



403(b) Plan Correction Issues

IRS, Employee Plans

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Retirement Plan Resources

- Retirement Plans Website – www.irs.gov/retirement
- 403(b) Plans – from the Retirement Plans website, look to the left-hand navigation bar, select “Types of Retirement Plans,” and click on “403(b) Plans.”
- Newsletters – from the Retirement Plans website, select “Newsletters” in the left-hand navigation bar, choose “subscribe” and then select “Retirement News for Employers,” our newsletter for employers sponsoring retirement plans and “Employee Plans News,” our newsletter for retirement plans professionals.



Goals of this Session

- Discuss changes made in Revenue Procedure 2013-12 that impact 403(b) Plans
- Understand what failures can be corrected under Rev. Proc. 2013-12



What will be covered

- Correction Issues with 403(b) Plans
- Correction under Rev. Proc. 2008-50
- Correction under Rev. Proc. 2013-12



403(b) Correction under 2008-50

- Operational, Demographic and Employer Eligibility Failures were covered
- Notably plan document failures could not be addressed
- Operational failure had a specific meaning for 403(b) plans and that definition limited operational failures to certain defined failures



403(b) Correction under 2013-12

- Generally correction is expected to be the same as correction for a qualified plan
- Plan document failures can now be addressed
- Operational Failure is no longer limited to certain predefined failures
 - Failure to operate in accordance with plan terms can now be addressed
- For SCP purposes the requirement to have established practices and procedures only applies for failures after December 31, 2009



Plan Document Failure

- For 403(b) plans a plan document failure:
 - means a plan provision (or the absence of a plan provision) that, on its face, violates the requirements of § 403(b)
 - Includes the failure of a plan to be adopted in written form or to be amended to reflect a new requirement within the plan's applicable remedial amendment period
 - Includes the failure to timely or properly amend the plan during an applicable remedial amendment period with respect to provisions required to maintain the status of the plan under § 403(b)
 - Includes any 403(b) Failure that adversely affects the status of the plan under § 403(b) and that is not an Operational Failure, Demographic Failure, or Employer Eligibility Failure [Rev. Proc. 2013-12, section 5.02(2)(a)]



Correction of Plan Document Failure

- Notice 2009-3 required 403(b) plans to adopt a written plan by the end of the 2009 plan year
- Failure to timely adopt a written plan in accordance with the 403(b) regs and Notice 2009-3 can be corrected in the EPCRS under Audit CAP and VCP



Correction of Plan Document Failure

- Correction under VCP
 - Plan will be treated as if it was timely adopted for purposes of the extended RAP under Announcement 2009-89
 - Plan generally will be treated as having a Favorable Letter [SCP]
 - The compliance statement is not a determination that the written plan meets the requirements of section 403(b) or the regulations [Rev. Proc. 2013-12, Sections 6.10(3) and 10.08]
 - If the failure is submitted on or before December 31, 2013, the applicant is eligible for a 50% fee reduction
 - Can be done by submitting Appendix C, Part II, Schedule 2
 - VCP Submission Kit for this failure available at IRS.gov



Plan Document Failure

Significance of the period of the failure:

- Remember that EPCRS *cannot* be used to correct a failure to follow the terms of a 403(b) plan document that occurred before January 1, 2009.
- This is because 403(b) plans were not required to have a “written plan” before that date.



Operational Failures

- Now broadly defined to:
 - a 403(b) Failure (other than an Employer Eligibility Failure) that arises solely from the failure to follow plan provisions
 - A failure to follow the terms of the plan providing for the satisfaction of the requirements of § § 403(b)(12)(ii) (relating to the availability of elective deferral contributions) and 401(m) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i)) is an Operational Failure
- A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively to reflect the plan's operations [Rev. Proc. 2013-12, Section 5.02(2)(b)]



Operational Failure under 2008-50

Operational Failures limited to the following:

- Universal Availability Failure 403(b)(12)(A)(ii)
- Failure to satisfy the requirements of 401(m)
- Failure to limit compensation under 401(a)(17)
- Failure to comply with the distribution restrictions under 403(b)(7) and (b)(11)
- Failure to satisfy incidental death benefit rules of 403(b)(10)
- Failure to pay minimum required distributions of 403(b)(10)
- Failure to allow employees the right to elect a direct rollover including meaningful notice of that right
- Failure in the annuity contract or custodial agreement to provide the direct rollover rights
- Failure to satisfy limit on elective deferrals in 403(b)(1)(E)
- Failure in the annuity contract or custodial agreement to provide the limit on elective deferrals
- A failure involving contributions or allocations of Excess Amounts
- Any other failure to satisfy the requirements under 403(b) that results in the loss of 403(b) status



Correction of Operational Failures

How do we handle an operational failure that spans the period before January 1, 2009 and continues past that date?

- *We cannot* address a failure to follow the terms of a 403(b) plan document that occurred before January 1, 2009 unless the failure meets one of the operational failures outlined in Rev. Proc. 2008-50.
- If the failure spans the period before and after January 1, 2009 the applicant will need to revise the submission to define the failure for the period of time in which it can be addressed under VCP (i.e. limit the period of the failure to on and after January 1, 2009).



Demographic Failure

Demographic Failure means:

- a failure to satisfy the requirements of § 401(a)(4) or 410(b) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i)) that is not an Operational Failure or an Employer Eligibility Failure
- the correction of a Demographic Failure generally requires a corrective amendment to the plan adding more benefits or increasing existing benefits (see § 1.401(a)(4)-11(g))



Employer Eligibility Failure

Employer Eligibility Failure means:

- the adoption of a plan intended to satisfy the requirements of § 403(b) by a Plan Sponsor that is not a tax-exempt organization described in § 501(c)(3) or a public educational organization described in § 170(b)(1)(A)(ii)
- An Employer Eligibility Failure is not a Plan Document, Operational, or Demographic Failure



Employer Eligibility Example

XYZ Credit Union, a 501(c)(14) organization, was sold a 403(b) plan in 2010 and has allowed its employees to participate in the plan and make contributions.

- Is the employer eligible to sponsor the plan?
- Can contributions that are already funded remain in the plan?



Employer Eligibility Example

Is the employer eligible to sponsor the plan?

- No, the employer is not a tax-exempt organization described in § 501(c)(3) or a public educational organization described in § 170(b)(1)(A)(ii).



Employer Eligibility Example

Can contributions that are already funded remain in the plan?

- Yes, but no new employee or employer contributions will be permitted in the future and the assets in the plan will remain in the trust, annuity contract, or custodial account and will be distributed no earlier than the occurrence of one of the permitted events under § 403(b)(7) or § 403(b)(11).



Employer Eligibility Example

Is there an alternative correction method?

- Yes, as an alternative the contributions can be treated as not being excluded under 403(b) and the contribution can be treated as contributions to a 403(c) annuity contract. Sections 6.03(2) and 6.10(2).



Excluded Employees Example 1

Heart Hospital, a 501(c)(3) organization, sponsors a 403(b) plan. Employees who work less than 20 hours are excluded from the plan. The plan provides for a 100% match up to 3% of participant compensation. The hospital has several employees who work less than 20 hours. Five employees who regularly work less than 20 hours in the billing department have been making deferrals to the 403(b) plan.

- Is there a failure?
- If so, what is the failure?



Excluded Employees Example 1 cont.

- Is there a failure? *Maybe. It is permissible to include employees who regularly work less than 20 hours per week. However, plan could include them if all employees of that category are included.*
- If so, what is the failure? *If all employees of employees who work less than 20 hours per week are not included, then we have a universal availability problem. Alternatively, if the plan terms require exclusion of employees who regularly work less than 20 hours per week, you could have a problem of erroneous inclusion of 5 employees.*



Excluded Employees Example 1 cont.

The hospital makes a VCP submission

- Same facts as above and assume that there are 50 other employees (they regularly work less than 20 hours a week) who make \$25,000 annually and that they were not given an opportunity to make deferrals to the 403(b) plan during the 2010-2012.
 - Is there a failure?
 - If so, what is the failure and correction?



Excluded Employees Example 1 cont.

- Is there a failure? *Yes. Universal availability.*
- If so, what is the failure and correction? *Corrective contributions on behalf of the 50 employees.*



Excluded Employees Example 1 cont.

- How much is the corrective contribution?
 - The total corrective contribution owed to each excluded employee for the lost deferrals is \$750 ($(\$25,000 \times 3\%) \times 50\% = \375 , $\$375 \times 2$ years).
 - Considering the lost deferral amount of \$750 that the excluded employees could have made to the plan ($\$25,000 \times 3\%$), the matching contribution owed per year is equal to \$750. Total matching contributions owed to each excluded employee is \$1,500 ($\750×2 years).
 - Total corrective contribution owed to each excluded employee is \$2,250 ($\$750 + \$1,500$), adjusted for earnings through the date of correction.



Excluded Employees Example 2

Heart Hospital, a 501(c)(3) organization, sponsors a 403(b) plan. Under the terms of the plan “Nurses” as a group are excluded from making deferrals to the plan.

- Does the hospital have any 403(b) compliance issues?



Excluded Employees Example 2 cont.

- Does the hospital have any 403(b) compliance issues?
- *Yes. Universal availability. Nurses are not an excludable category. Correction would entail making corrective contributions for the missed deferral opportunity for the nurses. If the plan excludes employees who regularly work less than 20 hours per week, it might be possible to exclude nurses in that category.*



Excluded Employees Example 2

If there is a universal availability failure:

- Sponsor may be required to make a contribution for the improperly excluded employees
- Since ADP testing is not used to test discrimination in 403(b) plans how do we determine the appropriate corrective contribution amount to make those excluded employees whole for the lost opportunity to make deferrals into the plan?



Excluded Employees Example 2

- How to determine the corrective contribution:
 - safe harbor in Appendix A.05(6) can be used
 - Under that safe harbor the missed salary deferral is the greater of:
 - 3% of compensation or
 - the maximum deferral percentage for which the plan sponsor provides a matching contribution rate that is at least as favorable as 100% of the elective deferral made by the employee.



Contribution Limit

Employer and employee contributions to a 403(b) plan cannot exceed the limits under 415(c) (\$51,000 in 2013)

- Includes:
 - Employer contributions
 - Employee deferrals (including the 15-year catch-up)
 - Employee after-tax contributions
- Excludes:
 - age 50 catch-up contributions



Contribution Limit cont.

- If the employee contributed to more than one 403(b) account, contributions made to all 403(b) accounts must be combined.
- If the employee participates in a 403(b) plan and a qualified plan, contributions made to the 403(b) account must be combined with contributions to a qualified plan and a simplified employee pension of all corporations, partnerships and sole proprietorships in which the employee has more than 50% control.
- Employee is considered to be in control of the 403(b) and contributions are aggregated with plans in entities in which the employee has a controlling interest)
- No aggregation with plans sponsored by employer



Contribution Limit Example

Doctor Q, who works for Heart Hospital and moonlights for Mind Hospital. She makes contributions to both the hospital's 403(b) plan and Mind Hospital's 401(k) plan.

- Are Doctor Q's contributions subject to single 402(g) limit? *Yes. Deferrals are an individual limit.*
- Do the hospitals need to coordinate to determine if Doctor Q has exceeded the 415 limit? *No. Unless Doctor Q has a controlling interest in Mind Hospital.*



Excess Amount

The term “Excess Amount” means:

- a contribution or other credit that is made on behalf of a participant or beneficiary to a plan in excess of the maximum amount permitted to be contributed or credited under the plan or that exceeds a limitation on contributions provided in the Code or regulations.
- any amount in excess of the amount permitted under the requirements of § 402(g), 401(m), or 415.
- A contribution in excess of the limitation of § 415(c) is not an Excess Amount (or a 403(b) Failure) if that excess is maintained in a separate account in accordance with the rules in the regulations under §§ 403(b) and 415.
- A contribution in excess of the limitation of § 415(c) that is not maintained in a separate account in accordance with the rules set forth in regulations under §§ 403(b) and 415 is an Excess Amount. Thus, the correction principles in section 6.06 apply.



Excess Contributions

How to correct an excess contribution failure

- the excess amount, adjusted for earnings can be transferred to a separate account that complies with IRC Section 403(c), or
- The excess amount is distributed to the participant by the end of the year in which the excess occurred.
- The excess is includable in the participant's gross income (to the extent the amount is nonforfeitable).
- If custodial account (unlike an annuity contract) the excess is subject to 4973.



Excess Contributions Example 1

Marco, a 57 year old doctor, has worked at Heart Hospital for 22 years. Heart Hospital's 403(b) plan allows for 15-years of service catch-up contributions. Marco, although eligible to make those contributions, did not make any catch-up contributions until 2009. In 2009 his maximum elective deferral is: \$25,000 (\$16,500 (2009 402(g) limit) + \$3,000 (15-years-of-service catch-up) + \$5,500 (2009 age 50 catch-up)). The 415(c) limit is \$49,000 for the 2009 year.



Excess Contributions Example 1 cont.

- The maximum employer contribution is \$29,500. (Note- the age 50 catch up contribution is not included in annual additions for purpose of determining the 415 limit). Therefore for purposes of 415 limit, elective deferrals = 19,500 [402 g limit, after taking into account increase in deferral limit]. Therefore, the maximum permissible employer contribution is \$49,000 minus \$19,500 or \$29,500.
- The maximum combined limitation after taking into account catch ups is \$25,000 (elective deferrals) + 29,500 (employer contributions)= \$54,500



Excess Contributions Example 1 cont.

During 2009, Marco defers \$25,000 and the Hospital makes an employer contribution of \$30,000 for a total of \$55,000.

- How should they correct? *Excess employer contribution = \$500*
- *\$55000 (total contribution) minus 415 limit (\$49,000) minus catch up contribution (\$5,500) = \$500.*
- *Possible correction. Designate the \$500 excess as a 403 (c) account.*
- If the problem occurred in 2008, could they correct under VCP? *Yes. See 5.02(a)(xi)- A failure involving contributions or allocations of Excess Amounts*



Deferrals Exceeded 402(g) Limit

- A state university has discovered that during the 2009 plan year 14 participants exceeded the 402(g) limit. The excess has not yet been returned.
- How to correct
 - The excess contributions (plus earnings) should be returned to the participants.
 - Excess amounts are taxed both in the year contributed and in the year distributed.
 - Earnings on the excess deferrals are taxed in the year distributed.



Overpayment

An Overpayment:

- Is a 403(b) Failure due to a payment being made to a participant or beneficiary that exceeds the amount payable under the terms of the plan or that exceeds a limitation provided in the Code or regulations.
- Includes payments either made from the participant's or beneficiary's 403(b) custodial account or annuity contract under the plan or not permitted to be paid under the Code, the regulations, or the terms of the plan.

NOTE: Overpayment does not include a payment that is made pursuant to a correction method provided under this revenue procedure for a different 403(b) Failure.



Hardship Distributions

The Regulations clarify that 403(b) plan hardship distributions will follow the 401(k) rules.

Hardship distributions are considered premature distributions when:

- adequate documentation of the financial hardship was not obtained,
- other available financial means were not previously exhausted, or
- total distributions from multiple vendors exceeded the amount needed to relieve the hardship.



Hardship Distribution Example

A public university sponsors a 403(b) plan that allows for hardship distributions. The 403(b) vendors make the determination that a distribution meets the hardship requirements. Blanca, a professor, received a hardship distribution without providing any supporting information to verify the hardship and used the amount to make a down payment on a sailboat.

- How should they correct?



Hardship Distribution Example cont.

A public university sponsors a 403(b) plan that allows for hardship distributions. The 403(b) vendors make the determination that a distribution meets the hardship requirements. Blanca, a professor, received a hardship distribution without providing any supporting information to verify the hardship and used the amount to make a down payment on a sailboat.

- How should they correct? *Attempt to recover distributions. If not successful in recovery, no additional employer contributions are required provided that the distributions were otherwise properly attributed to the Professor's account balance. There is also a notification requirement that the distributions are not eligible for tax favored treatment (However, hardship distributions, even if properly made, are not eligible for tax free rollover)*



Information Sharing Agreements

If a failure results from a contract being issued in an exchange not being part of the plan due to lack of an information sharing agreement, a permitted correction is for the assets in the contract to be transferred to another vendor to which contributions are being made under the plan. Appendix A, Section .09(2)(b).



403(b) Examination Trends

1. Failure of the 15 years of service catch-up.
IRS Regulation 1.403(b)-4(c)(3)(ii) allows 403(b) plans that are eligible to permit employees to make the special Section 403(b) catch-up limitation for an employee with 15 years of service. If the plan permits, employees who attain age 50 or more by end of calendar year can also make the age 50 catch-up under IRC 414(v). We frequently find issues with coordination of these two catch-ups on exam.



403(b) Examination Trends

Many public schools have been found to have excess deferrals due to poor tracking of participant's prior compensation and contribution history in application of the 15 year rule.

Individuals who take the special 15 years of service catch-up usually do not realize that this catch-up provision is not automatic, but subject to 3 calculations.

Contribution is increased by the lesser of:

\$3,000

\$5,000 multiplied by the number of years of service less the total amount of your elective deferrals (including Roth deferrals and 15-year catch-up).

\$15,000 minus prior year 15-year catch-up contribution amounts (both pre-tax and Roth)

See Pub 571 and www.irs.gov/pub/irs-tege/403b_attachment2_epcu.pdf



403(b) Examination Trends

2. Failure of Universal Availability non-discrimination requirements, IRC section 403(b)(12)(A)(ii),

a) Not giving an employee the effective opportunity to participate and make salary deferrals

b) The most frequent failure is excluding a classification of employee such as for “Part Time” and the employee worked over 20 hours per week.



403(b) Examination Trends

- c) Categories of employees which a 403(b) plan may exclude from elective deferrals are: (1) employees who are eligible to defer under another employer plan (457(b) plan, 401(k) plan or another 403(b) plan); (2) non-resident aliens; (3) students performing services as described in Code § 3121(b)(10); and (4) employees who normally work fewer than 20 hours per week.
- d) Effective Opportunity to defer. Treas. Reg. § 1.403(b)-5(b)(2)
A section 403(b) plan satisfies the effective opportunity requirements ... only if, at least once during each plan year, the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election.



403(b) Examination Trends

3) IRC 401(a)(17) not limiting compensation for employer non-elective and matching contributions.

The annual compensation limit under Sections 401(a)(17), increased in 2013 from \$250,000 to \$255,000.

4) Miscoding of W-2 for Box 12 Deferrals

- a) Amounts are reported as 457 deferrals instead of 403(b)
- b) Reporting Matching Contribution in box 12 instead of In box 14.
- c) Post Service contributions are not in Box 12.



403(b) Examination Trends

- 5) 403(b) Non-elective contribution not uniform, and no 401(a)(4) testing done, causing discrimination failure.
- 6) Poor Coordination Between Vendors contributing to excess 402(g) deferrals.
- 7) Several instances of Government Entities incorrectly adopting a 403(b) plan as an ineligible employer.



403(b) Examination Trends

- 8) Several 501(c)(3) entities that lost their status due to non-filing the 990 return became ineligible to continue to sponsor their 403(b) plans.
- 9) Self certification for hardships and for plan loans limits, which is not allowed for.
- 10) Medical student leftovers (i.e. schools needing to fix where they excluded medical residents but should not have according to the Supreme Court ruling).



403(b) Examination Trends

10) Continued: The regulations provide that a school, college or university can exclude from making contributions any student who is described under § 3121(b)(10)

(i.e., a student who is enrolled and regularly attends classes at the school, college or university).

However the U.S. Supreme Court has ruled that medical residents are not students as defined in § 3121(b)(10).

11) Mandatory Contributions: Mischaracterized as elective deferrals.

Mandatory contributions are non-elective employer contributions as far as the plan is concerned. Except for church plans and governmental plans, these contributions are subject to nondiscrimination testing under Code § 401(a)(4). They are not subject to the universal availability rule (and cannot be used to satisfy that rule) or the 402(g) limit.



403(b) Examination Trends

- 12) 403(b) Special Pay Plan for unused sick and vacation leave not properly administered. Plan incorrectly allows for either an election to defer to 403(b) benefits or current income, causing current taxation to the participant.
- 13) Misapplication of 5 year post retirement contribution rule in section 403(b)(3). Making contributions beyond the five year period.



403(b) Examination Trends

14) Plan Document Failure: Very few instances right now but we have run into a few situations where the employer did not have a 403(b) plan after 1/1/2009.

Most errors in regards to the plan document requirement we are finding are, not following the plan terms-operational, or choosing inconsistent options in regards to how the plan is really run or plan terms are inconsistent an employee handbook.



403(b) Examination Trends

- 15) Designated 403(b) Roth Account Deferrals, see some issues with failure to consider Roth deferrals in 402(g) limit testing.

- 16) Record Retention; missing source documents for support of loans, hardships, notification of plan eligibility



Resources

VCP Submission Kit for 403(b) Plan Document Failure:

http://www.irs.gov/pub/irs-tege/vcp_submission_kit_403b.pdf

IRS Publication 571: <http://www.irs.gov/pub/irs-pdf/p571.pdf>

Fix-It Guide: [http://www.irs.gov/pub/irs-tege/403\(b\)_fixit_guide.pdf](http://www.irs.gov/pub/irs-tege/403(b)_fixit_guide.pdf)

Misc.: [http://www.irs.gov/Retirement-Plans/IRC-403\(b\)-Tax-Sheltered-Annuity-Plans---Additional-Resources](http://www.irs.gov/Retirement-Plans/IRC-403(b)-Tax-Sheltered-Annuity-Plans---Additional-Resources)

Questions...

