minimum age and service exclusion for salary reduction contributions.**

(3) Like elective deferrals under *IRC section 402(g)*, salary reduction contributions for nondiscrimination testing consist of employer contributions made pursuant to a salary reduction agreement.

(4) Under Notice 89-23, employer means the common law employer (and not the controlled group) for purposes of testing salary reduction contributions for nondiscrimination. A good faith, reasonable interpretation as to the identity of the employer is sufficient for this purpose.

Salary reduction contributions made pursuant to a one-time irrevocable election at initial eligibility to participate in the salary reduction agreement, or pursuant to certain other one-time irrevocable elections specified in the regulations, and pre-tax contributions made as a condition of employment are treated for limitation purposes and tested for nondiscrimination purposes as non-salary reduction contributions. See [text 4.72.13.5](#) for a discussion of a similar definition for elective deferrals under *IRC section 402(g)*.

(5) The following examples illustrate that salary reduction contributions are tested separately from other contributions for nondiscrimination and that these contributions must be offered universally to non-excludable employees. The effect of violating nondiscrimination is the loss of 403(b) status. Contributions to the Plans are therefore subject to income tax, employment tax and withholding.

**Example:** Employer is a large public university located in City Y. Employer maintains an annuity plan (Plan) intended to be a 403(b) plan. Both non-elective, non-matching contributions and salary reduction contributions are provided under the Plan. Under the Plan, only senior administrative staff and faculty are eligible to elect to defer a portion of their salary pursuant to salary reduction agreements with Employer. Employer also maintains a defined benefit plan for remaining employees. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory. The Plan does not satisfy the requirements of *IRC section 403(b)*.

**Example:** Same as above example, except that all full-time employees are eligible to participate in the Plan. There are 40 part-time clerical employees who are not students and who normally work 29 hours per week (or 1,508 hours per year). Since the part-time employees in this example are not excludable, the salary reduction contributions are discriminatory. The Plan is not a 403(b) plan.

**Example:** Employer is a small private school which maintains an annuity plan intended to be a 403(b) plan. All eligible employees may elect to defer at least 4% of compensation. An eligible employee, A, has compensation of \$25,000 for 2005 and elects prior to 2005 to defer 1.5% of compensation. The plan administrator declines to process the election and informs A that the minimum deferral is 4% of compensation. The salary reduction contributions are discriminatory, and the Plan fails to satisfy 403(b).

**Example:** Employer is a private hospital maintaining an annuity plan (Plan) intended to be a 403(b) plan. The Plan provides only a salary reduction arrangement. Under the Plan, all medical doctors and senior administrative staff are eligible to participate in the Plan immediately upon hire. Remaining employees, including nurses and other support staff, are eligible only after two years of service and attainment of age 21. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory, and the Plan loses its status as a 403(b).

### **Eligible Employers**

(1) Not all non-profit or tax-exempt organizations are eligible to maintain a 403(b) plan. There are only four types of tax-exempt employers eligible to maintain a 403(b) plan:

- a. A State, a political subdivision of a State, or an agency or instrumentality of any one or more of these for employees **who perform services for a public education organization described in IRC section 170(b)(1)(A)(ii)**;
- b. A non-profit organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 501(a)*, or an organization treated as described in *IRC section 501(c)(3)*;
- c. A grandfathered Indian tribal government; and
- d. Beginning in years after December 31, 1996, a minister described in *IRC section 414(e)(5)(A)*.

(2) A trade association described in *IRC section 501(c)(6)* and exempt from tax under *IRC section 501(a)* is **not eligible** to maintain a 403(b) plan.

- a. If an employer maintains an annuity plan and is not eligible, the plan is not a 403(b) plan. For resulting tax consequences, see *IRC sections 403(c)* and *72*.
- b. An ineligible employer may enter into a closing agreement with the Service under the [Employee Plans Compliance Resolution System](#).

IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):  
4.72.13.2.1.1 (03-01-2005)

### **Public Education Organizations**

(1) A state or local government or any agency or instrumentality of one or more of these is an eligible employer only with respect to employees who perform services directly or indirectly for an educational organization.

(2) To be an educational organization, the organization must normally maintain a regular faculty and curriculum, and normally have a regularly enrolled body of students in attendance at the place where it regularly carries on educational activities. Included in this category are:

- a. public schools
- b. state colleges
- c. universities

(3) Both non-academic staff (e.g., a custodial employee) and faculty may be covered but elected or appointed officials holding positions in which persons who are not education professionals may serve are not eligible (e.g., a member of the school board, university regent or trustee may not be eligible).

**Example:** Public High School Y maintains a 403(b) plan (Plan) for its employees. Employee A performs timekeeping and payroll services for High School Y. A may participate in the Plan because A performs services for a public educational organization. *Rev. Rul. 72-390, 1972-2 C.B. 227.*

**Example:** A, a state employee, provides in-home teaching services. A may be covered by a 403(b) plan maintained by A's employer because A performs services for a public educational organization.

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## Certain Tax-Exempt Organizations:

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.2.1.2 (03-01-2005)

### Organizations Described in *IRC section 501(c)(3)*

(1) Another type of eligible employer is an organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 501(a)* (501(c)(3) organization). A 501(c)(3) organization is defined generally as one organized and operated exclusively for the following purposes:

- religious
- charitable
- scientific
- public safety testing
- literary or educational
- to encourage national or international amateur sports competition
- for the prevention of cruelty to children or animals.

(2) These organizations include:

- a. charities,
- b. social welfare agencies,
- c. private hospitals and
- d. health care organizations,
- e. private schools,
- f. religious institutions and
- g. research facilities.

(3) In order to be recognized as a 501(c)(3) organization, all organizations except church and related organizations, and other organizations excepted under section 508, must apply to the Service for a determination letter by filing [Form 1023](#), Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. See [Publication 557](#), Tax-Exempt Status of Your Organization.

4.72.13.2.1.3 (03-01-2005)

### Grandfathered Indian Tribe

(1) A designated Indian Tribal Government is treated as a State for purposes of *IRC section 403(b)*, so an educational organization or a 501(c)(3) organization associated with a tribal government is always eligible to maintain a 403(b).

(2) In addition, an Indian tribal government, a subdivision, agency or instrumentality of an Indian tribal government, or a corporation chartered under federal, State, or tribal law which is owned in whole or in part by any of the foregoing is treated as an employer described in section 501(c)(3) with respect to any annuity contract purchased in a plan year beginning before January 1, 1995.

4.72.13.2.1.4 (03-01-2005)

### ***IRC section 414(e)(5)(A)*** **Minister**

(1) A self-employed minister may deduct, within the limits of *IRC section 404(a)(10)*, contributions to a retirement income account described in *IRC section 403(b)(9)*.

(2) Similar deductions may be taken by a minister employed by a non-501(c)(3) organization, and one with which the minister does not share common religious bonds.

(3) Beginning January 1, 1998, contributions to a 403(b) plan are not includible in the gross income of a minister described in (2) above. *IRC section 414(a)(5)(E)*.

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## Salary Reduction Agreements:

Publication 571 Excerpt (for complete [Pub 571 click here](#)):

**Salary reductions (referred to as Elective Deferrals)** are contributions made under a salary reduction agreement. This agreement allows your employer to withhold money from your paycheck to be contributed directly into a 403(b) account for your benefit. You do not pay tax on these contributions until you withdraw them from the account. You can enter into more than one salary reduction agreement during a year.

IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):  
4.72.13.4 (03-01-2005)

### Salary Reduction Contributions

(1) 403(b) plans are very commonly funded in whole or in part through salary reduction contributions. The requirements for salary reduction and non-salary reduction contributions differ under *IRC section 403(b)*. This section focuses on requirements applicable only to salary reduction contributions.

(2) Salary reduction contributions under a 403(b) plan are also subject to specific requirements such as [annual contribution limits](#), [nondiscrimination rules](#), and [withdrawal restrictions](#).

(3) Salary reduction contributions are defined as contributions made by an employer as a result of an agreement with an employee to take a reduction in salary or forego an increase in salary, bonuses or other wages. Salary reduction contributions are made pursuant to a salary reduction agreement.

(4) Salary reduction contributions made to a 403(b) plan are similar to voluntary deferrals under a cash or deferred arrangement described in *IRC section 401(k)* (CODA). Many of the same rules applicable to cash or deferred elections under *IRC section 401(k)* apply to salary reduction contributions under a 403(b) plan, including the –

- a. frequency that an employee is permitted to enter into or modify a salary reduction agreement,
- b. compensation to which an agreement may apply, and
- c. ability to revoke the agreement.

(5) A 403(b) plan is neither required to permit, nor precluded from permitting, an employee to make multiple salary reduction agreements in a single taxable year. A 403(b) salary reduction agreement applies to compensation that is not yet paid or currently available to the employee at the effective date of the agreement. The salary reduction agreement must be legally binding.

(6) An automatic reduction of an employee's salary by a certain amount may be treated as a salary reduction agreement if the employee has an effective opportunity to elect to receive the amounts in cash. ([Rev. Rul. 2000-35](#))

(7) The salary reduction contributions must be in the nature of compensation.

(8) Salary reduction contributions are generally treated as employer contributions (notably for purposes of *IRC sections 403(b)*, *402(g)* and *415*) but are treated as employee contributions for other purposes, including FICA.

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## Non-Elective Employer Contributions:

Publication 571 Excerpt (for complete [Pub 571 click here](#)):

**Nonelective contributions** are employer contributions that are not made under a salary reduction agreement. Nonelective contributions include matching contributions, discretionary contributions, and mandatory contributions from your employer. You do not pay tax on these contributions until you withdraw them from the account.

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.6.2 (03-01-2005)

### Non-Salary Reduction Contributions

(1) Non-salary reduction contributions are:

- a. all contributions that are not salary reduction contributions
- b. basically all non-elective and matching contributions
- c. tested separately from salary reduction contributions for nondiscrimination.

(2) Nonelective (non-matching) contributions, and matching and after-tax employee contributions, are also tested separately for nondiscrimination. *IRC section 403(b)(12)(A)(i)* requires compliance with the following provisions:

- a. *IRC section 401(a)(4)* (nondiscrimination)
- b. *IRC section 401(a)(5)* (permitted disparity)
- c. *IRC section 401(a)(17)* (the \$220,000 ceiling on compensation for 2006, [indexed thereafter](#))
- d. *IRC section 401(a)(26)* (minimum participation)
- e. *IRC section 401(m)* (matching and after-tax employee contributions)
- f. *IRC section 410(b)* (minimum coverage) for non-salary reduction contributions

(3) Non-salary reduction contributions of 403(b) plans maintained by **public education institutions, or governmental entities which qualify as 501(c)(3) organizations**, are **not subject to the nondiscrimination or coverage requirements** (other than *IRC section 401(a)(17)*) beginning in tax years on or after August 5, 1997 (prior to that date, governmental plans are deemed to satisfy these requirements, except *IRC section 401(a)(17)*).

(4) For 501(c)(3) organizations, under Notice 89-23, nondiscrimination requirements for non-salary reduction contributions are deemed satisfied if the employer operates the plan in accordance with a good faith reasonable interpretation of the above Code sections. The safe harbors in the notice are one means of satisfying the good faith/reasonable interpretation test.

(5) Excludable employees are those employees who have not satisfied any permissible age and service requirements of the plan, in addition to those listed in [4.72.13.6.1 \(2\)](#).

(6) Employer is generally defined for purposes of nondiscrimination with respect to non-salary reduction contributions under the following provisions of *IRC section 414*:

- (b) (controlled groups)
- (c) (groups under common control)
- (m) (affiliated service groups)
- (o) (other organizations or arrangements described by regulations).

Note: [Until further guidance is issued](#), a good faith, reasonable interpretation applies in defining the employer for this purpose. See Notice 89-23 for more detail.

## Maximum Elective Deferral

Aggregate annual elective deferral limit:

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

### General Limit

Under the general limit on elective deferrals, the most that can be contributed to your 403(b) account through a salary reduction agreement is the least of:

- a. your [includible compensation](#) for your [most recent year of service](#)
- b. The 402(g) Limit (\$14,000 in 2005, \$15,000 in 2006, [indexed thereafter](#))

This limit applies without regard to community property laws.

See Exceptions to these limits under [Catch-up Contributions](#).



**More than one 403(b) account.** If, for any year, elective deferrals are contributed to more than one 403(b) account for you (whether or not with the same employer), you must combine all the elective deferrals to determine whether the total is more than the limit for that year.

**403(b) plan and another retirement plan.** If, during the year, contributions in the form of elective deferrals are made to other retirement plans on your behalf, you must combine all of the elective deferrals to determine if they are more than your limit on elective deferrals. The limit on elective deferrals applies to amounts contributed to:

- 401(k) plans, to the extent excluded from income,
- Section 501(c)(18) plans, to the extent excluded from income,
- SIMPLE plans,
- Salary reduction simplified employee pension (SARSEP) plans, and
- All 403(b) plans.

**Excess elective deferrals.** If the amount contributed is more than the allowable limit, you must include the excess in your gross income for the year contributed. This is explained under [Interest and Penalties](#).

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.1.1.3 (03-01-2005)

### Aggregated Annuity Contracts

(1) All annuity contracts (including custodial accounts and retirement income accounts) purchased by an employer on behalf of an employee are treated as a single annuity contract for purposes of applying the requirements of *IRC section 403(b)*.

4.72.13.5 (03-01-2005)

### Contribution Limits

(1) For years beginning on or after January 1, 2002, there are two separate limitations on the amount of contributions to a 403(b) plan which are excludable from gross income. These limitations are found in:

- *IRC section 402(g)*, and
- [IRC section 415](#)

(2) Section 402(g) imposes a limit on the annual dollar amount of elective deferrals made by a participant during the year. Section 402(g) limits the elective deferrals in a 403(b) plan.

(3) All elective deferrals made by a participant to a SARSEP, CODA, 403(b) plan, 501(c)(18) plan, and SIMPLE retirement account are included in applying the limit. The limit is designed to restrict the total amount that may be deferred by a participant on a salary reduction basis.

(4) Under *IRC section 414(u)*, contributions by an employer or employee pursuant to veterans' re-employment rights under the Uniform Services Employment and Reemployment Rights Act of 1994 (USERRA), are not treated as contributions made in the year the contributions are made, but in the year to which they relate, for purposes of *IRC section 402(g)* and *IRC section 415*.

4.72.13.5.1.1 (03-01-2005)

### **One-Time Irrevocable Election**

(1) Elective deferrals for income tax purposes do not include elective contributions made pursuant to a one-time irrevocable election that is made at:

- a. initial eligibility to participate in the salary reduction agreement, or
- b. pre-tax contributions made as a condition of employment.

(2) If a participant has the right or ability to terminate or modify an election, the contributions are elective deferrals even if the participant never exercises this right. The *IRC section 402(g)* limit affects only elective deferrals, it does not apply to other kinds of contributions. Consequently, it is critical to determine which (if any) contributions are elective deferrals.

**Example:** X participates in a 403(b) plan (Plan). In order to receive employer contributions under the Plan, X is required to elect to defer 3% of salary in the form of Mandatory Contributions. X has the option of revoking this election at any time, although X never terminates his election. The Mandatory Contributions are elective deferrals because X's election is revocable. These contributions are therefore included in applying the *IRC section 402(g)* limit. They are also subject to FICA (if applicable).

**Example:** Assume the same facts as in the above *example*, except that the Plan further provides that an election to terminate participation in the Plan is irrevocable. Thus, an employee who terminates his election will be permanently excluded from participating in the Plan. Even so, since the election to participate is revocable, the Mandatory Contributions are elective deferrals under *IRC section 402(g)*. The contributions are subject to FICA (if applicable).

**Note:** The above *example* points out that if an employee may terminate his election to participate in a plan, the election is not considered to be irrevocable. Irrevocability relates to the election to participate rather than an election to terminate participation in a plan.

4.72.13.5.2 (03-01-2005)

### **Section 415 Limit**

(1) Section 415 limits on contributions (hereinafter referred to as 415 limits or 415 contribution limits) that apply to qualified plans also generally apply to 403(b) plans. A 403(b) plan is treated as a defined contribution plan for purposes of the 415 contribution limits. Consequently, contributions to a 403(b) plan (including salary reduction contributions and after-tax employee contributions) may not exceed the lesser of 100% of [includible compensation](#) or \$42,000 (2005) (\$44,000 (2006), [indexed thereafter](#)) in the limitation year (although *IRC section 402(g)* further limits elective deferrals to \$14,000 (2005), \$15,000 (2006), [indexed thereafter](#)).

(2) The 415 limit applies to contributions made to a 403(b) plan with respect to the limitation year regardless of whether they are vested.

## Plan Aggregation

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

**Participation in a qualified plan.** If you participate in a 403(b) plan and a qualified plan, you must combine contributions made to your 403(b) account with contributions to a qualified plan and simplified employee pensions of all corporations, partnerships, and sole proprietorships in which you have more than 50% control.

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.5.2.2 (03-01-2005)

(1) Under *IRC section 415*, a participant generally is considered to exclusively control and maintain his own 403(b) plan. Consequently, contributions to a 403(b) plan are not combined or aggregated with contributions to a qualified plan except when a participant controls any employer. In this situation, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.

(2) Thus, where a participant controls any employer (this may be the employer contributing to the 403(b) plan or another employer) for a limitation year, the contributions to the 403(b) plan are combined with contributions to a qualified plan by the controlled employer or any affiliated employer under *IRC section 415*.

(3) The following example illustrates that an employee who is covered by a pension plan of the employer may also participate in a 403(b) plan through the employer without having to aggregate the plans under *IRC section 415*. Thus, the employer could contribute non-salary reduction contributions of up to \$42,000 to the 403(b) plan even though the employee has contributions under the qualified plan which are at the *IRC section 415* maximum.

**Example:** Employee A is employed by a hospital which is a 501(c)(3) organization. The hospital contributes to a 403(b) plan on behalf of A in the limitation year, and A is also a participant in the hospital's defined contribution plan. Employee A is not required to aggregate contributions under the qualified defined contribution plan with those made under the 403(b) plan for purposes of testing under *IRC section 415*.

**Example:** The facts are the same as in the above example, except that A is also a physician maintaining a private practice in which he is more than a 50% owner. A is a participant in a defined contribution plan maintained by A's private practice. The defined contribution plan of A's private practice must be combined with A's 403(b) plan for purposes of applying the limit under *IRC section 415(c)* because A controls his private practice.

4.72.13.5.2.3 (03-01-2005)

### Limitation Year

(1) The limitation year generally is the calendar year unless a participant elects another 12-month period.

(2) If a participant is in control of an employer, the limitation year is the limitation year of the employer.

(3) Control and affiliation for purposes of this section of the guidelines are defined under *IRC sections 414(b)*, *414(c)* and *415(h)*.

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## Additional Taxes and Penalties:

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.5.1.3.2 (03-01-2005)

### Operational Requirement

(1) Excess deferrals are elective deferrals in excess of the 402(g) limit. If 403(b) contracts purchased by a single employer accept excess deferrals, 403(b) status is lost for affected contracts unless the excess deferrals are timely corrected.

- a. Under Reg. 1.402(g)-1(e), a contract may avoid the loss of 403(b) status by distributing the excess deferrals plus the earnings thereon by April 15 of the following taxable year, if the contract so permits.
- b. The distribution may be made notwithstanding any other provision of law.
- c. The portion of the distribution attributable to excess deferrals is taxable in the year of contribution, while the earnings are taxable in the year of receipt.
- d. The issuer must file a Form 1099 indicating the distribution.

(2) If a contract loses its status as a 403(b) because of paragraph (1) above, the affected annuity contract (or custodial account) loses its status under section 403(b) for the taxable year of the violation. Thus, all amounts contributed to the affected annuity contract or contracts for the year of the violation are includible in gross income.

- a. The excess deferrals are taxable again on distribution.
- b. The employer is responsible for applicable employment taxes and income tax withholding.

(3) If excess deferrals are made by the employee to contracts of two unrelated employers and they are not timely corrected, there is no loss of 403(b) status of the annuity contracts but the excess is taxed both in the year contributed and again on distribution.

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

**Tax treatment of excess deferrals.** If the excess deferral is **distributed no later than April 15**, it is included in your income in the year contributed and the earnings on the excess deferral will be taxed in the year distributed.

**Example:** William's maximum contribution for 2004 was \$13,000. All of William's contributions were made through salary reductions. He contributed \$14,000 in 2004, an excess deferral of \$1,000. He notified his plan administrator and his employer of the excess contribution on March 15, 2005, and the excess deferral was distributed on April 13, 2005. Because the excess deferral was distributed before April 15, 2005, the excess deferral will be included in his income for 2004, and any earnings on the excess is included in his income in the year they are distributed.

**If you do not receive a distribution of excess elective deferrals by April 15** of the year following the year it is contributed, it will be included in your earned income in the year contributed and in the year distributed.

**Example:** Assume that, in the above example, a distribution of the excess deferral was not made to William by April 15, 2005. Because the distribution was not made timely, the excess deferral will be taxed in 2004 (the year contributed) and again in the year the excess deferral is distributed. The earnings on the distribution will be taxed in the year they are distributed.

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## Catch-Up Contributions

### Age 50 Catch-Up Contributions

Publication 571 Excerpt (for complete [Pub 571 click here](#)):

The most that can be contributed to your 403(b) account by salary reduction is the lesser of your limit on annual additions or your limit on elective deferrals.

If you will be age 50 or older by the end of the year, you may also be able to make additional catch-up contributions. These additional contributions cannot be made with after-tax employee contributions.

You are eligible to make catch-up contributions if:

- You will have reached age 50 by the end of the year, and
- The maximum amount of elective deferrals that can be made to your 403(b) account have been made for the plan year.

The maximum amount of catch-up contributions is the least of:

- \$4,000 for 2005 (\$5,000 for 2006, [indexed thereafter](#)), or
- Your [includible compensation](#) minus your other elective deferrals for the year.

**Figuring catch-up contributions.** When figuring allowable catch-up contributions, combine all catch-up contributions made by your employer on your behalf to the following plans.

- Qualified retirement plans. (To determine if your plan is a qualified plan, ask your plan administrator.)
- 403(b) plans.
- Salary reduction simplified employee pension (SARSEP) plans.
- SIMPLE plans.

*The total amount of the catch-up contributions on your behalf to all plans maintained by your employer cannot be more than the annual limit. For 2005, the limit is \$4,000 and for 2006 the limit is \$5,000, [indexed thereafter](#).*



*Catch-up contributions do not affect your maximum contribution limit. Therefore, the maximum amount that you are allowed to have contributed to your 403(b) account is your MAC plus your allowable catch-up contribution.*

You can use Worksheet C in chapter 9 of [Publication 571](#) to figure your limit on catch-up contributions.

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## Years-of-Service Catch-up and Certain Employers:

### 15-Year Rule

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.5.1.2 (03-01-2005)

#### Catch-Up Election

(1) Section 402(g)(7) provides a special election for certain long-term employees. Under the rule, they may catch up on the funding of their retirement benefit by increasing their elective deferrals over the \$14,000 for 2005 (\$15,000 for 2006, [indexed thereafter](#)) limit.

(2) **The election is available only to** an employee who has completed at least 15 years of service (defined in *IRC section 403(b)*) with an employer that is either a(n):

- a. educational organization
- b. hospital
- c. home health service agency
- d. health and welfare service agency
- e. church
- f. related church organization.

(3) With the exception of churches, years with different employers cannot be added together for purposes of satisfying the 15-year requirement.

(4) Under the election, the annual limitation is increased by the smallest of:

- a. \$3,000,
- b. \$15,000 minus any elective deferrals made by the organization and previously excluded under the catch-up election, or
- c. \$5,000 times the employee's years of service minus the elective deferrals made to plans of the organization in prior taxable years.

(5) As can be seen from this election, there is an aggregate limit on increases under the election of \$15,000, and the annual limit cannot exceed \$17,000 for 2005 (\$14,000 + \$3,000). The catch-up applies to elective deferrals made by the qualified organization on behalf of the employee. The catch-up election is per employer and not per employee.

(6) For an individual who attains age 50 prior to the end of the year, there is an additional catch-up of \$4,000 in 2005 and \$5,000 in 2006 ([indexed thereafter](#)).

### Employee with 15 Years of Service:

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

#### Years of Service

To determine if you are eligible for the increased limit on elective deferrals you will first need to figure your "years of service." How you figure your years of service depends on whether you were a full-time or a part-time employee, whether you worked for the full year or only part of the year, and whether you have worked for your employer for an entire year.

You must figure years of service for each year during which you worked for the employer who is maintaining your 403(b) account.

If more than one employer maintains a 403(b) account for you in the same year, you must figure years of service separately for each employer.

### Definition

Your “years of service” are the total number of years you have worked for the employer maintaining your 403(b) account as of the end of the year.

### Figuring Your Years of Service

Take the following rules into account when figuring your years of service.

**Status of employer.** Your years of service include only periods during which your employer was a qualified employer. Your plan administrator can tell you whether or not your employer was qualified during all your periods of service.

**Service with one employer.** Generally, you cannot count service for any employer other than the one who maintains your 403(b) account.

**Church employee.** If you are a church employee, treat all of your years of service with related church organizations as years of service with the same employer.

**Self-employed ministers.** If you are a self-employed minister, your years of service include full and part years in which you have been treated as employed by a tax-exempt organization that is a qualified employer.

**Less than one year of total service.** Your years of service cannot be less than one year. If at the end of your tax year, you have less than one year of service (including service in any previous years), figure your limit on annual additions as if you have one year.

**Total years of service.** When figuring years of service, figure each year individually and then add the individual years of service to determine your total years of service, ending with the year for which the limit on annual additions is being calculated. The total years of service will be used when figuring your limit on annual additions.

**Example:** The annual work period for full-time teachers employed by ABC Public Schools is September through December and February through May. Marsha began working with ABC schools in September 2001. She has always worked full time for each annual work period. At the end of 2005, Marsha had 4.5 years of service with ABC Public Schools, as shown below:

**Note.** This table shows how Marsha figures her years of service, as explained in the previous example.

### Marsha’s Years of Service

Year	Period Worked	Portion of Work Period	Years of Service
2001	Sept.-Dec.	.5 year	.5 year
2002	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2003	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2004	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2005	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
<b>Total years of service</b>			4.5 years

**Full time or part time.** To figure your years of service, you must analyze each year individually and determine whether you worked full time for the full year or something other than full time. When determining whether you worked full time or something other than full time, you use your employer's annual work period as the standard.

**Employer's annual work period.** Your "employer's annual work period" is the usual amount of time an individual working full time in a specific position is required to work. Generally, this period of time is expressed in days, weeks, months, or semesters and can span two calendar years.

**Example:** All full-time teachers at ABC Public Schools are required to work both the September through December semester and the February through May semester. Therefore, the annual work period for full-time teachers employed by ABC Public Schools is September through December and February through May. Teachers at ABC Public Schools who work both semesters in the same calendar year are considered working a full year of service in that calendar year.

### **Full-Time Employee for the Full Year**

Count each full year during which you were employed full time as one year of service. In determining whether you were employed full time, compare the amount of work you were required to perform with the amount of work normally required of others who held the same position with the same employer and who generally received most of their pay from the position.

**How to compare.** You can use any method that reasonably and accurately reflects the amount of work required. For example, if you are a teacher, you can use the number of hours of classroom instruction as a measure of the amount of work required.

In determining whether positions with the same employer are the same, consider all of the facts and circumstances concerning the positions, including the work performed, the methods by which pay is determined, and the descriptions (or titles) of the positions.

**Example:** An assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he or she is required to perform is the same as the amount of work normally required of assistant professors of English at that university who get most of their pay from that position.

If no one else works for your employer in the same position, compare your work with the work normally required of others who held the same position with similar employers or similar positions with your employer.

**Full year of service.** A full year of service for a particular position means the usual annual work period of anyone employed full time in that general type of work at that place of employment.

**Example:** If a doctor works for a hospital 12 months of a year except for a one-month vacation, the doctor will be considered as employed for a full year if the other doctors at that hospital also work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches these semesters will be considered as working a full year.

### **Other than Full Time for the Full Year**

If, during any year, you were employed full time for only part of your employer's annual work period, part time for the entire annual work period, or part time for only part of the work period, your year of service for that year is a fraction of your employer's annual work period.

**Full time for part of the year.** If, during a year, you were employed full time for only part of your employer's annual work period, figure the fraction for that year as follows:

- The numerator (top number) is the number of weeks, months, or semesters you were a full-time employee.
- The denominator (bottom number) is the number of weeks, months, or semesters considered the normal annual work period for the position.

**Example:** Jason was employed as a full-time instructor by a local college for the 4 months of the 2004 spring semester (February 2004 through May 2004). The annual work period for the college is 8 months (February through May and July through October). Given these facts, Jason was employed full time for part of the annual work period and provided  $\frac{1}{2}$  of a year of service.

**Part time for the full year.** If, during a year, you were employed part time for the employer's entire annual work period, you figure the fraction for that year as follows.

- The numerator (top number) is the number of hours or days you worked.
- The denominator (bottom number) is the number of hours or days required of someone holding the same position who works full time.

**Example:** Vance teaches one course at a local medical school. He teaches 3 hours per week for two semesters. Other faculty members at the same school teach 9 hours per week for two semesters. The annual work period of the medical school is two semesters. An instructor teaching 9 hours a week for two semesters is considered a full-time employee. Given these facts, Vance has worked part time for a full annual work period. Vance has completed  $\frac{1}{3}$  of a year of service.

**Part time for part of the year.** If, during any year, you were employed part time for only part of your employer's annual work period, you figure your fraction for that year by multiplying two fractions.

Figure the first fraction as though you had worked full time for part of the annual work period. The fraction is as follows:

- The numerator (top number) is the number of weeks, months, or semesters you were a full-time employee.
- The denominator (bottom number) is the number of weeks, months, or semesters considered the normal annual work period for the position.

Figure the second fraction as though you had worked part time for the entire annual work period. The fraction is as follows:

- The numerator (top number) is the number of hours or days you worked.
- The denominator (bottom number) is the number of hours or days required of someone holding the same position who works full time.

Once you have figured these two fractions, multiply them together to determine the fraction representing your partial year of service for the year.

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## Includible Compensation:

Publication 571 Excerpt (for complete [Pub 571 click here](#)):

### Includible Compensation for Your Most Recent Year of Service

**Definition.** Generally, “includible compensation for your most recent year of service” is the amount of taxable wages and benefits you received from the employer that maintained a 403(b) account for your benefit during your most recent year of service.

When figuring your includible compensation for your most recent year of service, keep in mind that your most recent year of service may not be the same as your employer’s most recent annual work period. This can happen if your tax year is not the same as your employer’s annual work period.

When figuring includible compensation for your most recent year of service, do not mix compensation or service of one employer with compensation or service of another employer.

### Most Recent Year of Service

Your “most recent year of service” is your last full year of service, ending on the last day of your tax year that you worked for the employer that maintains a 403(b) account on your behalf.

**Tax year different from employer’s annual work period.** If your tax year is not the same as your employer’s annual work period, your most recent year of service is made up of parts of at least two of your employer’s annual work periods.

**Example:** A professor who reports her income on a calendar-year basis is employed on a full-time basis by a university that operates on an academic year (October through May). For purposes of figuring her includible compensation for her most recent year of service for 2005, the professor’s most recent year of service consists of her service performed during January through May of 2005 and her service performed during October through December of 2005.

### Figuring Your Most Recent Year of Service



To figure your most recent year of service, begin by determining what constitutes a full year of service for your position. A “full year of service” is equal to full-time employment for your employer’s annual work period.

After identifying a full year of service, begin counting the service you have provided for your employer starting with the service provided in the current year.

**Part-time or employed only part of year.** If you are a part-time employee, or a full-time employee who is employed for only part of the year, your most recent year of service consists of your service this year and your service for as many previous years as is necessary to total one full year of service. You add up your most recent periods of service to determine your most recent year of service. First, take into account your service during the year for which you are figuring the limit on annual additions. Then add your service during your next preceding tax year, and years before that, until either your total service equals 1 year of service or you have taken into account all of your service with the employer.

**Example:** You were employed on a full-time basis during the months July through December 2003 (1/2 year of service), July through December 2004 (1/2 year of service), and October through December 2005 (1/4 year of service). Your most recent year of service for purposes of computing your limit on annual additions for 2005 is the total of your service during 2005 (1/4 year of service), your service during 2004

(1/2 year of service), and your service during the months October through December 2003 (1/4 year of service).

**Not yet employed for 1 year.** If, at the close of the year, you have not yet worked for your employer for 1 year (including time you worked for the same employer in all earlier years), use the period of time you have worked for the employer as your most recent year of service.

### **Includible Compensation**

After identifying your most recent year of service, the next step is to identify the includible compensation associated with that full year of service.

Includible compensation is not the same as income included on your tax return. "Compensation" is a combination of income and benefits received in exchange for services provided to your employer.

Generally, "includible compensation" is the amount of income and benefits:

- Received from the employer who maintains your 403(b) account, and
- Must be included in your income.

You determine the amount you must include in income without taking into account the foreign earned income exclusion.

Includible compensation does include the following amounts.

- Elective deferrals (employer's contributions made on your behalf under a salary reduction agreement).
- Amounts contributed or deferred by your employer under a section 125 cafeteria plan.
- Amounts contributed or deferred, at the election of the employee, under an eligible section 457 nonqualified deferred compensation plan (state or local government or tax-exempt organization plan).
- Wages, salaries, and fees for personal services earned with the employer maintaining your 403(b) account.
- Income otherwise excluded under the foreign earned income exclusion.
- The value of qualified transportation fringe benefits (including transit passes, certain parking, and transportation in a commuter highway vehicle between your home and work).

Includible compensation does not include the following items.

1. Your employer's contributions to your 403(b) account
2. Compensation earned while your employer was not an eligible employer.
3. Your employer's contributions to a qualified plan that:
  - a. Are on your behalf, and
  - b. Are excludable from income.
4. The cost of incidental life insurance.

Contributions after retirement. Nonelective contributions may be made for an employee for up to five years after retirement. These contributions would be based on includible compensation for the last year of service before retirement.

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## Distributions and Rollovers

### Rollover:

*Publication 571 Excerpt (for complete [Pub 571 click here](#)):*

## Tax-Free Rollovers

You can generally roll over tax free all or any part of a distribution from a 403(b) plan to a traditional IRA or an eligible retirement plan. The most you can roll over is the amount that, except for the rollover, would be taxable. The rollover must be completed by the 60th day following the day on which you receive the distribution. For information on eligible retirement plans, see [Publication 575](#).

**Rollovers to and from 403(b) plans.** You can roll over, tax free, all or any part of a distribution from an eligible retirement plan to a 403(b) plan.

If a distribution includes both pre-tax contributions and after-tax contributions, the portion of the distribution that is rolled over is treated as consisting first of pre-tax amounts (contributions and earnings that would be includible in income if no rollover occurred). This means that if you roll over an amount that is at least as much as the pre-tax portion of the distribution, you do not have to include any of the distribution in income.

For more information on rollovers and eligible retirement plans, see [Publication 575](#).



If you roll over money or other property from a 403(b) plan to an eligible retirement plan, see [Publication 575](#) for information about possible effects on later distributions from the eligible retirement plan.

**Nonqualifying distributions.** You cannot roll over tax free:

- Minimum distributions (generally required to begin at age 70 1/2),
- Substantially equal payments over your life or life expectancy,
- Substantially equal payments over the joint lives or life expectancies of your beneficiary and you,
- Substantially equal payments for a period of 10 years or more,
- Hardship distributions, or
- Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or excess annual additions and any allocable gains.

**Eligible retirement plans.** The following are considered eligible retirement plans.

- Individual retirement arrangements.
- Qualified retirement plans. (To determine if your plan is a qualified plan, ask your plan administrator.)
- 403(b) plans.
- Government eligible 457 plans.

**Direct rollovers of 403(b) plan distributions.** You have the option of having your 403(b) plan make the rollover directly to the IRA or new plan. Before you receive a distribution, your plan will give you information on this. It is generally to your advantage to choose this option because your plan will not withhold tax on the distribution if you choose it.

**Withholding.** If you receive a distribution that qualifies to be rolled over, the payer must withhold 20% of it for taxes (even if you plan to roll the distribution over).

**Distribution received by you.** If you receive a distribution that qualifies to be rolled over, you can roll over all or any part of the distribution. Generally, you will receive only 80% of the distribution because 20% must be withheld. If you roll over only the 80% you receive, you must pay tax on the 20% you did not

roll over. You can replace the 20% that was withheld with other money within the 60-day period to make a 100% rollover.

**Hardship exception to rollover rules.** The IRS may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

To obtain a hardship exception, you must apply to the IRS for a waiver of the 60-day rollover requirement. You apply for the waiver by following the general instructions used in requesting a letter ruling. These instructions are stated in [Revenue Procedure 2005-4](#) found in Internal Revenue Bulletin 2005-1. You must also pay a user fee with the application.

In determining whether to grant a waiver, the IRS will consider all relevant facts and circumstances, including:

1. Whether errors were made by the financial institution,
2. Whether you were unable to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
3. Whether you used the amount distributed (for example, in the case of payment by check, whether you cashed the check), and
4. How much time has passed since the date of distribution.

For additional information on rollovers, see [Publication 575](#).

**Excess employer contributions.** The portion of a distribution from a 403(b) plan transferred to a traditional IRA that was previously included in income as excess employer contributions is not an eligible rollover distribution.

Its transfer does not affect the rollover treatment of the eligible portion of the transferred amounts. However, the ineligible portion is subject to the traditional IRA contribution limits and may create an excess IRA contribution subject to a 6% excise tax (see chapter 1 of [Publication 590](#)).

**Qualified Domestic Relations Order.** You may be able to roll over tax free all or any part of an eligible rollover distribution from a 403(b) plan that you receive under a qualified domestic relations order (QDRO). If you receive the interest in the 403(b) plan as an employee's spouse or former spouse under a QDRO, all of the rollover rules apply to you as if you were the employee. You can roll over your interest in the plan to an eligible plan or another 403(b) plan. For more information on the treatment of an interest received under a QDRO, see [Publication 575](#).

**Spouses of deceased employees.** If you are the spouse of a deceased employee, you can roll over the qualifying distribution attributable to the employee. You can make the rollover to any eligible retirement plan. You cannot roll it over to a Roth IRA.

If after you roll over money and other property from a 403(b) plan to an eligible retirement plan, you take a distribution from that plan, you will not be eligible to receive the capital gain treatment or the special averaging treatment for the distribution.

**Second rollover.** If you roll over a qualifying distribution to a traditional IRA, you can, if certain conditions are satisfied, later roll the distribution into another 403(b) plan. For more information, see IRA as a holding account (conduit IRA) for rollovers to other eligible plans, in [Publication 590](#).

**Frozen deposits.** The 60-day period usually allowed for completing a rollover is extended for any time that the amount distributed is a frozen deposit in a financial institution. The 60-day period cannot end earlier than 10 days after the deposit ceases to be a frozen deposit.

A frozen deposit is any deposit that on any day during the 60-day period cannot be withdrawn because:

1. The financial institution is bankrupt or insolvent, or
2. The state where the institution is located has placed limits on withdrawals because one or more banks in the state are (or are about to be) bankrupt or insolvent.

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Eligible distribution:

## Distributions

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.8 (03-01-2005)

### Early Distribution Restrictions

(1) Congress intended that pre-tax contributions to a 403(b) plan should generally be used for retirement and thus, *IRC section 403(b)* imposes early distribution restrictions on contributions to a 403(b) annuity contract. These restrictions are based on distribution events and relate to the earliest date at which distributions from a 403(b) annuity contract may be made. Distributions generally may not be made prior to a distribution event. A 403(b) plan may properly distribute amounts any time after such an event has occurred (as long as the minimum distribution rules are complied with).

4.72.13.8.1 (03-01-2005)

### Annuity Contracts

(1) Under *IRC section 403(b)(11)*, salary reduction contributions (and amounts attributable thereto) used to purchase annuity contracts described in section 403(b)(1) for years beginning after December 31, 1988, are not permitted to be distributed earlier than:

- a. attainment of age 59 1/2
- b. death
- c. disability
- d. severance of employment or
- e. hardship of the employee (not including earnings).

Note: Amounts held in a 403(b)(1) annuity contract as of the close of the last year beginning before January 1, 1989, and amounts contributed as non-salary reduction contributions are not subject to distribution restrictions.

(2) Certain loans may also violate *IRC section 403(b)(11)* or *(b)(7)*. For example, a loan that is repaid through a reduction in the participant's accrued benefit results in an actual distribution for purposes of *IRC section 403(b)(11)*.

**Example:** Employee A began participating in a 403(b) plan (Plan) in 1989. The Plan is funded through both salary reduction and non-salary reduction contributions, which are invested in annuity contracts. A is 30 years old, has not separated from service and is not disabled. In 2005, A makes a \$ 5,000 withdrawal that is not a hardship withdrawal. If any portion of the withdrawal is attributable to salary reduction contributions and the earnings thereon, the early distribution restrictions of *IRC section 403(b)(11)* would be violated.

**Example:** The same facts as to the above **example**, except that the Plan provides only for non-salary reduction contributions. A's withdrawal does not violate *IRC section 403(b)(11)* (although A must pay an early distribution tax under *IRC section 72(t)*).

4.72.13.8.2 (03-01-2005)

### Custodial Accounts

(1) Under *IRC section 403(b)(7)*, a distribution from a custodial account may not be paid or made available to a distributee before the employee attains age 59 1/2, severs employment, dies or becomes disabled.

(2) Salary reduction contributions may be distributed upon hardship of the employee.

**Example:** Employee A is a participant in a 403(b) plan (Plan). Contributions under the Plan are strictly non-salary reduction. In 2005, A withdraws \$10,000 from the Plan. A has not severed employment or become disabled. A is 40 years old. The funds in A's 403(b) account are invested in a custodial account. Since the contributions are invested in a custodial account, A's withdrawal violates *IRC section 403(b)(7)*.

Publication 571 Excerpt (for complete [Pub 571 click here](#)):

## Minimum Required Distributions

You must receive all, or at least a certain minimum, of your interest accruing after 1986 in the 403(b) plan by April 1 of the calendar year following the later of the calendar year in which you become age 70 1/2 or the calendar year in which you retire.

Check with your employer, plan administrator, or provider to find out whether this rule also applies to pre-1987 accruals. If not, a minimum amount of these accruals must begin to be distributed by the later of the end of the calendar year in which you reach age 75 or April 1 of the calendar year following retirement, whichever is later. For each year thereafter, the minimum distribution must be made by the last day of the year. If you do not receive the required minimum distribution, you are subject to a nondeductible 50% excise tax on the difference between the required minimum distribution and the amount actually distributed.

For more information on minimum distribution requirements and the additional tax that applies if too little is distributed each year, see [Publication 575](#).

## No Special 10-Year Tax Option

A distribution from a 403(b) plan does not qualify as a lump-sum distribution. This means you cannot use the special 10-year tax option to calculate the taxable portion of a 403(b) distribution. For more information, see [Publication 575](#).

4.72.13.7.4 (03-01-2005)

## Excise Taxes

For years after December 31, 1988, the excise tax under IRC section 4974 for failure to make minimum distributions applies to 403(b) plans.

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## Loan Limitations

### Conditions:

*Publication 575 Excerpt (for complete [Pub 575 click here](#)):*

**Exception for qualified plan, 403(b) plan, and government plan loans.** At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (403(b) plan), or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

- Is used to buy your main home, or
- Must be repaid within 5 years.

If a loan qualifies for this exception, you must treat it as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all your loans from all plans of your employer (and certain related employers) exceeds the lesser of:

- \$50,000, or
- Half the present value (but not less than \$10,000) of your nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

You must reduce the \$50,000 amount if you already had an outstanding loan from the plan during the 1-year period ending the day before you took out the loan. The amount of the reduction is your highest outstanding loan balance during that period minus the outstanding balance on the date you took out the new loan. If this amount is zero or less, ignore it.

**Substantially level payments.** To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan. This level payment requirement does not apply to the period in which you are on a leave of absence without pay or on a rate of pay that is less than the required installment. Generally, this leave of absence must not be longer than one year. You must repay the loan within 5 years from the date of the loan (unless the loan was used to buy your main home). Your installment payments must not be less than your original payments.

However, if your plan suspends your loan payments for any part of the period during which you are in the uniformed services, you will not be treated as having received a distribution even if the suspension is for more than one year and the term of the loan is extended. The loan payments must resume upon completion of such period and the loan must be repaid within 5 years from the date of the loan (unless the loan was used to buy your main home) plus the period of suspension.

**Example:** On July 1, 2004, you borrowed \$40,000 from your retirement (403(b)) plan. The loan was to be repaid in level monthly installments over 5 years. The loan was not used to buy your main home. You make 9 monthly payments and start an unpaid leave of absence that lasts for 12 months. You were not in a uniformed service during this period. You must repay this loan by June 30, 2009 (5 years from the date of this loan). You can increase your monthly installments or you can make the original monthly installments and on June 30, 2009, pay the balance.

**Example:** The facts are the same as in the above example, except that you are on a leave of absence performing service in the uniformed services for two years. The loan payments were suspended for that period. You must resume making loan payments at the end of that period and the loan must be repaid by June 30, 2011 (5 years from the date of the loan plus the period of suspension).

**Denial of interest deduction.** If the loan from a qualified plan is not treated as a distribution because the exception applies, you cannot deduct any of the interest on the loan during any period that:

- The loan is secured by amounts from elective deferrals under a qualified cash or deferred arrangement (section 401(k) plan) or a salary reduction agreement to purchase a tax-sheltered

- annuity, or
- You are a key employee as defined in section 416(i) of the Internal Revenue Code.

**Reporting by plan.** If your loan is treated as a distribution, you should receive a Form 1099-R showing code "L" in box 7.

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## Distribution Requirements (on loan defaults):

*Publication 575 Excerpt (for complete [Pub 575 click here](#)):*

### Loans Treated as Distributions

If you borrow money from your retirement (403(b)) plan, you must treat the loan as a nonperiodic distribution from the plan unless it qualifies for the exception explained above. This treatment also applies to any loan under a contract purchased under your retirement (403(b)) plan, and to the value of any part of your interest in the plan or contract that you pledge or assign (or agree to pledge or assign). It applies to loans from both qualified and nonqualified plans, including commercial annuity contracts you purchase directly from the issuer. Further, it applies if you renegotiate, extend, renew, or revise a loan that qualified for the exception below if the altered loan does not qualify. In that situation, you must treat the outstanding balance of the loan as a distribution on the date of the transaction.

You determine how much of the loan is taxable using the allocation rules for nonperiodic distributions discussed under Figuring the Taxable Amount, [Publication 575](#). The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

*IRS 403(b) Examination Guidelines Excerpt (for complete [403\(b\) Exam Guidelines click here](#)):*  
4.72.13.8.5 (03-01-2005)

#### Early Distribution Tax under *IRC section 72(t)*

(1) *IRC section 72(t)* restricts premature distributions from a 403(b) plan by imposing a 10% additional income tax with respect to distributions that are made prior to the events described in *IRC section 72(t)*. These events differ from those under *IRC sections 403(b)(7)* and *(b)(11)* which prevents access to the funds prior to the events described therein.

(2) The section 72(t) tax generally applies to all distributions except for those:

- a. made after the attainment of age 59 1/2, separation from service after age 55, death, disability, or
- b. which are part of a series of substantially equal payments made over the life or life expectancy of the employee or the joint lives or life expectancies of the employee and the employee's designated beneficiary.

(3) A distribution allowable under *IRC section 403(b)(7)* or *(b)(11)* may nevertheless be subject to *IRC section 72(t)*.

- For example, the tax applies to early distributions of non-salary reduction contributions made to an annuity contract even though *IRC section 403(b)(11)* would not restrict such distributions.

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## Hardship distributions

**Hardship distributions.** A 403(b) plan may allow you to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 403(b) plan are limited to the amount of the employee's elective deferrals and generally do not include any income earned on the deferred amounts. If the plan permits, certain employer matching contributions and employer discretionary contributions may also be included in hardship distributions. Hardship distributions cannot be rolled over to another plan or IRA.

A distribution is treated as a hardship distribution only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution is made both on account of an **immediate and heavy financial need** of the employee and is **necessary to satisfy that financial need**. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

A distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to your total elective deferrals as of the date of distribution, reduced by the amount of previous distributions of elective contributions.

Under Proposed 403(b) Regulations, rules governing Hardship Distributions from 403(b) plans are the same as those for Cash or Deferred Arrangements (401(k)). See section 1.401(k)-1(d)(3) of the 401(k) regulations for details on hardship distributions.

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## Immediate and Heavy Financial Need

Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. **A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.**

A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents; or
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.
- Funeral expenses
- Certain expenses relating to the repair of damage to the employee's principal residence.

**Distribution necessary to satisfy financial need.** A distribution may not be treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee.

This determination generally is to be made on the basis of all relevant facts and circumstances. The employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

An immediate and heavy financial need generally may be treated as not capable of being relieved from other resources reasonably available to the employee if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

- Through reimbursement or compensation by insurance or otherwise;
- By liquidation of the employee's assets;
- By cessation of elective contributions or employee contributions under the plan; or
- By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

A need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

- The distribution is not in excess of the amount of the immediate and heavy financial need of the employee.
- The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer.
- The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

Under Proposed 403(b) Regulations, rules governing Hardship Distributions from 403(b) plans are the same as those for Cash or Deferred Arrangements (401(k)). See section 1.401(k)-1(d)(3) of the 401(k) regulations for details on hardship distributions.

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