

# I. SECTION 403(b) TAX-SHELTERED ANNUITY ARRANGEMENTS

by  
Ron Hallsten and Bob Architect

## 1. Introduction

This chapter describes the rules pertaining to Internal Revenue Code 403(b) plans or arrangements ("403(b) plans"). Section 1 provides a technical overview, historical background, and description of 403(b) plans. Section 2 discusses the types of employers eligible to maintain a 403(b) plan. Section 3 describes the various funding vehicles for 403(b) plans. Section 4 addresses the requirements of salary reduction contributions. Section 5 addresses the contribution limits applicable to 403(b) plans. Section 6 discusses the applicable nondiscrimination rules. Finally, Sections 7 through 9 address distributions from a 403(b) plan.

### A. Legislative Background

In 1958, Congress made available a tax deferred savings device for employees of certain section 501(c)(3) organizations by adding section 403(b) to the Internal Revenue Code. Before enactment of this section, it was possible for an employee of certain tax-exempt organizations to defer income through the use of a tax-sheltered annuity arrangement. IRC 403(b) was enacted as a restriction on the portion of compensation that may be sheltered.

In 1961, IRC 403(b) was extended to employees of public education institutions, including colleges and universities. In 1974, certain custodial accounts in which contributions are invested in mutual funds were made available as funding vehicles. IRC 403(b) was further expanded in 1982 to cover retirement income accounts for employees of church organizations.

The Tax Reform Act of 1986, Pub. L. No. 99-514 ("TRA '86"), made several notable changes to IRC 403(b) by imposing certain rules similar to those applicable to qualified plans, including a new ceiling on elective deferrals, nondiscrimination and minimum distribution requirements, and restrictions on withdrawals of salary reduction contributions. Finally, additional requirements regarding rollovers were added by the Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318.

### B. Technical Overview

A 403(b) plan is a retirement plan, contributions to which are eligible for tax-deferred treatment, under which a public school or organization described in IRC 501(c)(3) ("501(c)(3) organization") purchases annuity contracts or contributes to custodial accounts for its employees. IRC 403(b) plans are governed by their own requirements under IRC 403(b), and are specifically exempted from the requirements applicable to annuity plans qualified under IRC 403(a). IRC 403(b) plans are also known as "tax-sheltered annuities, "tax-deferred annuities" or "annuity contracts."

Because 403(b) plans may not resemble what we typically think of as a "plan," 403(b) plans are also frequently referred to as "403(b) arrangements." A 403(b) plan may not consist of a basic plan document, but merely salary reduction agreements and annuity contracts with the insurance company, or a custodial account agreement with the custodian. A summary plan description and descriptive literature communicated to employees may also form part of an arrangement. The employer's involvement in such a plan might be limited to merely providing a list of insurance carriers to employees and executing the salary reduction agreements. On the other hand, there may be a much higher degree of involvement on the part of the employer in maintaining a 403(b) plan. The plan may in fact consist of a basic plan document that is as comprehensive as a qualified plan described in IRC 401(a). For purposes of this chapter, the term "403(b) plan" refers to the entire spectrum of these various arrangements.

403(b) plans may be funded through an employee's salary reduction contributions, as well as by the employer's contributions. These funds may be invested in annuity contracts, mutual funds, and, in the case of churches, retirement income accounts. The requirements applicable to 403(b) plans vary depending on the type of contributions, type of funding arrangement, and the identity of the employer.

Contributions to a 403(b) plan that do not exceed the exclusion allowance and that meet other requirements imposed under IRC 403(b) are generally tax-deferred until distributed. Earnings on contributions are also tax-deferred until distributed. Thus, covered employees are taxed on amounts when they are actually distributed from the plan. An employee benefits from favorable tax consequences if contributions satisfy the IRC 403(b) requirements. Whether or not contributions satisfy the requirements is also important from the employer's perspective because the employer is responsible for federal income taxes, employment taxes, and withholding on contributions not entitled to tax deferral treatment. Distributions

from a 403(b) plan are taxable under IRC 72, relating to annuities.

403(b) plans generally are required to file Form 5500. However, certain plans, including church plans not electing coverage under IRC 410(d), governmental plans, and 403(b) plans that are not "employee benefit plans" under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), are not required to file. A 403(b) plan that provides only salary reduction contributions and under which the employer is minimally involved in selecting the funding vehicles is not an employee benefit plan under Title I of ERISA. See Department of Labor Regulations section 2510.3-2(f).

## 2. Eligibility

As indicated above, a 403(b) plan may be maintained only by eligible employers on behalf of eligible employees. The two key issues here are: (1) whether the employer is eligible to maintain a 403(b) plan on behalf of the participating employees, and (2) whether an individual participating in the 403(b) plan performs services for the employer as an employee. If the employer is not eligible, the plan is not a plan described in IRC 403(b), with a resulting loss of the tax deferred treatment for employees. Situations in which the employer's eligibility varies between taxable years are discussed in Section 5(B) below.

Under IRC 403(b)(1)(A)(i) and (ii), only two types of employers are eligible to maintain a 403(b) plan: (1) a state, a political subdivision of a state, or an agency or instrumentality of any of these, for an employee who performs services for an educational organization described in IRC 170(b)(1)(A)(ii); and (2) a non-profit organization described in IRC 501(c)(3). It is important to note that not all non-profit organizations are eligible to maintain a 403(b) plan.

### A. Public Educational Organizations

A state or local government, or any agency or instrumentality of either of these can be an eligible employer only for employees who perform services directly or indirectly for an educational organization.

To be an educational organization described in IRC 170(b)(1)(A)(ii), 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 public schools, state colleges and universities. Both nonacademic staff (for

example, a custodial employee) and faculty may be covered with the caveat that elected or appointed officials holding positions in which persons who are not educational professionals may serve are not eligible (for example, a member of the school board, university regent or trustee may not be eligible). See IRC section 170(b)(1)(A)(ii); sections 1.170A-9(b)(1) and 1.403(b)-1(b)(5) of the Income Tax Regulations; and Revenue Ruling 73-607, 1973-2 C.B. 145.

### B. IRC 501(c)(3) Organizations

The other type of organization that may maintain a 403(b) plan is an IRC 501(c)(3) organization. These organizations are defined generally as those organized and operated exclusively for religious, charitable, scientific, public safety testing, literary or educational purposes, or to encourage national or international amateur sports competition, or for the prevention of cruelty to children or animals. These organizations include charities, social welfare agencies, private hospitals and health care organizations, private schools, religious institutions and research facilities. A public institution, such as a public hospital, may qualify if it is created as a separate entity that serves the exclusive purpose described in IRC 501(c)(3), and does not have enforcement or regulatory powers. See Revenue Ruling 74-15, 1974-1 C.B. 126.

### C. Employee Status

A qualified employer can purchase a tax-sheltered annuity only for an employee. If an individual is subject to the direction and control of an employer regarding what work is to be done, and how to do it, that person is generally considered an employee. If a person is subject to the control or direction of another as to the result only, and not how to do the work, that person will generally be considered an independent contractor. The question of whether an individual is an employee or independent contractor is most likely to arise with professionals such as physicians. Employee status under IRC 403(b) is determined by reference to whether the participant is an employee for federal employment tax purposes, which is generally determined under common law principles. See Revenue Ruling 66-274, 1966-2 C.B. 446.

## 3. Funding Arrangements

Funds contributed to a 403(b) plan may be invested in annuity contracts, custodial accounts for regulated investment company stock (mutual) funds, retirement income accounts for churches, or a combination of these funding

vehicles. Because custodial accounts and retirement income accounts are treated as annuity contracts under IRC 403(b)(7) and (b)(9)(A)(i) for purposes of the Code, the term "annuity contract" incorporates all three types of arrangements unless otherwise indicated. While most of the fundamental rules apply to all three types of 403(b) plans, some regulations apply only to certain types of plans. The requirements pertaining to these arrangements are discussed in further detail in Sections 4 through 9 below.

#### A. Annuity Contracts

The most common vehicle used to fund a 403(b) plan is an annuity contract under IRC 403(b)(1). An annuity contract may be offered only by an insurance company. The contract may be owned by the individual, or, in the case of a group annuity contract, by the employer. The annuity may be either variable or guaranteed. See Revenue Ruling 81-102, 1982-1 C.B. 62.

Under IRC 401(g), the contract must provide that it is nontransferable. However, loans may be made from an annuity contract, and amounts held under the contract may be transferred or rolled over to another 403(b) plan. Salary reduction contributions to an annuity contract and their earnings are subject to certain early distribution restrictions.

An annuity contract may provide (or be part of an arrangement which includes a contract that so provides) life insurance protection as long as the death benefit is merely incidental to the primary purpose of providing retirement benefits. See Reg. 1.403(b)-1(c)(3). The rules applicable to qualified plans for determining whether life insurance is incidental are the same for 403(b) plans. See Revenue Ruling 74-115, 1974-1 C.B. 100. Like qualified plans, the portion of each year's premium representing the cost of life insurance protection (referred to as "P.S. 58 costs") is includible in gross income and counts toward the employee's basis in the annuity contract on distribution. In addition, a contract on a participant's life must be converted to cash or an annuity, or distributed to the participant at retirement. See Revenue Ruling 60-84, 1960-1 C.B. 159; Revenue Ruling 66-143, 1966-1 C.B. 79; and Revenue Ruling 68-31, 1968-1 C.B. 151.

A policyholder of an annuity contract, the assets of which are invested in mutual funds (a "wrap-around annuity contract"), may be considered the owner of the investments for federal income tax purposes if the policyholder has sufficient incidents of ownership (such as investment control over the mutual fund shares) and the shares are available to the general public. If this is the case, the earnings

and/or gains are includible in gross income under IRC 61(a). See Revenue Ruling 81-225, 1981-2 C.B. 12. Where the wrap-around annuity is considered owned by the participant, it is not suitable as a product for 403(b) funding.

In order to effectuate a purchase of an annuity contract by the employer, the insurer must be contractually obligated to provide annuity benefits. Prior to a purchase, there is no IRC 403(b)(1) annuity contract.

**Example** Employer, an IRC 501(c)(3) organization, maintains an annuity plan intended to be a 403(b) plan (the Plan). Employer makes both salary reduction and non-salary reduction contributions to individual investment accounts (not mutual funds) for each of its employees. An employee is not entitled to annuity benefits unless the employee directs the custodian of the accounts to apply the funds to a group annuity contract. The arrangement is not the purchase of annuity contracts by the employer since the custodian of the fund is not obligated to provide annuity benefits. Consequently, the plan is not one described in IRC 403(b). See Revenue Ruling 68-487, 1968-2 C.B. 187; and Revenue Ruling 68-488, 1968-2 C.B. 188.

## B. Custodial Accounts

Because a custodial account under IRC 403(b)(7) is treated as an annuity contract, it generally must satisfy the various requirements of IRC 403(b). In addition, the assets of a custodial account must be held by a bank or other person who is approved by the Commissioner of the Service pursuant to IRC 401(f) (a "nonbank trustee"). The assets must be invested exclusively in regulated investment company stock (e.g. mutual funds). Consequently, a 403(b)(7) custodial account may not provide life insurance, although it may permit loans to participants. Both salary and nonsalary reduction contributions to a custodial account are subject to certain early distribution restrictions. Excess contributions to a custodial account are subject to a six percent cumulative excise tax under IRC 4973.

## C. Retirement Income Accounts

A retirement income account is defined under IRC 403(b)(9)(B) as a defined

contribution program (although some may be defined benefit plans) established and maintained by: (1) a church, or (2) a convention or association of churches, including a related organization principally engaged in the administration or funding of an arrangement providing benefits to employees of a church or convention or association of churches. Generally, a defined contribution plan is one in which funds are contributed to a separate account on behalf of each participant and paid at retirement. A defined benefit plan, generally, is one in which the benefit is expressed as an amount to be paid at retirement, and is a result of a formula based on age, service, and level of compensation at the time of retirement. Separate accounts, in a defined benefit plan, are not maintained for each participant. These IRC 403(b)(9) arrangements may offer a combination of IRC 403(b)(1) or 403(b)(7) funding, and/or utilize the type of funding that might be found in any ordinary employer pension plan, such as certificates of deposit, stocks, or bonds.

#### 4. Salary Reduction Contributions

##### A. In General

403(b) plans are commonly funded in whole or in part by salary reduction contributions. In general, "salary reduction contributions" are 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. They are amounts that would otherwise be paid as taxable compensation. While ordinarily thought of as "employee contributions", technically these contributions are treated as employer contributions (although they are still salary reduction contributions). The agreement under which salary reduction contributions are made is a "Salary Reduction Agreement", which is typically reflected on an election form.

Salary reduction contributions under a 403(b) plan are subject to certain specific requirements concerning: (1) withdrawals, (2) annual contribution limits, and (3) nondiscrimination. Salary reduction contributions are also referred to as "elective contributions" or "elective deferrals".

##### B. Regulatory Requirements for Salary Reduction Contributions

Section 1.403(b)-1(b)(3)(i) of the regulations provides that the exclusion allowance applies to salary reduction contributions only with respect to amounts earned after the salary reduction agreement becomes effective. Salary is "earned" when the services that give rise to the employee's entitlement to pay are

performed. This regulation also requires that a salary reduction agreement be legally binding on the parties and irrevocable with respect to amounts earned while the agreement is in effect; however, the employee may be permitted to terminate the agreement at any time with respect to amounts not yet earned. Finally, the regulation requires that the employee not be permitted to make more than one salary reduction agreement with the same employer during any taxable year of the employee. Failure to satisfy this latter requirement causes the amounts contributed under any additional agreements in the same taxable year to be includible in the employee's gross income.

Generally, the making of a new agreement means there must be some affirmative change in the salary reduction agreement rather than the voluntary continuation of an agreement of indefinite duration into a new taxable year. See Revenue Ruling 87-114, 1987-2 C.B. 116. Consequently, the employee cannot change the fixed dollar amount or percentage of compensation to be deferred in a given taxable year after one agreement has been made in that year. However, if salary reduction contributions are based on a percentage of compensation, changes in the amount deferred due to increases or decreases in salary do not constitute new agreements. Similarly, changing insurers during a taxable year in which a salary reduction agreement was made will not result in a new agreement for that year, even though the initial agreement identified the first insurer by name.

## 5. Contribution Limits

There are three separate, yet interrelated, limitations on the amount that may be excluded from income as a contribution to a 403(b) plan: (1) the annual limitation on the amount of elective deferrals under IRC 402(g), (2) the exclusion allowance under IRC 403(b)(2), and (3) the limitation on employer contributions under IRC 415. Rollovers and transfers are not included in applying the limitations.

### A. Limit on Elective Deferrals

A 403(b) plan to which contributions are made by a salary reduction agreement, as discussed in section 4A of this article, must satisfy the annual limitation on the amount of elective deferrals under IRC 402(g). In the absence of a special catch-up election (discussed below), the maximum amount of elective deferrals that may be deferred under a 403(b) plan is \$9,500 (subject to cost of living increases). See IRC 402(g)(4).

An "elective contribution" is any contribution that arises because of an employee's election between current compensation or deferral pursuant to a salary reduction agreement under the plan. Elective deferrals under a 403(b) plan technically are employer contributions that are used to purchase an annuity contract (or made to a custodial account) under a salary reduction agreement as defined in IRC 3121(a)(5)(D). "Excess elective deferrals" are elective deferrals in excess of the IRC 402(g) limit. The limit is based on aggregated elective deferrals and applies to the participant rather than the plan. Elective deferrals are also coordinated with IRC 457.

Elective deferrals under a 403(b) plan do not include elective contributions made pursuant to a one-time irrevocable election that is made upon the initial eligibility to participate in the plan. The mere right or ability to modify or terminate an election will cause the contributions to be elective deferrals regardless of whether the participant actually exercises this right. The IRC 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.

IRC 402(g)(8) provides for a special election for certain long-term employees, pursuant to which they may "catch up" on the funding of their retirement benefit by increasing their elective deferrals over the \$9,500 limit. The election is available only to an employee who has completed at least 15 years of service with an employer that is an educational organization; hospital; home health service agency; health and welfare service agency; church, convention or association of churches, or an organization controlled by or associated with any of these (as defined under IRC 415(c)(4)). The annual limitation under the election is increased by the least of: (1) \$3,000, (2) \$15,000 less elective deferrals previously excluded under the IRC 402(g)(8) catch-up election, or (3) \$5,000 multiplied by the employee's years of service less the elective deferrals made to plans of the employer in prior taxable years. The term "years of service" is defined under IRC 403(b) for purposes of IRC 402(g)(8). As can be seen from this election, there is a life-time limit on increases under the election of \$15,000, and in no event will the annual limit exceed \$12,500.

Under IRC 403(b)(1)(E), a 403(b) plan must comply with IRC 401(a)(30). Under this section a plan will lose IRC 403(b) status if, by its terms, it does not preclude excess elective deferrals unless the excess deferrals are made to a plan of an unrelated employer, or the plan timely corrects the excess. A plan may avoid loss of its IRC 403(b) status by distributing the excess deferrals by April 15 of the

following taxable year, if the plan permits such a distribution and the employee requests a distribution of the excess. Such a distribution may be made notwithstanding any other provision of the law.

What this means for 403(b) plans is that excess elective deferrals that are not timely corrected can result in the 403(b) plan's loss of IRC 403(b) status for the plan year, with a resulting loss in the exclusion allowance for all employees participating in the plan for the taxable years ending with or within the plan year. If excess deferrals are not distributed by April 15 and the plan does not lose its status as a 403(b) plan, the excess is taxed both in the year contributed and again upon distribution.

**Example (1)** Employee participates in a 403(b) plan (the Plan). As a condition of participating in the Plan, Employee is required to elect to defer three percent of salary, by the salary reduction method, in the form of "Mandatory Contributions." Employee has the option of terminating this election at any time with respect to amounts not yet earned, although Employee never terminates his election. The Mandatory Contributions are elective deferrals, because they are made as a result of a revocable election, and therefore included in applying the limit of IRC 402(g).

**Example (2)** Assume the same facts as in Example (1) above, 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 participation in the Plan. Because the election to participate is revocable, the mandatory contributions are nevertheless elective deferrals.

Example (2) illustrates 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, not terminate participation, in a plan.

## B. Exclusion Allowance

The exclusion allowance sets forth the basic maximum amount that may be contributed to a 403(b) plan on a tax-deferred basis. In other words, only contributions within the exclusion allowance are not includible in compensation in the year in which contributed. Both employer contributions and employee salary reduction contributions are subject to the exclusion allowance. The exclusion allowance is available for the taxable year only if the employer is eligible to maintain a 403(b) arrangement at the time contributions are made.

### (1) Formula

The exclusion allowance for any employee for the taxable year equals 20 percent of includible compensation multiplied by years of service with the employer less amounts previously excludable from gross income. The year of service multiplier causes the exclusion allowance to be cumulative in nature. Because the exclusion allowance is cumulative, the limit may be greater than 20 percent of compensation in any given year (but not more than the limits under IRC 415 and 402(g)). Thus, for an employee with \$40,000 of includible compensation and three years of service who has had \$16,000 contributed in prior years, the exclusion allowance for the taxable year would be \$8,000 ( $\$40,000 \times 20 \text{ percent} \times 3 \text{ minus } \$16,000$ ). Each of the elements of the formula are discussed in greater detail below.

A separate exclusion allowance is calculated with respect to each employer, with separate calculations of the amount of contributions, years of service, and includible compensation. See Reg. 1.403(b)-1(d)(2). Annuity contracts purchased by the same employer are treated as a single annuity contract for purposes of the exclusion allowance. See IRC 403(b)(5). All years of service as an employee of a church, a convention or association of churches, or an organization associated with or controlled by any of these, are considered years of service for one employer, both for purposes of the exclusion allowance and IRC 415(c)(4) (discussed below). Contributions to separate 403(b) plans maintained by the same employer are combined for purposes of calculating the exclusion allowance.

Employees of certain organizations (such as an employee of an educational organization, hospital, home health service agency, health and welfare service agency, church, convention or association of churches, or an organization controlled by or affiliated with any of these) may alternatively elect to calculate their exclusion allowance under IRC 415. In addition, for an employee of a church

or related organization described above who has an adjusted gross income of \$17,000 or less, the minimum exclusion allowance is the lesser of \$3,000 or includible compensation. See IRC 403(b)(2)(D).

## (2) Compensation

"Includible compensation" is, generally, all salary from the employer includible in gross income for the employee's most recent one-year period of service ending not later than the taxable year for which the exclusion allowance is being calculated. Thus, it does not include tax-deferred contributions made by the employer to a qualified plan because those contributions are not currently includible in compensation. See Revenue Ruling 79-221, 1979-2 C.B. 188. It also does not include any contributions to a 403(b) plan of the employer regardless of whether the contributions are excludable from gross income. In addition, includible compensation does not include compensation earned while the employer was not eligible to maintain a 403(b) plan. Finally, it does not include amounts earned for services rendered prior to the most recent one-year period of service (although the one-year period may span more than one taxable year) nor amounts which are essentially in the nature of deferred compensation. See IRC 403(b)(3), and Reg. 1.403(b)-1(e).

**Example (1)** Public School System Y pays employees who leave service, after 25 years of service, a separation payment based on two percent of salary times years of service. Employees may include in includible compensation only that portion of the payment accrued for services performed in their most recent one-year period of service ending with the taxable year for which the exclusion allowance is being calculated. See Reg. 1.403(b)-1(e)(1)(i); cf. G.C.M. 39659 (Sept. 8, 1987).

**Example (2)** Hospital M, an IRC 501(c)(3) organization, intends to pay eligible employees an early retirement incentive. They have done this several years before and intend to offer this in the foreseeable future. This incentive payment may not be considered part of the employees' includible compensation as it represents a payment of deferred compensation.

## (3) Years of Service

"Years of service" include all years of service for the employer ending no later than the taxable year in which the exclusion allowance is being calculated. It does not include years during which the employer was not eligible to maintain a 403(b) plan. See Reg. 1.403(b)-1(f). For years of service for church employees, see Section 5B(1) above.

#### (4) Amounts Previously Excludable

"Amounts previously excludable" include all employer contributions (including salary reduction) to a 403(b) plan of the employer that were excludable from gross income in taxable years prior to the taxable year in which the exclusion allowance is being calculated. It also includes aggregate contributions made by the employer to: (1) a qualified plan (whether forfeitable or nonforfeitable); (2) a plan described in IRC 457(a), even if sponsored by a different employer; (3) a qualified bond purchase plan; (4) certain non-qualified retirement plans; and (5) a 403(b) plan that are in excess of the IRC 415 limits. See Reg. 1.403(b)-1(d)(1) and (3).

### C. Section 415 Limits

The IRC 415 limitations on contributions that apply generally to qualified plans also apply to 403(b) plans. A 403(b) plan is treated as a defined contribution plan for purposes of the limitations on annual contributions under IRC 415. See Reg. 1.415-6(e)(1)(i). Consequently, unless a special election is made, contributions to a 403(b) plan (including salary reduction contributions) may not exceed the lesser of 25 percent of compensation (defined below) or \$30,000 in the limitation year under IRC 415(c)(1). The combined limit under IRC 415(e) also applies if the 403(b) plan is aggregated with a defined benefit plan of an employer. Unlike the exclusion allowance, the section 415 limit applies to contributions made to a 403(b) plan in the limitation year regardless of whether they are vested.

#### (1) Special "Catch-Up" Elections

Partly to reflect the cumulative nature of the exclusion allowance, there are also special "catch-up" elections under IRC 415(c)(4) that are unique to 403(b) plans. As with the special election under IRC 402(g)(8), only an employee of an educational organization, hospital, home health service agency, health and welfare service agency, church, convention or association of churches, or an organization controlled by or affiliated with any of these is eligible to make a special election (although the employee need not be long term). A special election is made by

filing the individual's return in a manner consistent with the election. Once made, the election is irrevocable. See Reg. 1.415-6(e). Note that even when a special election is made, contributions in a limitation year may not exceed \$30,000.

The respective limits under these elections are:

- a. The "(A) Election Limitation," under which an employee separating from service may use his or her full exclusion allowance up to a maximum of \$30,000 in the year of separation without regard to the 25 percent limitation. For this purpose, the exclusion allowance takes into account only the ten years of service (as defined in IRC 403(b)(2)), ending with the separation from service. See IRC 415(c)(4)(A).
- b. The "(B) Election Limitation," under which an employee may defer the least of: (1) \$4,000 plus 25 percent of compensation (as defined under IRC 403(b)(3)), (2) the amount of the exclusion allowance, or (3) \$15,000. This limit, in effect, replaces the 25 percent limit up to a maximum of \$15,000. See IRC 415(c)(4)(B).
- c. The "(C) Election Limitation," under which an employee may elect to use the limit of IRC 415 rather than the exclusion allowance. See IRC 415(c)(4)(C).

There are also alternative limitations under IRC 415(c)(7) that are available in the case of employees of a church or related organization described above. Such employees may elect to substitute the IRC 415 limit with an annual limit of \$10,000 (even if more than 25 percent of compensation). The total contributions over the employee's lifetime under this election cannot be more than \$40,000. Alternatively, church employees may elect to use the minimum exclusion allowance under IRC 403(b)(2)(D).

**Example** A public school district contributes \$30,000 to a 403(b) plan on behalf of one of its teachers for the 1993 limitation year, the year of a teacher's separation from service. The entire contribution is made pursuant to a revocable salary reduction agreement. The teacher properly elects the special "(A) Election Limitation." The maximum amount that may be contributed on a

tax-deferred basis is \$9,500, or, if the election under IRC 402(g)(8) of the Code (if applicable) is made, \$12,500.

Even though the limitation under IRC 403(b)(2) and IRC 415 is \$30,000 in the example, IRC 402(g) further limits the elective deferrals to \$9,500. Because the salary reduction was revocable, the contributions are considered "elective" for purposes of the various limits. The IRC 402(g) limit must always be considered in evaluating a 403(b) plan with elective deferrals.

## (2) Limitation Year

If the participant is not in control of the employer, the "limitation year" is usually the calendar year. If the participant is in control of the employer, the limitation year is the limitation year of the employer. Reg. 1.415-2(b)(7). "Control" for purposes of this section of the chapter is defined under IRC 414(b), 414(c) and 415(h).

## (3) Plan Aggregation

Because the participant is generally considered to exclusively control and maintain an annuity contract purchased on his or her behalf, contributions to purchase the annuity contract are not combined or aggregated with contributions to a qualified plan of an employer under IRC 415, with two exceptions: When a participant (1) elects the "(C) Election Limitation" (to substitute the IRC 415 limit for the exclusion allowance), or (2) controls any employer, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.

If a participant makes the above election, any contributions made to a qualified plan by the employer contributing to the 403(b) plan or an affiliated employer must be aggregated with the contributions under the annuity contract for purposes of applying the limits under IRC 415(c)(1), and IRC 415(e), if applicable.

Similarly, where a participant is in control of the 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 or aggregated with contributions to a qualified plan by the controlled employer or any affiliated employer under IRC 415. See IRC 415(f), and Reg. 1.415-7(h) and section 1.415-8(d).

**Example (1)** Employee is employed by a hospital which is an IRC 501(c)(3) organization. The hospital purchases an IRC 403(b)(1) annuity contract for Employee in the limitation year, and Employee is also a participant in the hospital's defined benefit plan. Employee does not elect the "(C) Election Limitation" and is not in control of the hospital. Because Employee, and not the hospital, is considered to have exclusive control of the contract, the plans are not aggregated for purposes of applying the limits under IRC 415(b), (c) and (e).

This 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 for purposes of IRC 415.

**Example (2)** The facts are the same as in Example (1) above, except that Employee elects to have the "(C) Election Limitation" apply to the annuity contract for the limitation year. The annuity contract and defined benefit plan are aggregated for purposes of applying the limits under IRC 415(b), (c), and (e).

**Example (3)** The facts are the same as in Example (1) above, except that Employee is a physician maintaining a private practice in which he is more than a 50 percent owner. Employee is a participant in a defined contribution plan maintained by his private practice. The defined contribution plan of Employee's private practice must be combined with Employee's annuity contract for purposes of applying the limit under IRC 415(c).

#### (4) Compensation

Note that compensation for purposes of applying the limits of IRC 415 to a 403(b) plan is generally the same as for qualified plans. As with the exclusion allowance, compensation does not include any amounts contributed to the 403(b) plan, regardless of whether they are excludable from gross income. If a 403(b) plan is aggregated with a qualified plan, compensation from the controlled

employer may be aggregated with compensation from the employer who is contributing to the 403(b) plan. See Reg. 1.415-2(d)(7)(ii).

#### (5) Effect of Excess Contributions

Contributions to a 403(b) plan in excess of the IRC 415 limit (referred to as excess contributions) have two effects: (1) the excess is includible in the gross income of the employee in the tax year ending with or within the limitation year, and (2) the excess reduces the available exclusion allowance in future years. The latter is accomplished by treating the excess contributions as amounts previously excludable (even though they were includible in gross income). Excess contributions will not cause the plan to lose its IRC 403(b) status. See IRC 415(a)(2), and Reg. 1.415-6(e)(1)(ii).

**Example** University M is an IRC 501(c)(3) organization. University M annually contributes 20 percent of compensation on behalf of all of its employees to a 403(b) plan (the Plan). The annual compensation of each of the highly compensated employees (HCEs) is \$300,000. Contributions to the Plan on behalf of each of the HCEs equal \$60,000 in the limitation year ending December 31, 1993. The \$30,000 excess is includible in the HCEs' gross income for the 1993 taxable year. Beginning in 1994, the \$30,000 excess reduces the HCEs' available exclusion allowances.

The available exclusion allowance is reduced by treating the excess amounts as amounts previously excludable in future years even though these amounts were previously includible in gross income. To correct the IRC 415 excesses and minimize the six percent excise tax under IRC 4973, the employer must under-contribute in future years until these excesses are fully absorbed.

#### (6) Correction

In addition to under-contributing in future years to minimize excess contributions, a 403(b) plan may timely distribute excess elective deferrals under IRC 402(g) to cure excess contributions under IRC 415 for the current limitation year. If a timely corrective disbursement is made, these amounts are treated as never having been contributed to the plan. See Reg. 1.402(g)-1(e). Thus, in the above example, if the \$30,000 excess consisted of excess elective deferrals, the

amount timely disbursed under IRC 402(g) would reduce the excess contributions for limitation year 1993. With the exception of a timely disbursement of excess elective deferrals, the correction mechanisms available for qualified plans with excess annual additions are generally not available to 403(b) plans.

#### D. Excise Tax

Under IRC 4973 of the Code, a six percent cumulative excise tax is imposed on the employee for the excess of the amount contributed to an IRC 403(b)(7) custodial account over the lesser of the amount excludable from gross income under IRC 403(b)(2) or 415 (excess contributions here consist of amounts exceeding either or both of these limits). The excise tax applies only to excess contributions to a custodial account and not to an IRC 403(b)(1) annuity contract. Excess contributions may be corrected by under-contributing in future years until the excess is fully absorbed or by receiving a taxable distribution of the excess (if not restricted by IRC 403(b)(7)(A)(ii)).

#### 6. Nondiscrimination

Prior to 1986, there were no nondiscrimination rules applicable to 403(b) plans. TRA '86 added separate nondiscrimination rules for non-salary reduction and salary reduction contributions under clauses (i) and (ii), respectively, of IRC 403(b)(12)(A). These rules generally must be satisfied in operation for plan years beginning after December 31, 1988.

Pending the issuance of regulations or other guidance, Notice 89-23, 1989-1 C.B. 654 (extended by Notice 92-36, 1992-2 C.B. 364), provides guidance for complying with the nondiscrimination rules. Specifically, Notice 89-23 deems a 403(b) plan to satisfy nondiscrimination if either the employer operates the plan in accordance with a good faith, reasonable interpretation of section 403(b)(12) of the Code, or in accordance with the safe harbors set forth in the Notice.

#### A. Salary Reduction Contributions

Salary reduction contributions are tested separately for nondiscrimination under clause (ii) of IRC 403(b)(12)(A). Nondiscrimination with respect to salary reduction contributions generally is satisfied only if each employee may elect to defer more than \$200 annually. Thus, for salary reduction contributions to a 403(b) plan, there is no nondiscrimination analysis of the amounts contributed. The test focuses on eligibility and generally requires universal eligibility. There is

no requirement to offer the opportunity to make salary reduction contributions. Once that opportunity is offered to any employee, it must be offered to all employees in order to satisfy this requirement.

Pursuant to IRC 403(b)(12)(A) certain employees may be excluded, including: (1) nonresident aliens with no U.S. source income; (2) employees covered under a plan collectively-bargained; (3) employees who normally work less than 20 hours per week; (4) students performing services described in IRC 3121(b)(10); (5) employees whose maximum salary reduction contributions under the plan would be no greater than \$200; and (6) participants in an IRC 457 plan, qualified "cash or deferred arrangement", or other salary reduction 403(b) plan. Unlike a qualified plan, there is no minimum age and service exclusion.

Similar to elective deferrals under IRC 402(g), salary reduction contributions for purposes of clause (ii) consist of employer contributions made pursuant to a salary reduction agreement as defined in IRC 3121(a)(5)(D). Salary reduction contributions made pursuant to a one-time irrevocable election at initial eligibility to participate in a plan are treated as non-elective contributions tested under clause (i), relating to non-salary reduction contributions.

## B. Non-Salary Reduction Contributions

"Non-salary reduction contributions" are defined as all contributions that are not salary reduction contributions. They consist of all nonelective and matching contributions. They are tested separately for nondiscrimination under IRC 403(b)(12)(A)(i). Specifically, this test requires compliance with rules generally applicable to qualified plans. These rules are IRC 401(a)(4) (nondiscrimination), 401(a)(5) (permitted disparity), 401(a)(17) (the \$150,000 ceiling on compensation), 401(a)(26) (minimum participation), 401(m) (nondiscrimination in matching contributions tested for separately pursuant to the Notice) and 410(b) (minimum coverage). There is a delayed effective date for compliance with the final regulations under section 401(a)(4) and related sections for governmental plans and plans maintained by tax-exempt organizations.

Under Notice 89-23, an employer must operate a 403(b) plan in accordance with a good faith, reasonable interpretation of these sections and their legislative histories. The safe harbors in the Notice are one means of satisfying the reasonable/good faith interpretation test. Employees described in Sections 6A(1) through (4) above may be excluded in testing under clause (i). In addition, employees who have not satisfied the age and service requirements under the plan

are excludable.

### C. Employer

"Employer" is generally defined for purposes of nondiscrimination under IRC 414(b) (controlled group of corporations), 414(c) (partnerships, proprietorships etc. which are commonly controlled), 414(m) (affiliated service groups) and 414(o). The nondiscrimination rules under clauses (i) and (ii) apply to all employers eligible to maintain a 403(b) plan except churches and qualified church-controlled organizations defined in IRC 3121(w)(3)(A) and (B). This definition differs from the definition of a religious organization in the regulations under IRC 501(c)(3) and 414(e).

## 7. Minimum Distribution Requirements

### A. Applicable Rules

TRA '86 added IRC 403(b)(10), which imposes minimum distribution requirements on 403(b) plans. These requirements relate to the latest date at which distributions of a minimal amount must commence.

Section 1.403(b)-2, Q&A-1(b) of the Proposed Income Tax Regulations ("proposed regulations") provides that in applying the minimum distribution rules, 403(b) plans generally are treated as individual retirement accounts or individual retirement annuities under IRC 408(a) and (b) of the Code ("IRAs"). The rules applicable to IRAs are generally the same as those applicable to qualified plans under IRC 401(a)(9) and sections 1.401(a)(9)-1 and -2 of the proposed regulations. Pending the issuance of final regulations, these proposed regulations may be relied on by taxpayers.

### B. Required Beginning Date

As with qualified plans, the required beginning date (the "RBD"), or the date at which distributions must minimally commence, with respect to pre-death distributions from a 403(b) plan, is April 1 of the calendar year immediately following the calendar year in which the participant attains age 70 1/2. For church and governmental plans, the RBD is the later of this date or April 1 following the calendar year of retirement. There is a special transitional rule for 403(b) plans for employees who attained age 70 1/2 prior to 1988. The RBD for these employees is April 1 of the calendar year following the calendar year in which the employee

retires.

### C. More Than One 403(b) Plan

The required minimum distribution must be calculated separately for each 403(b) plan. However, an employee who is a participant in more than one 403(b) plan may total the amounts required to be distributed from each and satisfy the minimum distribution requirement through distributions from one or more 403(b) plans. See Notice 88-38, 1988-1 C.B. 524.

### D. Bifurcated Account

If the issuer or custodian keeps the records necessary to identify the pre-1987 account balance and, if the plan so provides, the minimum distribution commencement requirements apply only to benefits that accrue after December 31, 1986, including the income on pre-1987 contributions. Prior law (generally requiring distributions by age 75) would apply to pre-1987 accruals. If records are not kept, the entire account balance is subject to the current minimum distribution rules.

### E. Excise Taxes

For years after December 31, 1988, the excise tax under IRC 4974 of the Code, for failure to make minimum distributions applies to 403(b) plans. The excess distributions tax under IRC 4980A also applies to 403(b) plans. In general, an excess distribution means the aggregate amount of the retirement distribution with respect to any individual during any calendar year to the extent such amount exceeds the greater of (1) \$150,000, or (2) \$112,500, adjusted for cost of living.

## 8. Early Distribution Restrictions

Certain IRC 403(b) amounts may be subject to restrictions on distributions. Note that the rules of IRC 403(b)(7) and (b)(11) relate to the earliest date at which distributions from a 403(b) plan may be made. Thus, a 403(b) plan may properly distribute amounts well after these events have occurred, as long as there is compliance with the minimum distribution rules.

### A. IRC 403(b)(7) Custodial Accounts

As indicated above, custodial accounts must satisfy certain restrictions on

distributions. Under IRC 403(b)(7)(A)(ii), a distribution from a custodial account may not be paid or made available to a distributee before the employee attains age 59-1/2, separates from service, dies, becomes disabled, or, in the case of salary reduction contributions, encounters financial hardship. If a distribution is made that violates these distribution restrictions (and/or the restrictions of the following paragraph) the plan will lose its IRC 403(b) status.

### B. Salary Reduction Contributions

Under IRC 403(b)(11), salary reduction contributions made to an IRC 403(b)(1) annuity contract may not be paid or made available to a distributee before the employee attains age 59 1/2, separates from service, dies, becomes disabled, or encounters financial hardship. IRC 403(b)(11) is effective for years beginning after December 31, 1988, with respect to any post-1988 contributions and earnings. Certain deemed distributions of defaulted loans under IRC 72(p) may also violate IRC 403(b)(11).

### C. Additional Income Tax Under Section 72(t) of the Code

Where early distributions are permissible and are made to a participant, then a ten percent tax applies to such premature distribution from a 403(b) plan. This tax is the same as that imposed on premature distributions from qualified plans. This tax does apply to early distributions of non-salary reduction contributions made to an IRC 403(b)(1) annuity contract.

## 9. Transfers and Rollovers

Funds may be moved by transfer or rollover from one 403(b) plan to another without being includible in gross income in the taxable year of the transfer or rollover.

### A. Transfers

Transfers of funds between 403(b) plans are not considered actual distributions under IRC 403(b)(1) of the Code, and consequently are not taxable transfers if the transferred funds continue to be subject to the same or more stringent distribution restrictions. Note, as discussed above, the statutorily imposed restrictions differ between IRC 403(b)(1) and 403(b)(7) arrangements, so transfers between these types of accounts may be difficult.

Funds from an IRC 403(b)(7) custodial account may be transferred tax free to another IRC 403(b)(7) custodial account, or to an IRC 403(b)(1) annuity contract if the transferred funds continue to be subject to the same or more stringent distribution restrictions. Note, as discussed above, the statutorily imposed restrictions of IRC 403(b)(1) and IRC 403(b)(7) differ between these types of plans, so transfers between these types of plans may be difficult.

The transfer may be made regardless of whether a complete or partial interest is transferred, the transfer is directed by the individual, or the individual is a current or former employee, or a beneficiary of a former employee. These transfers may be made without violating the nontransferability requirement under IRC 401(g). See Revenue Ruling 90-24, 1990-1 C.B. 97. Transfers are not reported on Form 1099-R.

## B. Rollovers

In a rollover from a 403(b) plan, an employee's interest in the 403(b) plan is distributed and reinvested in another arrangement. Under IRC 403(b)(8), distributions from a 403(b) plan are not currently includible in the employee's gross income if they are properly rolled over. The requirements for a proper rollover are that a portion of the balance to the credit of the distributee be paid to the employee in an eligible rollover distribution; the employee transfers any portion of the property received in the distribution to an IRA, or another IRC 403(b) investment (and not to a qualified plan); and, if property other than money is distributed, that the property transferred consist of the property distributed. A proper rollover is required to be completed within 60 days of the employee's receipt of the distribution. Distributions not properly rolled over are currently includible in the employee's gross income and may be subject to additional tax under IRC 72(t).

An "eligible rollover distribution" from a 403(b) plan is any distribution (including an in-service distribution) to an employee of all or a portion of the balance to the credit of the employee, not including required minimum distributions, periodic distributions, or distributions not otherwise includible in gross income (Note that prior to January 1, 1993, the rules as they pertained to rollover distributions were more restrictive).

Generally, beginning in 1993, a 403(b) plan must offer a direct rollover option. Unless made in the form of a direct rollover, all eligible rollover distributions are subject to 20 percent mandatory income tax withholding, even if

they subsequently are properly rolled over ( and thus excludable from gross income). A direct rollover is both exempt from withholding and excludable from gross income. A direct rollover is an eligible rollover distribution from a 403(b) plan that is paid directly from the 403(b) plan to an IRA or another 403(b) plan.

Except for state and local governments, 403(b) plans must be operated in compliance with the above rules for direct rollovers for distributions after 1992. A 403(b) plan need not be amended to comply with the direct rollover provisions until the end of the remedial amendment period. The remedial amendment period applicable to qualified plans may be used as a guide in this regard.