403(b) PLAN CHECKLIST

This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

It is important to review the requirements for operating your 403(b) retirement plan annually. This checklist is a "quick tool" to help you keep your plan in compliance with many important tax rules. See IRS Publication 571, *Tax Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations* at *www.irs.gov/ep*. Underlined text below shows a link to expanded explanations and resources, also at *www.irs.gov/ep.*

1. Does your organization qualify as a public educational institution or as a charitable organization exempt from tax under IRC 501(c)(3)? Yes ☐ No ☐

Only public educational institutions described in IRC 170(b)(1)(A)(ii), or 501(c)(3) organizations may establish a 403(b) plan.

2. Are ALL employees who normally work 20 hours or more per week (Universal Availability rule) given the opportunity to make a salary deferral? Yes ☐ No ☐

Failure to meet this rule is often due to excluding part-time employees who would otherwise be eligible to participate.

3. Are elective deferrals, including any designated Roth contributions, limited to the amounts under IRC 402(g) in a calendar year? Yes ☐ No ☐

Failure to limit deferrals to the 402(g) limit ($15,000 for 2006) may result in additional taxes and penalties to the employee and employer.

4. Are the total employer and employee contributions limited so as not to exceed the IRC 415(c) limits? Yes ☐ No ☐

Total employee and employer contributions cannot exceed the lesser of $44,000 for 2006, or 100% of includible compensation.

5. If the IRC 402(g) "15 years of service catch-up" contributions are being made, does the employer have the required 15 years of full-time service with the same employer? Yes ☐ No ☐

Even if this requirement is met, a calculation must still be made to determine the level of entitlement.

6. If your program permits age 50+ catch-up contributions, were each of your employees age 50 and over informed of their rights to make catch-up deferrals? Yes ☐ No ☐

If your plan permits, participants age 50+ may defer an additional $5,000 to the 403(b) plan for 2006.

7. Does the 403(b) annuity contract or custodial account: contain the nontransferability provisions (annuity contract only); state the limits under IRC 402(g); and contain the direct rollover provisions of IRC 401(a)(31)? Yes ☐ No ☐

Certain provisions are required for annuity contracts or custodial accounts.

8. If your plan offers a 5-year post severance provision, are amounts contributed through a non-elective method? Yes ☐ No ☐

Amounts contributed to an IRC 403(b) plan that an employee had an option of receiving in cash are considered elective deferrals and are not eligible for the 5-year provision.

9. Are you (as the employer) and your vendor enforcing participant loan repayments and limiting aggregate loan amounts as required under IRC 72(p)? Yes ☐ No ☐

If not, defaulted loans or loans in violation of IRC 72(p) may be deemed a taxable distribution and reported as income to the participant.

10. Are you and your vendors requiring documentation that hardship distributions meet the definitions and requirements for hardship found in the IRC 401(k) regulations? Yes ☐ No ☐

The employer should certify, based on the facts, that the participant has an immediate and heavy financial need.

If you answered "No" to any of the above questions, you may have a mistake in the operation of your 403(b) plan. This list is only a guide to a more compliant plan, so answering yes to each question may not mean your plan is 100% compliant. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877) 829-5500**

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403(b)

This checklist is intended to be one of the many tools a tax-exempt employer may use to keep its plan in compliance. It's just ten questions, so we're only hitting a few of the trouble spots. Also, you'll notice our list of ten questions and these expanded explanations don't contain information related to the proposed regulations to 403(b). If and when those regulations become final, this information will be updated. Since only eligible employers can set up a 403(b) account, participants may not find this checklist very valuable. Participants should follow this link to our 403(b) publication for participants, Pub 4483. Employers may also find the 403(b) publication for employers helpful, Pub 4484.

Hold Harmless Agreements were not discussed in any of the questions, mainly because the IRS isn't a party to the agreement. If a plan is ever subjected to an IRS audit, the Hold Harmless Agreement means very little to the auditor. If the 403(b) plan's loan program is not being operated properly, if hardship distributions weren't properly documented, if the universal availability rule wasn't met – the employer is held responsible for the problem. It's always a good idea to get in writing what is required of your vendors and other plan servicers, but a Hold Harmless Agreement does not lessen the employer's responsibility to properly administer the 403(b) plan.

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1. Organization

Only certain tax-exempt employers are eligible to maintain a 403(b) plan on behalf of eligible employees. Following is a list of employees eligible to participate in a 403(b) plan:

- Employees of tax-exempt organizations established under 501(c)(3) of the Internal Revenue Code (IRC).
- Employees of public school systems who are involved in the day-to-day operations of a school.
- Employees of a cooperative hospital service organization.
- Civilian faculty and staff of the Uniformed Services University of the Health Sciences.
- Employees of public school systems organized by Indian tribal governments.
- Certain ministers:
  - Employed by a 501(c)(3) organization.
  - Self-employed.
  - Ministers not employed by a 501(c)(3) organization, but they function as a minister in their day-to-day responsibilities with their employer, such as a hospital chaplain.

We need to further explain the second one on the list, *Employees of public school systems…* Under IRC 170(b)(1)(A)(ii), what we call public school systems are more properly defined *as an education organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.* Included in this category are:

- Public schools.
- State colleges.
- Universities.

Both faculty and non-academic staff (custodial employees, maintenance staff) performing services for a public educational organization may be covered, but elected or appointed officials holding positions in which persons who are not education professionals may serve are not eligible. Members of the school board, university regents or trustees may not be eligible.

In order to be considered a tax-exempt organization established under 501(c)(3), the organization may apply to the IRS for a determination letter by filing Form 1023. There is an exception for filing for church and related organizations, and other organizations excepted under IRC 508.

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2. Universal Availability.

This *universal availability* rule means that if an employer permits one employee to defer salary into a 403(b) plan, the employer must extend this offer to all employees of the organization. However, certain employees may be excluded from the plan:

- Employees who will contribute $200 annually or less.
- Those employees who participate in a 401(k) or 457 plan, or in another 403(b) plan.
- Non-resident aliens.
- Employees who normally work less than 20 hours per week.
- Students performing services described in section 3121(b)(10).

This condition requires extra care from the employer. It's easy to mistakenly assume certain employees who only have a support role with the organization or who work in what is typically considered a part-time role are not eligible for the plan. However, under the universal availability rule, only employees who meet the specific exclusions do not have to be covered by the plan. A mistake in this area may lead to the entire 403(b) plan losing its tax deferred status.

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3. Designated Roth Contributions

IRC 402(g) Limits.
There is a limit on the amount of elective deferrals a plan participant may contribute to a 403(b) plan.

- Elective deferrals are limited to the lesser of $15,000 for 2006, $15,500 for 2007, or 100% of the participant's includible compensation.
- Designated Roth contributions to a 403(b) plan count toward the $15,000 ($15,500 for 2007) 402(g) limit.
- Any catch-up contributions made are in addition to the 402(g) limit. (See questions 4, 5, & 6 for information on the availability of different catch-up opportunities and associated limits)
- This limit is subject to cost-of-living increases after 2007.

This 402(g) limit is a participant limit. If an employee participates in more than one 403(b) plan, all elective deferrals to all 403(b) accounts must be combined to determine if the 402(g) limit of $15,000 for 2006 is exceeded.

If an employee participates in both a 403(b) plan and a 457 plan, up to $15,500 may be contributed to the 403(b) plan and another $15,500 to the 457 plan for 2007.

If an employee participates in both a 403(b) plan and a 401(k) plan, the deferrals to the 403(b) and 401(k) plans must be combined to determine if the 402(g) limit of $15,500 for 2007 is exceeded.

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4. IRC 415(c) Limits

Several contribution limits apply to a 403(b) plan. A plan that includes both employer contributions and employee elective deferrals is subject to both the limits under 402(g) and 415(c). Elective deferrals may not exceed the 402(g) limits and the total of all employer and employee elective deferrals may not exceed the limits under 415(c). For the 2007 year, the total of employer and employee contributions (including the 15 year catch-up discussed below) cannot exceed the lesser of $45,000 or 100% of includible compensation, plus any age 50 catch-up contributions.

If an eligible employer also sponsors a 457 plan for its employees, contributions to the 457 are not limited under 415(c).

For example, assume Pat, age 50, has worked as a teacher in the Lincoln ISD for fifteen years; is eligible for the 15 years of service catch-up; and has eligible compensation of $70,000 for 2007. Pat is eligible for the school system's 403(b) plan. What are the maximum employee and employer contributions for 2007?

- Pat may have elective deferrals to the 403(b) plan totaling $18,500 ($15,500 plus $3,000 15 years of service catch-up)
- Employer contribution of $26,500, bringing the total employee and employer contributions to $45,000, the 415(c) limit.
- Pat may also defer an additional $5,000 age 50 catch-up contribution for 2007.
- If Lincoln offers a 457 plan for 2007, Pat may defer an additional $15,500 to the 457 plan.

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5. 15-Years of Service Catch-up

To qualify for a 15-years of service catch-up, the employee must have 15 years of service with the same employer. If the employee has at least 15 years of service with the same employer in a public school system, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches, the limit on elective deferrals to his or her 403(b) account may be increased by up to $3,000 in any taxable year (lifetime employer by employer limit of $15,000). Sounds simple, but it gets much more complicated. There are several calculations to be dealt with prior to determining a participant's eligibility to make a $3,000 catch-up contribution.

- To qualify for a 15-year catch-up, the employee must have 15 years of service with the same employer; although, it doesn't have to be consecutive.
- The increased contribution is limited to no more than $3,000 for any year, with a lifetime employer by employer limit of $15,000.
- Level of Entitlement - This 15-year catch-up is only available to those participants who average less than $5,000 per year in elective deferrals. The basic calculation to determine the level of entitlement is (5,000 x Years of Service with the employer) minus (total of all elective deferrals made to a 403(b), 401(k), or SIMPLE IRA plan maintained by the employer – including the 15-year catch-up but excluding the age 50 catch-up) – for all years of service with the employer).
- Catch-up ordering - The ordering for participants eligible for both types of catch-up contributions is 15-year catch-up, then age 50+ catch-up.
- Maximum catch-ups - A participant eligible for both types of catch-ups may contribute up to $3,000 extra for the 15-year catch-up, along with an extra $5,000 for the age 50+ catch-up for 2007.

- Designated Roth contributions in a 403(b) plan are included within all the different limits.

Making a determination that the years of service are with the same employer has its own complications. We'll try a few rules.

- If an employee works for the same school district, but at different schools within that system, they work for the same employer.
- If an employee works for a hospital system, but works at different hospitals within that system, they work for the same employer.
- If a minister is a self-employed minister, all those years of service as a self-employed minister are considered working for the same employer.

It's also necessary to determine the years of service for any participant interested in making the additional 15-year catch-up contribution. How years of service are determined depends on whether the employee was full-time or part-time, whether the employee worked a full year or only a partial year, and if work was performed for the employer for an entire year.

A full-time position may be different for each position and each employer, and involves the employer's annual work period. The employer's annual work period is the usual amount of time an individual working full-time in a specific position is required to work. This period of time may be expressed in days, weeks, months, or semesters and can span more than one calendar year.

This calculation may get very complicated. An employer planning to use the 15 year catch-up should review our Pub 571 for a more detailed look at this calculation. This also may be an area to ask for the input of a benefits professional.

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6. Catch-up Contributions

A 403(b) plan may permit participants who are age 50 or over by the end of the calendar year to make additional salary deferral contributions. These catch-up contributions are not subject to the general limits that apply to 403(b) plans, including the limits under 402(g) and 415. An employer is not required to provide for catch-up contributions in any of its plans. However, if a plan allows catch-up contributions, it must allow all participants who are eligible for the catch-up to make an election with respect to catch-up contributions.

Here is a recap of the features and requirements of catch-up contributions in a 403(b) plan:

- The catch-up contribution limit for 2006 and 2007 is $5,000, subject to cost-of-living increases after 2007.
- Catch-up contributions are in addition to the maximum 402(g) limits of $15,000 for 2006 and $15,500 for 2007.
- Participants eligible for both types of catch-ups may contribute up to $3,000 extra for the 15-year catch-up, along with an extra $5,000 for the age 50 catch-up for 2006 and 2007.
- Catch-up ordering - The ordering for participants eligible for both types of catch-up contributions is the 15-year catch-up, then age 50 catch-up.
- If a 403(b) plan offers this catch-up to any participants, it must be offered to all participants who are eligible to make elective deferrals.
- Designated Roth contributions in a 403(b) plan are included within all the different limits.

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7. Annuity Contract or Custodial Account

We're all waiting to see what changes the final regulations under 403(b) will bring. Will they require a basic plan document or will a number of different documents and contracts, when taken as a whole, make up the plan document? Currently, a plan document requirement does not exist; however, a written requirement still exists in a number of instances. For the contributions not to be included in the employee's current income, an annuity contract or custodial account needs to contain certain provisions:

- Annuity contracts should state the contract is not transferable.
- Contracts should state the limits under IRC 402(g).
- Contracts should include the direct rollover provisions of IRC 401(a)(31).

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8. 5-Year Post Severance

5-year post severance contributions should not be confused with post severance elective deferrals. **Post severance elective deferrals** are employee deferrals that are based on amounts that represent pay an employee would have received or leave that could have been taken were he or she still employed (such as sick/vacation leave and back pay), but with some limits. In order for an employee to defer post severance compensation, the regulations require that:

- The post severance elective deferral must represent pay that employees would have received, or leave that could have been taken, if they had continued to work.
- The agreement to defer must be initiated prior to this compensation being paid or made available.
- Post severance elective deferrals must be made by the later of 2½ months following severance from employment or the end of the year in which the severance occurs.
- The total amount deferred for the calendar year (normal payroll deferrals plus post severance deferral) cannot exceed the annual maximum limit under IRC 402(g) or 415(c) that is in effect for the calendar year the deferral is made into the plan.
- Elective deferrals are always subject to FICA tax, which must be deducted from these amounts before deferring into the plan.

5-year post severance contributions are employer contributions made to a 403(b) plan after the employee's severance from employment. Contributions may be made for an employee for up to five years after their employment ends. These contributions are based on includible compensation for that employee's last year of service. In general, post severance contributions must meet the following:

- Employer contributions may be made for an employee for up to five years after their employment ends.
- Must be based on includible compensation for that employee's last year of service.
    - Includible compensation does not include amounts contributed by the employer to the employee's 403(b) account.
    - Compensation for an employee working less than full-time should include a time period that would constitute a year of service.
- Contributions may be made up to the limits under IRC 415 (see explanation for Q4 above) for each of the five years.

Following is an example of a 5-year post severance contribution and post severance elective deferral. Assume a teacher retires on May 31, 2006, with six months of accumulated sick and vacation leave that will be paid to him or her. Pay for the most recent period ending on the close

of the employee's tax year is $40,000. The employer's sick leave policy provides that $12,000 will be paid in cash to the employee and the balance will be made as an employer non-elective contribution to the 403(b) plan for five years, up to the 415(c) limits. Possible 403(b) contributions are:

- **Post severance elective deferral** – An employee may elect by May 31 to make an elective deferral contribution of all or part of the $12,000 cash payment based on the accumulated sick and vacation leave received by the later of 2 ½ months following severance from employment or the end of the year in which the severance occurs, subject to the limits under IRC 402(g).
- **5-year post severance contribution** – The employer may contribute up to $40,000 for each of the five years after retirement, subject to the limits under IRC 415.

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9. Loan Repayments

Generally, an employer maintaining a 403(b) plan for its eligible employees may permit plan loans. If participants are permitted to borrow from their accounts, these loans should be based on a detailed written loan program. Maintaining a loan program in a 403(b) plan can be very difficult. For example, some vendors may not allow plan loans; some may not be collecting the loan payments, while others may be ignoring the rules guiding the employer's 403(b) loan policy. Employers are responsible for the loan program, but sometimes rely exclusively on the vendor to determine if a loan meets the requirements of the loan program and to properly collect the payments.

That's a very important point. Employers are responsible for determining if each plan loan made to a participant meets the requirements of their loan program and IRC 72(p), and for enforcing loan repayments. Hold Harmless Agreements do not lessen the employer's responsibility.

A loan to a participant in a 403(b) plan is not taxable to the employee if it meets the following criteria:

- The loan must be made as part of a written loan program maintained by the employer.
- A participant may borrow the lesser of 50% of their vested account balance, or $50,000.
- The loan must be repaid within 5 years, unless the loan is used to purchase the participant's main home.
- Loan repayments must be made in substantially level payments, at least quarterly, over the life of the loan.

The $50,000 amount must be reduced if the participant has an outstanding loan from the plan (or any other plan of the employer or related employer) during the **1-year period ending the day before the loan.** The amount of the reduction is the participant's highest outstanding loan balance during that period minus the outstanding balance on the date of the new loan. If this amount is zero or less, ignore it.

The level payment requirement does not apply to the period in which the employee is 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. The employee must repay the loan within 5 years from the date of the loan (unless the loan was used to buy his or her main home). The installment payments must not be less than the original payments.

If the plan suspends an employee's loan payments for any part of the period during which the employee is in the uniformed services, the loan may be suspended for longer than one year. 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 the employee's main home) plus the period of suspension.

If an employee was were affected by hurricane Katrina, Rita, or Wilma, see Pub 4422 for more information.

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10. Hardship Distributions

A 403(b) plan may permit employees to receive a hardship distribution because of an immediate and heavy financial need. The requirements for a hardship distribution are found in the IRC 401(k) regulations. 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. At the end of this expanded explanation is a discussion on the special treatment available for qualified reservist distributions.

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 by the plan administrator. A distribution on account of hardship must be limited to the **distributable amount**. The distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions.

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;
- 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; or
- 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:

- If the distribution is in excess of the amount needed to relieve the financial need of an employee, or
- If the financial 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.

Record keeping is an important area that is commonly neglected. It's important that plan sponsors keep a record of all information used to determine that a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship. Even though the 403(b) plan sponsor may be relying on outside vendors for much of their plan administration, plan sponsors bear ultimate responsibility for determining that a distribution was properly determined to meet the hardship requirements listed above. Hardship distributions are subject to the 10% early distribution penalty on distributions made prior to reaching age 59 ½.

The Pension Protection Act of 2006 provides that for distributions made after September 11, 2001, the 10% early withdrawal penalty does not apply to **qualified reservist distributions.** A qualified reservist distribution is:

- One made to a reservist called to active duty for a period of at least 180 days or for an indefinite period.
- Made beginning on the date of such order calling to active duty and ending on the close of the active duty period.
- Made from an IRA or from amounts attributable to elective deferrals under a 403(b) plan, 401(k) plan, or certain similar arrangements.

A 403(b) or 401(k) plan is not in violation of other distribution restrictions by reason of making a qualified reservist distribution. If a determination is made that a distribution made in a closed tax year qualifies as a qualified reservist distribution, amended returns for those closed years may be filed through August 16, 2007. Additionally, the amounts withdrawn may be repaid to an IRA in one or more contributions within 2 years after the later of August 16, 2006, or the day after the active duty period ends. Such contributions will not be taken into account for purposes of the dollar limitations normally applicable to IRA contributions.

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