IRM 7.7.1
Employee Plans Examination Guidelines Handbook

Chapter 13
403(b) PLANS

13.1
Overview

(1) Guidance is provided on how to examine a plan described in Internal Revenue Code ' 403(b) (a "403(b) plan").

- 13.1 defines a 403(b) plan and provides a technical overview and historical background of 403(b) plans.
- 13.2 discusses the types of employers eligible to maintain a 403(b) plan.
- 13.3 describes the various funding vehicles for 403(b) plans.
- 13.4 addresses the requirements of salary reduction contributions.
- 13.5 addresses the contribution limits applicable to 403(b) plans.
- 13.6 discusses the applicable nondiscrimination rules.
- 13.7 - 9 address distributions from a 403(b) plan.
- 13.10 provides a list of possible defects in a 403(b) plan or annuity contract and resulting tax consequences.
- 13.11 is a glossary of terms.

(2) These guidelines address only employee plans issues and are intended to assist the employee plans specialist in examining a plan.

- Given the highly technical requirements of 403(b) plans, the agent may need to consult the Code and federal Income Tax Regulations for further development of a particular issue. Accordingly, cites are provided where appropriate.
- They are designed to help the examiner key in on the issues that should be raised in a particular plan. It is not expected that every issue raised in the guidelines will be relevant or should be raised in every examination.
- The techniques identified may be modified based on the actual examination issues encountered.

- Given the purpose of these guidelines, they cannot be, nor are they intended to be, a precedential or comprehensive statement of the legal position of the Service on the issues covered.

- They are not to be relied on or cited as authority by taxpayers.

- They are subject to change in accordance with future developments in the law.

13.1.1 **Technical Overview**

(1) Historical background and regulatory framework of 403(b) plans.

a. Section 403(b) was first added to the Code in 1958.

b. In 1964, pre-ERISA regulations were issued detailing some of the basic statutory provisions of § 403(b). These regulations were later amended as new provisions were added to § 403(b).

c. Final regulations were issued under § 415 in 1980.

d. In addition, there are recently issued proposed regulations pertaining to the minimum distribution requirements and final regulations regarding **direct rollovers**. (**Bold** font indicates the term or phrase is defined in the Glossary). Currently, there are no nondiscrimination regulations under § 403(b).

13.1.1.1 General Requirements

(1) Dating back to 1958, a 403(b) plan was less in the nature of a plan than an arrangement under which an employer purchased an individual **annuity contract** on behalf of an employee from an insurance company. With the enactment of the Tax Reform Act of 1986 ("TRA '86") and subsequent legislation, 403(b) plans became more like qualified retirement plans. For the first time, 403(b) plans or the **annuity contracts** thereunder must:

a. Comply with certain nondiscrimination and coverage rules (including §§ 401(a)(4), 401(m) and 410(b)),

b. Ensure that **elective deferrals** do not exceed the § 402(g) limit,

c. Conform to the minimum distribution rules of § 403(b)(10), and

d. Provide a participant with a meaningful opportunity to elect a **direct rollover** to another **eligible retirement plan**.

(2) 403(b) plans take a wide variety of forms. Even where a 403(b) plan takes the form of an arrangement rather than a plan, it is nevertheless subject to all of the requirements of § 403(b).

EXAMPLE 1: The employees of Public School District Y participate in a 403(b) plan ("Plan"). Employer's involvement in the Plan is strictly limited to providing a list of insurance carriers to employees and executing **salary reduction agreements**. The Plan is not described in a basic or summary plan description (SPD).

EXAMPLE 2: Employer is an organization described in § 501(c)(3) and exempt from tax under § 501(a). Employer maintains a 403(b) plan for its employees. The 403(b) plan consists of a lengthy plan document, and employees are informed of plan features through annual SPDs.

(3) A 403(b) plan is always subject to Title II (relating to the Code) but may not be subject to Title I, the Labor Title of ERISA.

EXAMPLE 3: Assume the same facts as in Example 1. While the Plan may not be an "employee benefit plan" under Department of Labor (DOL) Reg. § 2510.3-2(f), the Plan is nevertheless subject to Code requirements.

13.1.1.2 General Characteristics

(1) A 403(b) plan is a retirement plan under which a public school or an organization described under § 501(c)(3) and exempt from tax under § 501(a) purchases **annuity contracts** or contributes to **custodial accounts** for its employees. It also includes a **retirement income account** under which contributions are made by or on behalf of certain ministers. Section 403(b) plans are exempt from the requirements applicable to qualified annuity plans under § 403(a) and are governed by their own separate requirements under § 403(b). Section 403(b) plans are also known as:

- 403(b) arrangements
- tax-sheltered annuities
- tax-deferred annuities
- **annuity contracts**

NOTE: Throughout these Guidelines, the term "**annuity contracts**" encompasses **custodial accounts** and **retirement income accounts** unless otherwise specified.

(2) Contributions to a 403(b) plan may consist of

- **salary reduction,**
- **non-salary reduction,**
- after-tax employee contributions, or
- some combination of the above.

(3) In a salary reduction 403(b) plan, an employer gives participants a choice between receiving an amount in cash or having the employer contribute that amount to the 403(b) plan.

(4) Contributions made to a 403(b) plan are generally not includible for income tax purposes in participants' gross income until distributed, even if participants had the ability to receive the contributions as taxable wages in the year of the contributions.

(5) Earnings on contributions are also tax-deferred until distributed.

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

(7) Generally, participants are required to pay FICA tax on **salary reduction contributions** at the time of contribution. Although there is no deduction for the employer because it is exempt from income tax, the employer is responsible for FICA, and income and FICA tax withholding, if applicable. Keep in mind that certain governmental and church employers and employees may be exempt from FICA. See §§ 3121(b)(7) and (b)(8).

(8) The following examples illustrate that 403(b) plans may involve both employer and individual tax matters.

EXAMPLE 4: Hospital M maintains an annuity plan intended to be a 403(b) plan ("Plan"). The Plan provides for **non-salary reduction contributions** and is funded through **annuity contracts**. It is discovered on examination that the Plan is not a 403(b) plan, with the result that, for all open years under the statute: (i) the contributions made to the Plan are includible in the employees' gross income to the extent they are or become vested, (ii) the employees are responsible for FICA taxes, (iii) the employer may be responsible for income tax and FICA withholding, and (iv) Hospital M must pay FICA employment taxes.

EXAMPLE 5: The same facts as in Example 4, except that the Plan is a 403(b) plan and it provides both **non-salary reduction** and **salary reduction contributions.** The **salary reduction contributions** are subject to FICA tax at the time of contribution. Hospital M is generally responsible for FICA withholding, and FICA employment taxes.

13.1.1.3 Exclusion Allowance

(1) The **exclusion allowance** is integral to a 403(b) plan. The **exclusion allowance** permits contributions that would otherwise be includible in the employee's gross income to be made to a 403(b) plan on a pre-tax basis and, in addition, it establishes a maximum limit on such contributions.

a. The **exclusion allowance** is an allowance because it only applies to employer contributions (including **elective deferrals**) made to a plan which satisfies the requirements of § 403(b).

b. Because the **exclusion allowance** flows from the status of a plan as a 403(b), it is available only if all the requirements and conditions of eligibility under § 403(b) are satisfied.

(2) The **exclusion allowance** is a limit because only employer contributions (including **elective deferrals**) made to a 403(b) plan that are not in excess of the **exclusion allowance** (or the other contribution limits to the extent applicable) are excludable from gross income. See 13.5 for a detailed discussion of the **exclusion allowance**.

13.1.1.4 Aggregated Annuity Contracts

(1) All **annuity contracts** (including **custodial accounts** and **retirement income accounts**) purchased by an employer on behalf of an employee are treated as a single **annuity contract** for purposes of applying the requirements of § 403(b). See § 403(b)(5).

13.1.1.5 403(b) and Qualified Plans

(1) Although there are many similarities, 403(b) plans differ from qualified plans in some important respects.

a. Only certain types of tax-exempt employers, governments and ministers may contribute to a 403(b) plan.

b. Suitable **funding vehicles** for a 403(b) plan are limited to **annuity contracts** and **custodial accounts** (and **retirement income accounts** for churches).

c. The **exclusion allowance** is unique to 403(b) plans and is a further limit (in addition to modified §§ 415 and 402(g) limits) on contributions to a 403(b) plan.

d. **Salary reduction contributions** to a 403(b) plan are

subject to their own special nondiscrimination rules and not the average deferral percentage (ADP) test under ¸ 401(k)(3).

e. There is no special averaging for lump sum distributions from 403(b) plans.

f. A participant's interest in a 403(b) plan may not be rolled over to a qualified plan (except in limited instances with respect to an **annuity contract** purchased by an Indian tribal government, see 13.9).

(2) Unlike qualified plans, 403(b) plans are not subject to the requirement of a definite written program (although Title I requires a written plan document for certain 403(b) plans). Accordingly, there is no Title II requirement that a 403(b) plan operate in accordance with is terms. However, certain Code requirements must be reflected in the underlying **annuity contracts** or **custodial account** agreements. These include the:

a. nontransferability requirement for 403(b)(1) annuity contracts under ¸ 401(g)

b. direct rollover requirements under Reg. 1.403(b)-2, Q&A 4, (see 13.9)

c. 402(g) limit (see 13.5).

13.1.2 Correction Programs

(1) Three of the Service's correction programs apply to 403(b) plans. These include the:

! Administrative Policy Regarding Self-Correction (APRSC)

! Tax Sheltered Annuity Voluntary Correction (TVC) program

! Audit CAP for 403(b) Plans.

(2) These programs are set forth and described in the following revenue procedures (see also, IRM 7.9, Section 2, EPCRS):

! Rev. Proc. 99-13, 1999-5 I.R.B. 52
! Rev. Proc. 98-22, 1998-12 I.R.B. 11

13.1.2.1 APRSC

(1) APRSC is designed to further the Service's voluntary compliance initiatives by providing a self-correction procedure that applies to 403(b) plans. In general, under APRSC, an employer (either directly or through the insurer

or custodian) that has established compliance practices and procedures which are reasonably designed to facilitate overall plan compliance may correct Operational Failures (as defined in Section 3.05 of Rev. Proc. 99-13) in its 403(b) plan within two plan years following the plan year of the failure.

a. Eligible employers may also correct insignificant Operational Failures at any time.

b. APRSC permits correction of Operational Failures relating to contributions in excess of the limitation under ¤ 415 or the maximum **exclusion allowance** limit under ¤ 403(b)(2).

c. In general, APRSC is not available to correct significant Operational Failures if either the plan or the employer is Under Examination (within the meaning of Section 5.06 of Rev. Proc. 98-22).

(2) In examining a 403(b) plan, it is important to consider whether an employer has properly self-corrected an Operational Failure.

13.1.2.2
TVC

(1) Rev. Proc. 99-13 extended TVC indefinitely and transferred administration of the TVC Program to the Key District Offices (KDOs). The TVC Program generally allows an employer to correct any Operational, Demographic, or Eligibility Failure (as defined in Section 3 of Rev. Proc. 99-13) in its 403(b) plan that is within the jurisdiction of the EP/EO Division of the KDOs.

(2) Through TVC, an employer enters into a closing agreement with the Service which specifies the types of failures, the agreed method of correction, the applicable fee, and the effect the agreement has on potential tax liability of participants and the employer.

(3) TVC is not available if the plan or employer is Under Examination.

13.1.2.3
Audit CAP

(1) Audit CAP for 403(b) Plans is available to correct Operational, Demographic, or Eligibility Failures other than a failure that has been corrected under APRSC or TVC or is eligible for correction under APRSC. Under Audit CAP, an employer and the Service enter into a closing agreement specifying the form of correction and the sanction amount.

13.1.2.4
Effect of Correction under EPCRS; Reliance

(1) Although excise, FICA taxes, and FUTA taxes (and

corresponding withholding) are not waived under the agreement, the Service will not pursue the income tax liability of participants or income tax withholding obligations of the employer due to the failures covered by the closing agreement under TVC or Audit CAP, or failures properly corrected under APRSC. However, correction of failures may result in income tax and withholding for income tax (e.g., a distribution of **excess deferrals).**

(2) Excise taxes required to be filed on Form 5330, Return of Initial Excise Taxes Related to Pension and Profit-Sharing Plans, (other than those arising under ₰ 4974) should not be resolved as part of the closing agreement document under TVC or Audit CAP for 403(b) Plans.

(3) In general, excise tax issues should be resolved by securing a Form 5330 providing for 100% of the tax and interest outstanding (although recommendation to the Service Center to waive the failure to file and/or failure to pay penalty under ₰ 6551 is at the discretion of the EP specialist).

13.1.3
403(b) Filing Requirements

(1) With some exceptions, 403(b) plans are required to file the Form 5500, "Annual Return/Report of Employee Benefit Plan". The following types of plan are exempt from filing (see instructions to Form 5500):

- governmental plans
- church plans and
- 403(b) plans that are not "employee benefit plans" under Title I of ERISA

(2) In general, 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. See DOL Reg. 2510.3-2(f).

13.1.4 Examination Steps

(1) Request all documents pertaining to the 403(b) plan, including, to the extent applicable:

a. the determination of tax exemption,
b. basic plan document and amendments thereto,
c. SPDs,
d. **annuity contracts**,
e. **custodial account** agreements,
f. **salary reduction agreements**,
g. employment contracts and
h. other communications with employees.

Note: The plan may not have nor does the Code require it to have a basic plan document. However, faulty plan language may indicate operational defects.

(2) Regarding APRSC, verify that the method of correction was appropriate and timely.

(3) If the employer has a closing agreement through TVC:

a. verify that the employer complied with the terms of the agreement and that correction was properly and timely completed. Because TVC does not cover the accuracy of specific numbers, verify their accuracy.
b. check to see if there are any failures that fall outside of the scope of the agreement.

13.2 ELIGIBILITY

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

a. employer is eligible to maintain a 403(b) plan for participating employees,

b. participants in a 403(b) plan perform services for the employer as employees, and

c. minister is one described in ∋ 414(e)(5)(A).

13.2.1 Eligible Employers

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

a. A State, a political subdivision of a State, or an agency or instrumentality of any one or more of these for employees who perform services for a public education organization described in ∋ 170(b)(1)(A)(ii);

b. A non-profit organization described in ∋ 501(c)(3) and exempt from federal income tax under ∋ 501(a), or an organization treated as described in ∋ 501(c)(3);

c. A grandfathered Indian tribal government; and

d. Beginning in years after December 31, 1996, a minister described in ∋ 414(e)(5)(A).

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

a. If an employer maintains an annuity plan and is not eligible, the plan is not a 403(b) plan and the exclusion allowance is inapplicable. For resulting tax consequences, see §§ 403(c) and 72.

b. An ineligible employer may enter into a closing agreement with the Service pursuant to Rev. Proc. 99-13.

c. Situations in which an employer's eligibility varies among taxable years are discussed in 13.5 (text V.C. below).

13.2.1.1
Public Education
Organizations

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

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

a. public schools
b. state colleges
c. universities

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

EXAMPLE 6: Public High School Y maintains a 403(b) plan ("Plan") for its employees. Employee A performs timekeeping and payroll services for High School Y. A may participate in the Plan because A performs services for a public educational organization. See Rev. Rul. 72-390, 1972-2 C.B. 227.

EXAMPLE 7: A, a state employee, provides "in-home" teaching services. A may be covered by a 403(b) plan maintained by A's employer because A performs services for a public educational organization.

13.2.1.2
Organizations
Described in
§ 501(c)(3)

(1) Another type of eligible employer is an organization

described in ə 501(c)(3) and exempt from federal income tax under ə 501(a) ("501(c)(3) organization"). A 501(c)(3) organization is defined generally as one organized and operated exclusively for the following purposes:

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

(2) These organizations include:

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

(3) In order to be recognized as a 501(c)(3) organization, all organizations except church and related organizations, and other organizations excepted under ə 508, must apply to the Service for a determination letter by filing Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code". See Publication 557, Tax-Exempt Status of Your Organization; and also IRM 7.8.1, Exempt Organizations Examination Guidelines Handbook, Chapter 3.

13.2.1.3
Grandfathered Indian Tribe

(1) An Indian tribal government is treated as a State for purposes of ə 403(b), so an educational organization or a 501(c)(3) organization associated with a tribal government is always eligible to maintain a 403(b).

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

13.2.1.4
ə 414(e)(5)(A) Minister

(1) A self-employed minister may deduct, within the limits of ə 404(a)(10), contributions to a **retirement income**

account described in ∋ 403(b)(9).

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

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

13.2.2 Eligible Employees

(1) A 403(b) plan can only cover the employees of an eligible employer (with the exception of ministers described in ∋ 414(e)(5)(A)).

(2) Employee status under ∋ 403(b) is generally determined by employee status for federal employment tax purposes under common law principles. Whether an individual is a common law employee or independent contractor is most likely to arise with professionals such as physicians. See the 20 steps for determining employee status in Rev. Rul. 87-41, 1987-1 C.B. 296.

(3) Contributions made on behalf of an individual who is not an employee does not mean the plan is not a 403(b), but the **exclusion allowance** is not available for the individual.

13.2.3 Examination Steps

(1) Because the issue of the employer's eligibility is so basic it is easy to overlook. Check to see whether the employer:

a. is a public educational organization,
b. has ∋ 501(c)(3) status, or
c. has a closing agreement with the Service covering the employer's ineligibility.

(2) Be sure to consider the employer's relationship to the participating employees. If the employer is not eligible, consider a closing agreement under Audit CAP for 403(b) Plans as provided in Rev. Proc. 99-13.

(3) If the examination is conducted in connection with an Exempt Organizations audit, a loss of 501(c)(3) status will automatically cause the plan to fail the requirements of ∋ 403(b) for any plan year during which the employer was not eligible. Again, consider a closing agreement under Rev. Proc. 99-13.

(4) If the examination is not initiated by Exempt Organizations, you may want to request their assistance on the issue of employer eligibility.

13.3 FUNDING VEHICLES

(1) Amounts contributed to a 403(b) plan may be invested only in certain **funding vehicles**. **Funding vehicles** refer to the type of investment arrangement for the assets of a 403(b) plan.

(2) The **funding vehicles** for 403(b) plans are generally limited to--

a. **annuity contracts**,
b. **custodial accounts** for regulated investment company stock,
c. **retirement income accounts** for churches, or
d. any combination of these.

(3) **Custodial accounts** and **retirement income accounts** are treated as **annuity contracts** for purposes of the Code. Thus, **custodial accounts** and **retirement income accounts** are generally subject to the rules applicable to 403(b) **annuity contracts** (in addition to their own special requirements). **Custodial** and **retirement income accounts** must satisfy the--

a. contribution limits (including §§ 415 and 402(g)),
b. nondiscrimination (except those maintained by § 3121(w)(3) churches),
c. minimum distribution, and
d. **direct rollover** rules.

13.3.1 Annuity Contracts

(1) The most common type of **funding vehicle** for a 403(b) plan is an **annuity contract** under § 403(b)(1).

a. The **annuity contract** may be offered only by an insurance company.

b. The contract may be owned by the individual, or, in the case of a group **annuity contract**, by the employer.

c. The annuity may be either variable or guaranteed.

d. An **annuity contract** may contain a vesting schedule for **non-salary reduction contributions**, but the vesting schedule must comply with Title I, the Labor Title of ERISA, if applicable. However, the **exclusion allowance** is available only to **vested amounts** contributed during a taxable year or any amounts which become vested in the taxable year. See 13.5.

(2) Regulations extend the non-transferability requirement of § 401(g) to 403(b) **annuity contracts**. Thus, a 403(b)

annuity contract must provide that it is nontransferable. This means that the contract cannot be sold, assigned, or pledged as security for collateral.

a. 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 under certain conditions.

b. Salary reduction contributions to an **annuity contract** and their earnings are subject to certain early distribution restrictions to ensure that they are used for retirement purposes. See §§ 403(b)(7) and (b)(11).

c. **Excess contributions** to an **annuity contract** are not subject to the excise tax under § 4973. See 13.5 and 13.8.

(3) An **annuity contract** may provide life insurance protection as long as the death benefit is "merely incidental" to the primary purpose of providing retirement benefits. The rules for determining whether life insurance is incidental in qualified plans apply also to 403(b) plans.

a. Life insurance is incidental if less than 50% of total employer contributions made on behalf of a participant are used to purchase an ordinary life insurance contract, or in the case of term or universal life insurance, no more than 25% of total contributions are used to purchase the life insurance contract.

b. As in 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.

c. 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 Rev. Rul. 60-84, 1960-1 C.B. 159; Rev. Rul. 66-143, 1966-1 C.B. 79; and Rev. Rul. 68-31, 1968-1 C.B. 151.

(4) If a plan is structured so that contributions are placed in an employer's savings account to purchase **annuity contracts** for employees at retirement, the plan is not a 403(b) plan. See Rev. Rul. 68-487, 1968-2 C.B. 187, and Rev. Rul. 68-488, 1968-2 C.B. 188.

EXAMPLE 8: Foundation, a 501(c)(3) organization, maintains an annuity plan intended to be a 403(b) plan ("Plan"). Foundation makes both **salary reduction** and **non-salary**

reduction contributions to individual investment accounts (not mutual funds) for each of its employees. Foundation purchases **annuity contracts** for employees at their retirement. The arrangement is not a 403(b) plan.

EXAMPLE 9: Employer is a public education organization maintaining a plan intended to be a 403(b) plan ("Plan"). All contributions under the Plan are invested in life insurance policies for its employees. Because life insurance must be incidental to the primary purpose of providing retirement benefits, the Plan is not a 403(b) plan.

13.3.2 Custodial Accounts

(1) A **custodial account** under ∋ 403(b)(7) is treated as an **annuity contract** and must satisfy the various requirements of ∋ 403(b). In addition,

a. the assets of a **custodial account** must be held by a bank or an approved non-bank trustee or custodian under ∋ 401(f).

b. the assets must be invested exclusively in regulated investment company stock (e.g., mutual funds) and consequently, a **custodial account** may not provide life insurance.

c. a **custodial account** may permit loans to participants.

(2) Both **salary** and **non-salary reduction contributions** to a **custodial account** are subject to certain early distribution restrictions.

(3) Unlike contributions to **annuity contracts**, **excess contributions** to a **custodial account** are subject to the excise tax under ∋ 4973. See 13.5.3.

13.3.3 Retirement Income Accounts

(1) A **retirement income account** is defined under ∋ 403(b)(9) as a defined contribution program established and maintained by a church or related organization.

(2) A **retirement income account** may take the form of a defined benefit plan if it is grandfathered. A defined benefit plan which is established by a church or a convention or association of churches and is in effect on August 13, 1982, is not treated as failing to satisfy the requirements of ∋ 403(b) merely because it is a defined benefit arrangement.

(3) **Retirement income accounts** are generally subject to

the rules and requirements for **annuity contracts**.

(4) The **funding vehicles** for these accounts are varied, and include **annuity contracts** and **custodial accounts**.

13.4 SALARY REDUCTION CONTRIBUTIONS

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

(2) **Salary reduction contributions** under a 403(b) plan are also subject to specific requirements such as annual contribution limits, nondiscrimination rules, and withdrawal restrictions. These requirements are discussed in 13.5, 13.6, and 13.7.

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

a. often referred to as **elective deferrals** because they overlap with the definition of **elective deferrals** under ∋ 402(g). See 13.5.

b. made pursuant to a **salary reduction agreement**.

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

a. frequency that an employee is permitted to enter into or modify a **salary reduction agreement**,

b. compensation to which an agreement may apply, and

c. ability to revoke the agreement.

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

Special Note: Under prior law, employees were limited to one **salary reduction agreement** per taxable year and the agreement could only apply to amounts not yet earned at the effective date of the agreement.

(6) To qualify for the **exclusion allowance** under ə 403(b), the **salary reduction contributions** must be in the nature of compensation (rather than, for example, severance pay) paid by the employer to the employee.

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

13.4.1
Examination Step

(1) Check sample salary reduction election forms to determine whether the agreement applies to amounts not yet currently available to the employee at the time the agreement is effective.

13.5 CONTRIBUTION LIMITS

(1) There are three separate yet interrelated limitations on the amount of contributions to a 403(b) plan which are excludable from gross income. These limitations are found in:

- ə 402(g)
- ə 415
- ə 403(b)(2)

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

a. $9,500 for years prior to 1998
b. $10,000 for 1998.

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

(4) Section 415 places an overall limit on the amount of **elective** and **non-elective contributions** that may be made annually on an employee's behalf to a 403(b) plan during a single **limitation year**. Section 415 imposes a limit of the lesser of $30,000 or 25% of compensation on the maximum amount that may be contributed to a 403(b) plan for the year.

(5) The **exclusion allowance** under § 403(b)(2) is a cumulative limit which applies to both **elective** and **non-elective contributions**. Because employees of tax-exempt organizations typically have lower pay, especially early in their careers, the cumulative formula permits employees to make up retirement savings in later years. The limitations under §§ 402(g) and 415 are designed to coordinate with the cumulative formula of the **exclusion allowance**.

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

13.5.1 § 402(g) Limit on Elective Deferrals

(1) For plan years beginning after December 31, 1987, **elective deferrals** under a 403(b) plan are subject to the limitation under § 402(g).

a. In the absence of the special catch-up election discussed below, the maximum amount of **elective deferrals** that may be deferred under a 403(b) plan is $9,500 through 1997.

b. Beginning in 1998, the maximum amount is the $7,000 limit under § 402(g)(1) as indexed for COLAs (indexed to $10,000 for 1998 and 1999).

(2) For purposes of § 403(b), an **elective contribution** is any contribution that arises because of an employee's election between current cash compensation or deferral under the plan.

(3) An **elective deferral** is any **elective contribution** by a participant made to the following types of plans:

a. qualified CODA
b. salary reduction simplified employee pension plan ("SARSEP")
c. 501(c)(18) plan
d. 403(b) plan
e. simple retirement account.

(4) **Elective deferrals** are subject to FICA.

(5) **Elective deferrals** under a 403(b) plan are employer

contributions which are used to purchase an **annuity contract** (or made to a **custodial account**) under a **salary reduction agreement**.

(6) There are two limits restricting the amount of elective deferrals that may be made on behalf of a participant:

a. a participant limit under ə 402(g) and
b. a contract limit under ə 403(b)(1)(E). The contract limit has two components, a form and an operational requirement.

(7) The ə 402(g) participant limit applies to all the **elective deferrals** made on behalf of a participant.

Example 10: An employee participating in two salary reduction 403(b) plans with separate employers must count the **elective deferrals** made under both plans in applying the limit. If this employee also participated in a CODA under ə 401(k), or a simple retirement account under ə 408(p), these **elective deferrals** would also be counted. See ə 402(g)(3).

(8) The contract requirement under ə 403(b)(1)(E) applies only to limit **elective deferrals** (as defined in (3) above made on behalf of employees by a single employer. See 13.5.1.3.

Note: **Elective deferrals** to a 403(b) plan reduce the $7,500 deferral amount under əə 457(b) and 457(c)(2) (indexed to $8,000 for 1998 under ə 457(e)(15)), and may reduce the amount that can be deferred under ə 403(b).

(9) The effect of ə 457(c)(2) is that an individual who defers compensation in both an eligible section 457 plan ("457 plan") and in a 403(b) plan is limited to a total combined deferral of $8,000 annually (for 1998) if the individual is to enjoy tax deferral on the combined amounts.

a. If the combined deferral exceeds this amount, the amounts are treated as excesses in the eligible 457 plan and are taxable currently under ə 457.

b. However, an individual who, although eligible, does not defer any compensation under the 457 plan in any given year is not subject to the $8,000 annual limit of ə 457(c)(2). Such an individual can defer the full $10,000 under the 403(b) plan in 1998. The coordination limitation applies to plans of all employers rather than to each employer.

EXAMPLE 11: X participates in both an eligible 457 plan and a 403(b) plan maintained by two separate employers, respectively. X defers the maximum amount of $8,000 under the 457 plan and $2,000 under the 403(b) plan in 1998, for a total of $10,000. X will have an **excess deferral** of $2,000 under the 457 plan because of ϶ 457(c)(2). The $2,000 deferred under the 403(b) plan will be applied first against the $8,000 limit of ϶ 457, and the amount deferred under the 457 plan, $8,000, will then be applied and will exceed the $8,000 limit by $2,000.

13.5.1.1 One-Time Irrevocable Election

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

a. initial eligibility to participate in the **salary reduction agreement**, or

b. pursuant to certain other one-time irrevocable elections to be specified in regulations, or

c. pre-tax contributions made as a condition of employment.

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

EXAMPLE 12: X participates in a 403(b) plan ("Plan"). In order to receive employer contributions under the Plan, X is required to elect to defer 3% of salary in the form of "Mandatory Contributions." X has the option of revoking this election at any time, although X never terminates his election. The Mandatory Contributions are **elective deferrals** because X's election is revocable. These contributions are therefore included in applying the ϶ 402(g) limit. They are also subject to FICA (if applicable).

EXAMPLE 13: Assume the same facts as in Example 12, except that the Plan further provides that an election to terminate participation in the Plan is irrevocable. Thus, an employee who terminates his election will be permanently excluded from participating in the Plan. Even so, since the election to participate is revocable, the Mandatory Contributions are **elective deferrals** under ϶ 402(g). The contributions are subject to FICA (if applicable).

Note: Example 13 points out that if an employee may terminate his election to participate in a plan, the election is not considered to be irrevocable. "Irrevocability" relates to the election to participate rather than an election to terminate participation in a plan.

13.5.1.2 Catch-Up Election

(1) Section 402(g)(8) provides a special election for certain long-term employees. Under the rule, they may "catch up" on the funding of their retirement benefit by increasing their **elective deferrals** over the $10,000 (for 1998) limit.

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

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

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

a. $3,000,

b. $15,000 minus any **elective deferrals** made by the organization and previously excluded under the catch-up election, or

c. $5,000 times the employee's **years of service** minus the **elective deferrals** made to plans of the organization in prior taxable years.

(4) As can be seen from this election, there is a limit on increases under the election of $15,000, and the annual limit cannot exceed $13,000 for 1998. The catch-up applies to **elective deferrals** made by the **qualified organization** on behalf of the employee. In theory, an employee who has 15 **years of service** with another **qualified organization** could use the full amount of the catch up election with respect to the new organization.

13.5.1.3 Contract Limit

(1) As indicated in 13.5.1.2, § 402(g) limits all **elective deferrals** of a participant, even if the **elective deferrals** are made with respect to plans of separate employers. Section 403(b)(1)(E) imposes a contract requirement which limits the amount of **elective deferrals** under **annuity**

contracts purchased by a single employer. A failure to satisfy this requirement results in the loss of 403(b) status of the **annuity contracts**.

13.5.1.3.1
Contract Terms

(1) Under ∋ 403(b)(1)(E), a contract purchased by an employer must comply with the requirements of ∋ 401(a)(30). (2) Section 401(a)(30) requires a qualified plan to provide that the amount of **elective deferrals** under plans of the employer not exceed the limit under ∋ 402(g). Thus, in order to be a valid contract under ∋ 403(b), the contract by its terms must preclude the making of **excess deferrals**.

(3) Section 403(b) contracts must be amended to reflect the 402(g) limit no later than the first day of the first plan year beginning on or after January 1, 1998. See the Small Business Job Protection Act of 1996, Pub. L. 104-188, sec. 1450(c)(1), and sec. 1465; and Rev. Proc. 97-41.

13.5.1.3.2
Operational Requirement

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

a. Under Reg. 1.402(g)-1(e), a contract may avoid the loss of 403(b) status by distributing the **excess deferrals** plus the earnings thereon by April 15 of the following taxable year, if the contract so permits.

b. The distribution may be made notwithstanding any other provision of law.

c. The portion of the distribution attributable to **excess deferrals** is taxable in the year of contribution, while the earnings are taxable in the year of receipt. The issuer must file a Form 1099 indicating the distribution.

(2) If a contract loses its status as a 403(b) because of 13.5.1.3.1 or paragrah (1) above, the **exclusion allowance** is not available with respect to the affected **annuity contracts** (or **custodial accounts**) beginning with the taxable year of the violation. Thus, all amounts contributed to the affected **annuity contract** or contracts beginning with the year of the violation are includible in gross income.

a. The **excess deferrals** are taxable again on distribution.

b. The employer is responsible for applicable employment

taxes and income tax withholding.

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

EXAMPLE 14: Association, a 501(c)(3) organization, maintains a 403(b) plan ("Plan") with a calendar plan year. In 1998, each of Association's highly compensated employees ("HCEs") elects to make contributions of $30,000 on the mistaken assumption that the contributions are not **elective deferrals** limited by ֏ 402(g). The **excess deferrals** of $20,000 ($30,000 - $10,000) are not timely corrected. All contributions made to the affected **annuity contracts** in 1998 are includible in the employees' gross income for taxable year 1998 and are subject to FICA. In addition, Association is responsible for employment taxes and withholding. The **excess deferrals** are taxable again on distribution.

EXAMPLE 15: The same facts as Example 14, except that $15,000 of the $30,000 contributed to the Plan in 1998 consists of **non-elective contributions**. Even though only one-half of the contributions are elective, they are still in excess of the ֏ 402(g) limit for the year, and thus all contributions made to the affected **annuity contracts** are includible in gross income for tax year 1998.

13.5.1.4 Examination Steps

(1) The first step is to identify the **elective deferrals** under the plan(s) of the employer. Consider all contributions made to the plan(s).

(2) In determining whether contributions are **elective deferrals**, examine the substance of the arrangement. Do not be misled by the labels an employer attaches to the contributions, such as "employer," "employee", or "mandatory" contributions.

(3) In determining whether deferrals are elective or non-elective, you may want to consider the following, if applicable:

a. The operation of the plan - have any participants revoked their elections?

b. Employment contracts - is participation in the plan a condition of employment? If so, the contributions are not **elective deferrals**.

c. All plan documents, including SPDs, **funding vehicles**,

and any memoranda or other communications to employees, if any.

(4) In certain cases, it may be appropriate to check for any inconsistencies in the various documents.

(5) If there are **elective deferrals** under the plan, see if the underlying **annuity contracts** (including **custodial account agreements**) specifically limit **elective deferrals**. Also check for **excess deferrals** by requesting annual contributions records and/or salary reduction agreements.

(6) If the employer has another plan covering the same employees (including a 403(b) plan with **elective deferrals**, a section 457 plan, or qualified CODA), make sure that the combined amount of **elective deferrals** are within the 402(g) limit and the 457(c)(2) coordinated limit.

(7) Check to see if the **elective deferrals** were reported on the Form W-2, and on Form 1099-R if distributed.

(8) If a participant had **excess deferrals**, determine whether the excesses were timely and properly corrected.

13.5.2 Section 415 Limit

(1) Section 415 limits on contributions (hereinafter referred to as 415 limits or 415 contribution limits) that apply to qualified plans also generally apply to 403(b) plans. A 403(b) plan is treated as a defined contribution plan for purposes of the 415 contribution limits. Consequently, in the absence of a special election, contributions to a 403(b) plan (including **salary reduction contributions** and after-tax employee contributions) may not exceed the lesser of 25% of **compensation** or $30,000 in the **limitation year** (although ¸ 402(g) further limits **elective deferrals** to $10,000, as indexed for 1998).

a. Unlike the **exclusion allowance**, the 415 limit applies to contributions made to a 403(b) plan with respect to the **limitation year** regardless of whether they are vested.

(2) For **limitation years** beginning before January 1, 2000, the combined limit under ¸ 415(e) also applies if the 403(b) plan is aggregated with a defined benefit plan of an employer.

NOTE: For **limitation years** beginning after December 31, 1999, ¸ 415(e) is repealed (but see 13.5.3, **Exclusion Allowance).**

13.5.2.1
Special "Catch-Up"

Elections

(1) Partly to reflect the cumulative nature of the **exclusion allowance**, there are also special "catch-up" elections under ¤ 415(c)(4) that are unique to 403(b) plans. As with the special election under ¤ 402(g)(8), only an employee of one of the following types of entities are eligible to make a special election (although the employee need not be long term):

- education organization
- hospital
- home health service agency
- health and welfare service agency
- church or a related organization

(2) A special election is made by filing the individual's income tax return in a manner consistent with the election.

(3) Once made, the election is irrevocable. This means that no other special election may be made for any future year with the same employer (or an employer that is aggregated under ¤ 415), although a participant may always rely on the general rule. See Reg. 1.415-6(e).

Note: Even when a special election is made, contributions may never exceed $30,000 (as indexed under ¤ 415(d)) with respect to a single **limitation year**.

(4) Each catch-up election has its own limits. The respective limits under these elections are described under the following subsections.

13.5.2.1.1
(A) Election Limitation(1)

The "(A) Election Limitation," under which an employee separating from service may use the full **exclusion allowance** up to a maximum of $30,000 in the year of separation without regard to the 25% limitation. For this purpose, the **exclusion allowance** must take into account only the 10 years of service (as defined in ¤ 403(b)(2)) ending with the separation from service. See ¤ 415(c)(4)(A).

13.5.2.1.2
(B) Election Limitation(1)

The "(B) Election Limitation," under which an employee may defer the smallest of:

a. $4,000 plus 25% of **includible compensation**),

b. the amount of the **exclusion allowance**, or

c. $15,000. This limit in effect replaces the 25% limit up to a maximum of $15,000. See ¤ 415(c)(4)(B).

13.5.2.1.3 (C) Election Limitation

(1) The "(C) Election Limitation," under which an employee may elect to use the 415 limit rather than the **exclusion allowance**. See § 415(c)(4)(C).

13.5.2.1.4 Alternative Limitations

(1) There are also alternative limitations under § 415(c)(7) that are available in the case of employees of a church or related organization.

a. Such employees may elect to substitute the § 415 limit with an annual limit of $10,000 (even if more than 25% of compensation) up to a total lifetime limit of $40,000.

b. Alternatively, church employees may elect to use the minimum **exclusion allowance** under § 403(b)(2)(D).

(2) Even if the limitation under §§ 403(b)(2) and 415 is $30,000, § 402(g) further limits **elective deferrals** to $10,000 as indexed for 1999 (or a maximum of $10,000 as indexed plus $3,000 if the catch-up limit applies). The § 402(g) limit must always be considered in examining a 403(b) plan with **elective deferrals**.

(3) The following example illustrates that even where a special election is made under § 415, § 402(g) still limits the maximum amount of contributions that are elective deferrals.

EXAMPLE 16: A public school district contributes $30,000 to a 403(b) plan on behalf of one of its teachers for the 1998 **limitation year**, the year of the teacher's separation from service. The entire contribution is made pursuant to a valid revocable **salary reduction agreement**. The teacher has not previously made a special election under § 415 and properly elects the special "(A) Election Limitation." The entire $30,000 is within the **exclusion allowance** (which takes into account only the last 10 years). Nevertheless, because the contributions are **elective deferrals**, the maximum amount that may be contributed on an excludable basis is $10,000 or, if the special election under § 402(g)(8) is made, $13,000.

13.5.2.2 Plan Aggregation

(1) Under § 415, a participant generally is considered to exclusively control and maintain his own 403(b) plan. Consequently, contributions to a 403(b) plan are not combined or aggregated with contributions to a qualified

plan except when a participant elects the "(C) Election Limitation" (to substitute the 415 limit for the **exclusion allowance**), or controls any employer. In these situations, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.

(2) If a participant makes the "(C) election," any contributions made on the participant's behalf 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 403(b) plan for purposes of applying the limits under ¤ 415(c)(1), and ¤ 415(e) if applicable.

(3) Similarly, where a participant controls any employer (this may be the employer contributing to the 403(b) plan or another employer) for a **limitation year**, the contributions to the 403(b) are combined with contributions to a qualified plan by the controlled employer or any affiliated employer under ¤ 415. See Regs. ¤¤ 1.415-7(h) and 1.415-8(d).

(4) The following example illustrates that an employee who is covered by a pension plan of the employer may also participate in a 403(b) plan through the employer without having to aggregate the plans under ¤ 415. Thus, the employer could contribute non-salary reduction contributions of up to $30,000 to the 403(b) even though the employee has contributions under the qualified plan which are at the ¤ 415 maximum.

EXAMPLE 17: Employee A is employed by a hospital which is a 501(c)(3) organization. The hospital contributes to a 403(b) plan on behalf of A in the **limitation year**, and A is also a participant in the hospital's defined contribution plan. A does not elect the "(C) Election Limitation" and is not in control of the hospital. Because A and not the hospital is considered to have exclusive control of the contract, the plans are not aggregated.

EXAMPLE 18: The facts are the same as in Example 17, except that A makes the "(C) election" for the **limitation year**. The 403(b) and qualified defined contribution plans are aggregated for purposes of applying the limit under ¤ 415(c).

EXAMPLE 19: The facts are the same as in Example 17, except that A is a physician maintaining a private practice in which he is more than a 50% owner. A is a participant in a defined contribution plan maintained by his private practice. The defined contribution plan of A's private practice must be combined with A's 403(b) plan for purposes of applying the limit under ¤ 415(c) because A controls his private practice.

13.5.2.3
Limitation
Year

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

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

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

13.5.2.4
Compensation

(1) The definition of **compensation** under ¬ 415 for 403(b) plans is similar to the definition for qualified plans.

(2) **Compensation** under ¬ 415 for 403(b) plans is also similar to **includible compensation** under ¬ 403(b)(2) except that the period for computing ¬ 415 **compensation** is the **limitation year** (rather than the most recent one-year period of service). See 13.5.3, **Exclusion Allowance**.

(3) In addition, **includible compensation** is computed for each employer, whereas **compensation** from a controlled employer maintaining a qualified plan may be aggregated with **compensation** from the employer contributing to the 403(b) plan. See 13.5.3.

(4) For years beginning after December 31, 1997, **compensation** includes any **elective deferral** made to a qualified CODA, SARSEP, 501(c)(18) plan, 403(b) plan, or simple retirement account, or any amount contributed by the employer at the election of the employee and which is excludable from gross income under ¬ 125 or 457.

13.5.2.5
Effect of
Contributions in
Excess of ¬ 415
Limit

(1) Contributions to a 403(b) plan in excess of the ¬ 415 limit have two effects:

a. the excess is includible in the employee's gross income for the tax year ending with or within the **limitation year**, and

b. the excess reduces the available **exclusion allowance** in future years.

(2) The latter (b.) is accomplished by treating the excess ¬ 415 amounts ("415 amounts") as **amounts previously**

excludable (see 13.5.3) even though they were includible in gross income. Excess 415 amounts do not cause the plan or **annuity contract** to lose its 403(b) status. See § 415(a)(2).

EXAMPLE 20: Foundation is a 501(c)(3) organization which maintains a 403(b) plan ("Plan") for its employees. The gross annual **compensation** of each of the HCEs equals $160,000. Contributions to the Plan on behalf of each of the HCEs equal $37,500 (all are **non-salary reduction**) in **limitation year** ending December 31, 1998, $7,500 above the allowable 415 limit. The $7,500 excess is includible in the HCEs' gross income for the 1998 taxable year. In addition, beginning in 1999, the $7,500 excess reduces the HCEs' available **exclusion allowances** by increasing **amounts previously excludable.**

Note: **Compensation** in Example 20 is limited to $160,000, the § 401(a)(17) cap on annual **compensation** (as indexed for 1998) that may be considered for contributions to a plan and for nondiscrimination testing. See 13.6.

EXAMPLE 21: Employee A participates in a 403(b) plan ("Plan"). A's **compensation** is $45,000. A has two full years of service with Charity as of December 31, 1998, the end of the **limitation year**. In 1997, Charity started making **non-salary reduction contributions** on A's behalf to the Plan. Charity contributed $12,000 in 1997 and $12,000 in 1998 on A's behalf. A's 415 limit for 1997 (and 1998) equals 25% x **compensation** or .25 x $45,000, which equals $11,250. The excess 415 amounts are $750 in 1997 and $750 in 1998. A's **exclusion allowance** in 1997 and 1998 is computed as follows:

a. A's **exclusion allowance** for 1997 is $9,000, calculated as follows:

   20% x **includible compensation** x **years of service**, minus **amounts previously excludable**
   (.2 x $45,000 x 1) - 0 = $9,000

b. A's **exclusion allowance** for 1998 is $8,250, calculated as follows:

   (.2 x $45,000 x 2) - ($9,000 + $750)
$18,000 - 9,750 = $8,250.

Of the $12,000 contributed in 1997, only $9,000 is excludable. The other $3,000 is includible in gross income in 1997. $750 of the $3,000 is in excess of the 415 limit. Because of the 1997 excess 415 amounts, A's 1998 **exclusion allowance** is reduced from $9,000 to $8,250. $3,750 of the $12,000 contribution is therefore includible in A's gross income for 1998.

Note: The excess amounts in 1997 and 1998 are not added to **includible compensation** even though they are in fact includible in gross income.

13.5.2.6
Correction (1) Like qualified plans, excess 415 amounts in 403(b) plans may be corrected under Reg. 1.415-6(b)(6) to the extent the excess amounts are due to one of the following:

a. the allocation of forfeitures,

b. a reasonable error in estimating a participant's compensation,

c. a reasonable error in determining total **elective deferrals,** or

d. in certain other limited facts and circumstances as determined by the Commissioner. See Rev. Proc. 92-93, 1992-2 C.B. 505.

(2) In the absence of such correction, excess 415 amounts are currently includible in gross income and reduce the participant's future **exclusion allowances.**

EXAMPLE 22: Employer maintains a 403(b) plan ("Plan") under which it contributes excess 415 amounts to a **custodial account** on Participant A's behalf in **limitation year** 1998. To the extent the excess amounts are not properly corrected, the excess amounts are includible in A's gross income in 1998 and reduce Participant A's **exclusion allowance** in future years (by treating these amounts as **amounts previously excludable**). See also 13.5.4, regarding the ֏ 4973 excise tax.

13.5.2.7
Examination
Steps (1) Check the annual contributions to the 403(b) plan. If the amount deferred for any employee exceeds $30,000, there may be excess 415 amounts.

(2) Determine whether a participant in the 403(b) has his or her own practice (such as a medical clinic or consulting firm) which maintains a Keogh plan. Contributions under the qualified plan may have to be aggregated with 403(b) contributions.

(3) Check plan documents, including the basic plan document and SPDs, as well as the **funding vehicles**, to determine whether contributions are properly limited by ֏ 415. Plan language is not required, however, faulty plan language may indicate an operational defect.

(4) If the employer has more than one 403(b) plan, see how the plans interrelate. If the employer also has a

qualified plan, check to see if combined contributions are within the 415 limit for participants who elected the "C Election Limitation."

(5) For further details on the contribution limits, see Publication 571, Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.

13.5.3 Exclusion Allowance

(1) The **exclusion allowance** is an amount that may be contributed to a 403(b) plan on a pre-tax basis under ¤ 403(b)(2).

a. Unlike ¤ 402(g), the **exclusion allowance** applies to both **non-elective** and **elective contributions.** The **exclusion allowance** applies strictly to **vested amounts** contributed during a taxable year or any amounts which become vested in the taxable year. **See Example 26.**

b. The **exclusion allowance** is designed to work with ¤ 415, so the formulas and definitions of these terms under ¤¤ 403(b)(2) and 415 frequently overlap. Contributions in excess of the **exclusion allowance** for the year are currently includible in the employee's gross income in that year. Unlike **excess deferrals**, contributions in excess of the **exclusion allowance** do not result in the contract's loss of 403(b) status.

Note: Contributions to an annuity plan are not covered by the **exclusion allowance** if the employer was never eligible to sponsor a 403(b) plan. If the ineligible plan cannot satisfy the requirements of some other tax-favored plan (such as a qualified plan), no exclusion is available and all amounts contributed to the plan are includible in the employees' gross income in the taxable year they are or become vested.

13.5.3.1 Formula

(1) An employee's **exclusion allowance** for a taxable year is calculated as follows:

! Exclusion Allowance = 20% x **includible compensation** x **years of service** - **amounts previously excludable** from the employee's gross income.

Note: Each element of the formula is discussed in greater detail below, followed by examples.

(2) Although contributions are tested on an annual basis, the **exclusion allowance** is a cumulative formula.

Example: An employer who contributes less than the

available **exclusion allowance** in Year 1 to purchase an annuity for an employee may contribute the "unused" amounts in Year 2. Thus, the limit may be greater than 20% of compensation in any given year (but not more than the 402(g) or 415 limit).

Special NOTE: Remember that the **exclusion allowance** is calculated with respect to the taxable years of an employee.

(3) Separate **exclusion allowances** are generally calculated separately with respect to separate employers. Contributions to 403(b) plans of the same employer are combined in calculating the **exclusion allowance**. The amount of contributions, **years of service**, and **includible compensation** are all calculated for each employer.

Exception: All **years of service** as an employee of a church or a related organization are considered **years of service** for the same employer (both for purposes of the **exclusion allowance** and ɔ 415(c)(4)). Contributions by church organizations are also considered to be made by the same employer.

13.5.3.2 Employer

(1) The "employer" is generally the common law employer for purposes of applying the **exclusion allowance**.

Note: The "same desk" rule applies in determining whether there has been a change in the employer. Cf. Rev. Rul. 79-336.

EXAMPLE: Hospital A maintains a 403(b) plan for its employees and merges with Hospital B, which also has a 403(b) plan, to form Hospital C. Employees of Hospitals A and B work at the same location and perform substantially the same services as they did prior to the merger. Under the "same desk" rule, employees of Hospital C may determine **years of service**, **includible compensation**, and **amounts previously excludable** with respect to service performed for Hospitals A and B, respectively, and Hospital C. Employees of Hospitals A and B have not separated from service for purposes of the distribution restrictions.

13.5.3.3 Special Elections

(1) An employee on whose behalf a **qualified organization** purchases a 403(b) **annuity contract** may elect to calculate his or her **exclusion allowance** under ɔ 415(c)(4).

(2) If this election is made, the limit under ɔ 415 is substituted for the **exclusion allowance**.

(3) There is also a special minimum **exclusion allowance**

equal to the lesser of $3,000 or **includible compensation** for employees of a church or a related organization who have an adjusted gross income of $17,000 or less.

13.5.3.4 Includible Compensation

(1) **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 with or within the taxable year.

a. However, for years beginning after December 31, 1997, **includible compensation** also includes a participant's **elective deferrals** (all **elective deferrals** as described in section 402(g)(3)), and amounts not included in an employee's gross income by reason of ₰ 125 or 457. This is similar to the definition of **compensation** under ₰ 415.

(2) **Includible compensation** does not include:

a. Contributions (vested or not vested) made by the employer to a qualified plan, including contributions picked up by the employer under ₰ 414(h)(2), because they are not currently includible in compensation. See Rev. Rul. 79-221, 1979-2 C.B. 188.

b. Except for **elective deferrals**, any contributions to a 403(b) plan of the employer even if the contributions are includible in gross income.

c. Compensation earned while the employer was not eligible to maintain the 403(b) plan.

d. Compensation earned prior to the employee's most recent one-year period of service.

13.5.3.5 Years of Service

(1) **Years of service** include all years of service for the employer ending with or within the taxable year other than years during which the employer was not eligible to maintain a 403(b) plan.

(2) For **years of service** for church employees, **see 13.5.3.1(3)**.

13.5.3.6 Amounts Previously Excludable

(1) **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 prior taxable years.

(2) They also include all contributions under:

a. a qualified plan (whether vested or non-vested);
b. an eligible deferred compensation plan under § 457(b), even if sponsored by a different employer, see Reg. 1.403(b)-1(d)(1)(ii);
c. a qualified bond purchase plan;
d. certain non-qualified retirement plans; and
e. a 403(b) plan in excess of the 415 limit.

(3) **Amounts previously excludable** do not include:

a. contributions to a 403(b) plan that were not includible in the employee's gross income because they were not vested, and

b. prior amounts in excess of the **exclusion allowance** (except to the extent also in excess of § 415).

(4) To calculate **amounts previously excludable** in a qualified defined benefit plan, all contributions made by the employer for the benefit of the employee are included.

(5) If the employer's contributions to the defined benefit plan are not known, the amounts excludable in prior years under the plan are determined under any method utilizing recognized actuarial principles which are consistent with--

a. the plan's provisions and the employer's method for funding the plan, or

b. under the safe harbor method in Reg. 1.403(b)-1(d)(4).

13.5.3.6.1 Safe Harbor Method

(1) Under the safe harbor, contributions made by the employer on behalf of the employee as of the end of any taxable year are deemed to be the product of the:

a. projected annual amount of the employee's pension as of the end of the taxable year to be provided at normal retirement age from employer contributions, based on the plan provisions in effect at such time and on the assumption of the employee's continued employment with the employer at the employee's then current salary rate;

b. value at normal retirement age (as defined in the plan) of an annuity of $1.00 per annum payable in equal monthly installments during the life of the employee, based on the values derived from Table I of Reg. 1.403(b)-1(d)(4);

c. amount from Table II, also provided in the regulation, representing the level annual contribution which will accumulate to $1.00 at normal retirement age for the sum of the number of years remaining from the end of

the taxable year to normal retirement age and the lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time; and

d. lesser of the number of years of credited service through the end of the taxable year or the number of years that the plan has been in existence at such time.

(2) The safe harbor may be used to determine the aggregate excludable amounts as of any taxable year prior to the taxable year for which the **exclusion allowance** is being calculated based on computations made with respect to such prior taxable year, including the employee's salary rate, projected annual benefit, and **years of service** with the employer.

EXAMPLE 23: Employee A started employment with Hospital N on January 1, 1997. In 1997, Hospital N established a 403(b) plan ("Plan") for its employees. All amounts are **non-salary reduction** and are fully vested when contributed to the Plan. Hospital N maintains no other plans of deferred compensation. Hospital N contributed $6,500 in 1997 and $5,000 in 1998 on A's behalf. A's annual compensation is $50,000.

A's **exclusion allowance** for taxable year 1998 equals $13,500, and is calculated as follows:

20% x **includible compensation** x **years of service**, minus **amounts previously excludable**: (.2 x $50,000 x 2) - $6,500 = $13,500.

Because of the cumulative formula, A's available **exclusion allowance** is $13,500. However, ₰ 415 further reduces the excludable amount to $12,500 (25% of **compensation**).

(3) The following example illustrates that:

a. an employee may include in includible compensation only that portion of a payment of compensation attributable to personal services performed or earned in the most recent one-year period of service and

b. **includible compensation** need not be reduced for **elective deferrals** after 1997.

EXAMPLE 24: In 1998, pursuant to a prior year's election, Employee makes **elective deferrals** of $3,000 under Employer's 403(b) plan. Employee's **includible compensation** for 1998 (including the deferrals) is $30,000. On December 31, 1998, Employee decides to separate from service after

25 years of service with Employer. On such date, Employer pays Employee a separation payment based on accumulated sick leave, which is accrued for each calendar month of service performed by an employee for the Employer. The separation payment is computed by multiplying the number of hours of accumulated sick leave by an employee's average hourly pay during his final full calendar year of service with the Employer. The separation payment equals 600 x $30 or $18,000. $2,500 of this is based on sick leave accrued in 1998, Employee's most recent one-year period of service.

Employee's **includible compensation** for 1998:

= $30,000 + $2,500 (1998 separation payment earned) = $32,500.

Employee's **exclusion allowance** for 1998:

(.2 x $32,500 x 25), minus all **amounts previously excludable**.

EXAMPLE 25: Private School, a 501(c)(3) organization, maintains both a 403(b) plan ("Plan A") and a matching plan under §§ 401(a) and 401(m) ("Plan B"). The contributions provided under Plan B are matched to **elective deferrals** under Plan A. In 1998, Private School contributes $3,000 of **elective deferrals** and $3,000 of **matching contributions** to Plans A and B on behalf of Employee X. X must exclude the **matching contributions** in calculating **includible compensation** for purposes of computing X's 1998 **exclusion allowance**. In addition, X must include in **amounts previously excludable** any prior **matching contributions** to Plan B (in addition to any other previously excludable amounts). X will include the $6,000 in **amounts previously excludable** in computing X's **exclusion allowance** for 1999.

EXAMPLE 26: University is a 501(c)(3) organization maintaining a 403(b) plan ("Plan"). The Plan provides for **non-salary reduction contributions** which are subject to 0% vesting in Years 1 through 4, and 100% vesting in Year 5. Professor X's annual gross compensation is $45,000 in 1993 through 1997, his first 5 years of service with University. University contributes $7,000 per year for the purchase of a 403(b)(1) **annuity contract** under the Plan on behalf of Professor X. In Year 5, the contributions made during the 5 years, equalling $35,000, become vested. The value of the **annuity contract** is $40,000.

a. Professor X's **exclusion allowance** is computed as follows:

20% x **includible compensation** x **years of service**, less **amounts previously excludable**

includible compensation= $45,000

years of service= 5

amounts previously excludable = 0 (because amounts not vested)

(.2 x $45,000 x 5) - 0 = $45,000

b. The **exclusion allowance** equals $45,000, so the $40,000 of deemed contributions in Year 5 are excludable from Professor X's gross income. Section 415 is not a problem here because it applies to annual contributions whether or not they are vested ($7,000 < (25% x $45,000)).

c. Assume in Year 6 compensation and contributions for Professor X stay the same.

The **exclusion allowance** = (.2 x $45,000 x 6) - $40,000, or $14,000.

The ¸ 415, 25% limit yields a lower figure of $11,250. Thus, $11,250 is the maximum amount that can be excluded for the year.

EXAMPLE 27: Employer, a 501(c)(3) organization, maintains a 403(b) plan (the "Plan"). The Plan is pure salary reduction. Agent, in connection with an examination of the Plan for Plan year January 1, 1997 through December 31, 1997, requests information from the employer for the purpose of testing contributions under the maximum **exclusion allowance**. Specifically, agent requests an employee census, the number of **years of service** with the employer, prior contributions and **elective deferrals**, and employee compensation for the 1997 taxable year. Employer provides all requested data except prior contributions. Agent makes reasonable estimates based on the following alternative methodologies:

a. Agent uses account balances and applies a reasonable interest rate to determine prior contributions through December 31, 1996.

b. Agent uses current **salary reduction agreements** to determine the rate of **elective deferrals** as a percentage of compensation. A salary scale is applied to current compensation to determine prior compensation.

c. Agent then estimates prior **includible compensation** and prior excludable contributions by applying the current deferral rate to estimated prior years' **includible compensation**.

Examination Steps

(1) Neither a 403(b) plan document nor a 403(b) contract is required to provide the **exclusion allowance** or 415 limits. However, faulty plan language may indicate operational violations.

a. Check to see if the plan and worksheets for employees properly limit contributions. One common error is disregarding prior contributions or benefits under qualified plans in calculating **amounts previously excludable** in later years, particularly where state defined benefit plans utilize pick-up arrangements.

b. Check whether there have been excess 415 amounts in a prior **limitation year** that resulted in contributions exceeding the **exclusion allowance** in a subsequent year(s).

(2) Because the **exclusion allowance** is cumulative and because of the special elections, you may not be able to determine compliance solely on the basis of an employee's W-2 or annual contributions records. There may be a problem if:

a. the plan language (although not required) does not satisfy ə 415 or 403(b),

b. prior contributions exceed the 415 limit,

c. contributions are in excess of 20% of compensation for long-term employees with large account balances,

d. compensation has declined, or

e. the employee participates in other plans which must be aggregated with the 403(b).

(3) If so, obtain the social security numbers of employees, look up prior 1040 returns, and test check the contributions using the above formula. In no event can the amount deferred exceed the $30,000 limit, or the $10,000 (as indexed for 1998) plus $3,000 under the 402(g) special catch-up limit, if applicable.

13.5.4

Excise Tax

(1) Under ə 4973, a 6% cumulative excise tax is imposed on the employee for **excess contributions** made to a 403(b)(7) **custodial account**, or a 403(b)(9) **retirement income account** to the extent funded through **custodial accounts**.

(2) **Excess contributions** are the excess of the amount contributed over the lesser of:

a. the amount excludable from gross income under ə 403(b)(2) or

b. ∋ 415.

(3) To the extent contributions are in excess of the 403(b)(2) or 415 limits, the contributions are taxable. The excise tax:

a. applies only to **excess contributions** to a **custodial account** and is not applicable to a 403(b)(1) **annuity contract**.

b. may be minimized by reducing future contributions until the excess is fully absorbed or by correcting excess 415 amounts, as discussed above.

(4) The excise tax applies only to the **excess contributions** and not to earnings on the contributions. As illustrated in the following example, the excise tax does not apply to **excess contributions** (contributions in excess of the **exclusion allowance** or the 415 limit) invested in **annuity contracts**. It does not apply to **excess deferrals**. It continues to apply each year to the amount of any excess contributed to **custodial accounts** for prior or current taxable years until the excess is fully absorbed or otherwise corrected.

EXAMPLE 28: Foundation maintains a 403(b) plan ("Plan") on behalf of its employees. The **funding vehicles** for the Plan include both **annuity contracts** and **custodial accounts**. In the **limitation year** ending December 31, 1998, 50 employees receive contributions in excess of the 415 limit. All of the excess 415 amounts are includible in employees' gross income in taxable year 1998, and reduce the employees' available **exclusion allowances** in future years. In addition, the portion of the excess 415 amounts invested in the **custodial accounts** are subject to the excise tax under ∋ 4973. Foundation may contribute less in 1999 with respect to affected employees to eliminate the excise tax for that year.

13.5.4.1
Examination Steps

(1) If a plan has **excess contributions**, see whether or to what extent the funds of the 403(b) plan are invested in mutual funds through a **custodial account**.

(2) Ask the employer for the actual amount contributed to the **custodial account**, and check **salary reduction agreements** and annual compensation of participants.

13.6
NONDISCRIMINATION AND COVERAGE

(1) TRA '86 imposed nondiscrimination and coverage rules on 403(b) plans under ∋ 403(b)(12).

a. These rules generally must be satisfied for plan years beginning after December 31, 1988.

b. These rules do not apply to churches, including qualified church-controlled organizations, as defined by ' 3121(w)(3).

(2) For tax years prior to August 5, 1997, governmental 403(b) plans are deemed to satisfy nondiscrimination (except for ' 401(a)(17)) and coverage requirements with respect to **non-salary reduction contributions**. After that date, these requirements (except ' 401(a)(17)) do not apply to governmental 403(b) plans.

! A governmental plan (within the meaning of ' 414(d)) is one maintained by a State or local government or political subdivision, agency or instrumentality thereof.

(3) Currently there are no nondiscrimination regulations under ' 403(b)(12). Pending the issuance of regulations or other guidance, Notice 89-23, 1989-1 C.B. 654 (extended by Notice 96-64, 1996-2 C.B. 229), provides guidance for complying with the nondiscrimination rules.

a. Notice 89-23 deems a 403(b) plan to satisfy nondiscrimination if the employer operates the plan in accordance with a good faith, reasonable interpretation of ' 403(b)(12). One means of satisfying this test is through the safe harbors set forth in Notice 89-23.

b. Under the notice, **salary reduction** and **non-salary reduction contributions** are tested separately for nondiscrimination. Only **non-salary reduction contributions** (both **matching** and **non-elective**) are subject to the coverage requirements of ' 410(b). See **13.6.2.**

(4) Under ' 414(u), a 403(b) plan is not treated as failing nondiscrimination or coverage requirements by reason of the making of employer or employee contributions(or the right to make such contributions) made pursuant to veterans' re-employment rights under USERRA.

13.6.1
Salary Reduction
Contributions

(1) **Salary reduction contributions** are tested separately from **non-salary reduction contributions** for nondiscrimination. See ' 403(b)(12)(A)(ii).

a. The nondiscrimination requirement for **salary reduction**

contributions is satisfied only if the plan in operation allows each employee to elect to defer more than $200 annually. Unlike a qualified CODA, nondiscrimination with respect to **salary reduction contributions** is not satisfied through compliance with the ADP test.

b. The test for **salary reduction contributions** focuses on eligibility and generally requires universal eligibility. However, there is no requirement that the opportunity to make **salary reduction contributions** be available; but once that opportunity is available to any employee, it must be available to all nonexcludable employees to satisfy nondiscrimination.

c. Until future guidance is issued, both public education institutions and 501(c)(3) organizations MUST currently operate their 403(b) plans in accordance with a good faith/reasonable interpretation of the nondiscrimination requirement for **salary reduction contributions**. No plan provisions are currently required, but faulty plan language may indicate an operational violation.

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

a. nonresident aliens with no U.S. source income,

b. employees who normally work less than 20 hours per week,

c. collectively-bargained employees,

d. students performing certain services,

e. employees whose maximum **salary reduction contributions** under the plan would be no greater than $200,

f. participants in an eligible 457 plan, a qualified CODA, or other salary reduction 403(b) plan, and

g. certain ministers described in ¸ 414(e)(5)(C).

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

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

(4) Under Notice 89-23, "employer" means the common law

employer (and not the controlled group) for purposes of testing **salary reduction contributions** for nondiscrimination. A good faith, reasonable interpretation as to the identity of the employer is sufficient for this purpose.

a. **Salary reduction contributions** made pursuant to a one-time irrevocable election at initial eligibility to participate in the **salary reduction agreement**, or pursuant to certain other one-time irrevocable elections to be specified in regulations, and pre-tax contributions made as a condition of employment are treated and tested as **non-salary reduction contributions**. See 13.5 for a discussion of a similar definition for **elective deferrals** under ∋ 402(g).

(5) Examples 29 - 32 illustrate that **salary reduction contributions** are tested separately from other contributions for nondiscrimination and that these contributions must be offered universally to non-excludable employees. The effect of violating nondiscrimination is the loss of 403(b) status. Contributions to the Plans are therefore subject to income tax, employment tax and withholding.

EXAMPLE 29: Employer is a large public university located in City Y. Employer maintains an annuity plan ("Plan") intended to be a 403(b) plan. Both non-elective, non-matching contributions and **salary reduction contributions** are provided under the Plan. Under the Plan, only senior administrative staff and faculty are eligible to elect to defer a portion of their salary pursuant to **salary reduction agreements** with Employer. Employer also maintains a defined benefit plan for remaining employees. Employer maintains no other plans of deferred compensation. The **salary reduction contributions** are discriminatory. The Plan does not satisfy the requirements of ∋ 403(b).

EXAMPLE 30: Same as Example 29, except that all full-time employees are eligible to participate in the Plan. There are 40 part-time clerical employees who are not students and who normally work 29 hours per week (or 1,508 hours per year). Since the part-time employees in this example are not excludable, the **salary reduction contributions** are discriminatory. The Plan is not a 403(b) plan.

EXAMPLE 31: Employer is a small private school which maintains an annuity plan intended to be a 403(b) plan. All eligible employees may elect to defer at least 4% of compensation. An eligible employee, A, has compensation of $25,000 for 1998 and elects prior to 1998 to defer 1.5% of compensation. The plan administrator declines to process the election and informs A that the minimum deferral is 4% of compensation. The **salary reduction contributions** are discriminatory, and the Plan fails to satisfy 403(b).

EXAMPLE 32: Employer is a private hospital maintaining an annuity plan ("Plan") intended to be a 403(b) plan. The Plan provides only a salary reduction arrangement. Under the Plan, all medical doctors and senior administrative staff are eligible to participate in the Plan immediately upon hire. Remaining employees, including nurses and other support staff, are eligible only after two years of service and attainment of age 21. Employer maintains no other plans of deferred compensation. The **salary reduction contributions** are discriminatory, and the Plan loses its status as a 403(b).

13.6.2
Non-Salary Reduction
Contributions

(1) **Non-salary reduction contributions** are:

a. all contributions that are not **salary reduction contributions.**

b. basically all **non-elective** and **matching contributions.**

c. tested separately from **salary reduction contributions** for nondiscrimination.

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

a. ɔ 401(a)(4) (nondiscrimination)
b. ɔ 401(a)(5) (permitted disparity)
c. ɔ 401(a)(17) (the $160,000 ceiling on compensation, as indexed for 1998), and
d. ɔ 401(a)(26) (minimum participation)
e. ɔ 401(m) (matching and after-tax employee contributions)
f. ɔ 410(b) (minimum coverage) for **non-salary reduction contributions**

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

(4) For 501(c)(3) organizations, under Notice 89-23, nondiscrimination requirements for **non-salary reduction contributions** are deemed satisfied if the employer operates

the plan in accordance with a good faith reasonable interpretation of the above Code sections. The safe harbors in the notice are one means of satisfying the good faith/reasonable interpretation test.

(5) Excludable employees are those employees who have not satisfied any permissible age and service requirements of the plan, in addition to those listed above in 13.6.1(2).

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

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

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

13.6.3
Highly Compensated
Employee

(1) For years beginning after December 31, 1996, the definition of an HCE means any employee who:

a. was a 5% owner at any time during the year or the preceding year, or

b. for the preceding year has compensation from the employer in excess of $80,000 (as indexed for COLAs), and if the employer so elects for the preceding year, was in the top paid group of employees for such preceding year.

13.6.4
Examination
Steps

(1) Ask the employer for the number of HCEs and NHCEs, which of these participate or are eligible to participate in the 403(b) plan or other plans of the employer, and annual compensation and contributions records.

(2) Using employment records, check to see--

a. who can make **salary reduction contributions** and when they can be made.

b. whether **salary reduction contributions** are in fact available to all nonexcludable employees.

NOTE: Because the definition of **salary reduction contribution** and **elective deferral** are similar, refer to

13.5.1.4 (Examination Steps) concerning whether contributions are elective or non-elective. Nondiscrimination requirements may be violated if the employer fails to properly characterize the contributions. (3) Ask the employer which employees were excluded from participation and the basis on which they were excluded.

(4) Find out whether the employer aggregates plans to pass coverage under §§ 403(b)(12) and 410(b). Ask which test the employer uses to pass coverage, ratio percentage or average benefits.

(5) Consider whether employer contributions satisfy the safe harbors. If not, see if there is another basis on which employer contributions satisfy good faith/reasonable interpretation.

(6) See whether **matching contributions** satisfy the ACP test.

13.7 MINIMUM DISTRIBUTION REQUIREMENTS

(1) TRA '86 added § 403(b)(10), which imposes minimum distribution requirements on 403(b) **annuity contracts**. These requirements relate to the latest date at which distributions of a minimum amount must commence.

(2) The proposed Income Tax Regulations under § 403(b) provide that in applying the minimum distribution rules, 403(b) plans generally are treated as IRAs under § 408.

a. The rules applicable to individual retirement arrangements ("IRAs") are generally the same as those applicable to qualified plans under § 401(a)(9).

b. The minimum distribution requirements under § 401(a)(9) relate to the form and timing of both before- and after-death distributions. See Prop. Reg. § 1.401(a)(9)-1.

c. Pending the issuance of final regulations, the proposed regulations under the above Code sections may be relied on by taxpayers.

13.7.1 Required Beginning Date

(1) For minimum distributions required to be made during any calendar year beginning on or after January 1, 1997, the **required beginning date** (the "**RBD**") or the date at which distributions must commence from a participant's 403(b) **annuity contract** is April 1 of the calendar year immediately following the calendar year in which the participant attains age $70\frac{1}{2}$ or retires, whichever occurs last. See Notice 96-67 for a discussion of these rules.

(2) For years prior to January 1, 1997, minimum distributions were required to be made no later than April 1 of the calendar year immediately following the calendar year in which the participant attained age 70 2, except for participants in church or governmental plans.

EXCEPTION: For church and governmental plans, the **RBD** was and continues to be the later of this date or April 1 following the calendar year of retirement.

EXAMPLE 33: Participant has a 403(b) **annuity contract** with a 501(c)(3) organization and attains age 70 and 1/2 in 1996, but has not retired from employment by the end of 1996. This participant's **RBD** is April 1 of the calendar year following the year in which the participant retires.
EXAMPLE 34: Employer is a church maintaining a 403(b) plan for its church employees. Participant A turns 70 1/2 in calendar year 1993, but does not retire until 1996. A's **RBD** is April 1, 1997.

13.7.2 More Than One 403(b) Annuity Contract

(1) The required minimum distribution must be calculated separately for each 403(b) contract. However, an employee who is a participant in more than one 403(b) contract - with the same or a separate employer - may total the amounts required to be distributed from each and satisfy the minimum distribution requirement through distributions from one or more 403(b) contracts. 403(b) contracts cannot be aggregated with IRAs or qualified plans for purposes of satisfying these minimums. See Notice 88-38, 1988-1 C.B. 524.

13.7.3 Bifurcated Account

(1) If the issuer or custodian keeps the records necessary to identify the pre-1987 account balance, the minimum distribution commencement requirements apply only to benefits that accrue after December 31, 1986, including the income on pre-1987 contributions.

a. Prior law (generally requiring distributions by the end of the calendar year in which the participant attains age 75) would apply to pre-1987 accruals.

b. If records are not kept, the entire account balance is subject to ə 401(a)(9).

c. The minimum distribution incidental benefit ("MDIB") requirement applies to the entire account balance, although prior law applies to the pre-1987 account balance in this regard. See Prop. Reg. 1.403(b)-2, Q&A-3.

d. If no actual amount is required to be distributed by April 1, 1988, because of these rules, the participant may treat December 31, 1988, as the **RBD** for all purposes under ∋ 403(b)(10). See Notice 88-39, 1988-1 C.B. 525.

EXAMPLE 35: Employer is a 501(c)(3) organization maintaining a 403(b) plan ("Plan") on behalf of its employees. The Plan was established in 1972. The **funding vehicles** for the Plan are **annuity contracts**. The issuer of the **annuity contracts** kept records of the pre-1987 account balance for a participant who attains age 70 and 1/2 in 1998 and has not retired. The **RBD** for the pre-1987 account balance must be no later than the end of the calendar year in which the participant attains age 75 or, if later, April 1 of the calendar year immediately following the calendar year in which the participant retires. The **RBD** for the post-1986 account balance must be no later than April 1 immediately following the calendar year in which the participant retires.

13.7.4
Excise Taxes

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

(2) The excess distributions tax under ∋ 4980A was repealed with respect to excess distributions received after December 31, 1996.

13.7.5
Examination Steps

(1) Check all documents concerning the **RBD**.

(2) Request data on the age of participants and former participants.

(3) Test check to determine whether distributions have begun timely.

13.8
EARLY DISTRIBUTION RESTRICTIONS

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

13.8.1 Annuity Contracts

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

a. attainment of age 59½
b. death
c. disability
d. separation from service or
e. hardship of the employee (not including earnings, except as provided in the following sentence).

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

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

EXAMPLE 36: Employee A began participating in a 403(b) plan ("Plan") in 1989. The Plan is funded through both **salary reduction** and **non-salary reduction contributions**, which are invested in **annuity contracts**. A is 30 years old, has not separated from service and is not disabled. In 1998, A makes a $5,000 withdrawal that is not a hardship withdrawal. If any portion of the withdrawal is attributable to **salary reduction contributions** and the earnings thereon, the early distribution restrictions of ∋ 403(b)(11) would be violated.

EXAMPLE 37: The same facts as in Example 36, except that the Plan provides only for **non-salary reduction contributions.** A's withdrawal does not violate ∋ 403(b)(11) (although A must pay an early distribution tax under ∋ 72(t)). See 13.8.5.

13.8.2 Custodial Accounts

(1) Under ∋ 403(b)(7), a distribution from a **custodial account** may not be paid or made available to a distributee before the employee attains age 59½, separates from service, dies, OR becomes disabled.

(2) Salary reduction contributions, as well as any other amounts held in the **custodial account** as of the close of the last year beginning before January 1, 1989, may be

distributed upon hardship of the employee.

EXAMPLE 38: Employee A is a participant in a 403(b) plan ("Plan"). Contributions under the Plan are strictly **non-salary reduction**. In 1998, A withdraws $10,000 from the Plan. A has not separated from service or become disabled. A is 40 years old. The funds in A's 403(b) account are invested in a **custodial account.** Since the contributions are invested in a **custodial account**, A's withdrawal violates ' 403(b)(7).

13.8.3 Retirement Income Accounts

(1) A **retirement income account** is subject to the distribution restrictions that apply to the funding vehicles underlying the **retirement income account**.

! For example, to the extent a **retirement income account** is funded through **annuity contracts**, section 403(b)(11) applies.

(2) In the case of a trust with no underlying **annuity contracts** or **custodial accounts**, the rules of ' 403(b)(11) apply.

13.8.4 Grandfathered Annuity Contracts

(1) A distribution from an **annuity contract** or **custodial account** that was purchased or established prior to January 1, 1995, by an Indian tribal government need not be made on account of a distribution event under ' 403(b)(7) or 403(b)(11) to the extent that, prior to January 1, 1998, the distribution is properly rolled over under ' 403(b)(8) (regarding a rollover) or ' 403(b)(10) (regarding a **direct rollover**) to another 403(b) plan, an IRA, or a 401(k) arrangement. After December 31, 1997, such a distribution must be directly rolled over pursuant to ' 403(b)(10) to either an IRA or another 403(b) plan. Thus, unlike other 403(b) **annuity contracts**, a distribution event is not required for a distribution from a grandfathered **annuity contract** purchased by an Indian tribal government to the extent it is rolled over under ' 403(b)(8) (before January 1, 1998) or ' 403(b)(10) (before or after this date) to an appropriate funding vehicle.

13.8.5 Early Distribution Tax under ' 72(t)

(1) Section 72(t) restricts premature distributions from a 403(b) plan by imposing a 10% additional income tax with respect to distributions that are made prior to the events described in ' 72(t). These events differ from those under

ÀÀ 403(b)(7) and (b)(11).

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

a. made after the attainment of age 59½, separation from service after age 55, death, disability, or

b. which are part of a series of substantially equal payments made over the life or life expectancy of the employee or the joint lives or life expectancies of the employee and the employee's designated beneficiary.

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

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

Note: In Examples 36, 37 and 38, A is also subject to the additional tax under À 72(t).

13.8.6 Examination Steps (1) Examine the provisions of the basic plan document (if applicable) and **funding vehicles** regarding withdrawals.

a. If withdrawals are permitted at any time and the plan provides for **salary reduction contributions** or is funded through a **custodial account**, check the operation of the plan to see whether any distributions have been made prior to the events described above.

(2) To determine an employee's eligibility for a hardship distribution, consult rules applicable to hardship distributions under À 401(k).

(3) Look at beginning and ending account balances to determine whether minimum distributions have been made. Also, check Forms 1099-R.

13.9 TRANSFERS AND ROLLOVERS

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

13.9.1 Transfers

(1) Transfers of funds between 403(b) plans or contracts are not considered actual or deemed distributions and

consequently they are not currently taxable if the transferred funds continue to be subject to the same or more stringent distribution restrictions.

Note: As discussed in 13.8, the statutorily imposed restrictions differ between 403(b)(1) **annuity contracts** and 403(b)(7) **custodial accounts**, so transfers between these types of arrangements may be difficult. There is no Code requirement that a transfer from a 403(b) plan or contract be permitted, or that a 403(b) plan or contract have language to effect or accept a transfer (unlike **direct rollover** distributions, see 13.9.2).

EXAMPLE 39: A 403(b)(1) **annuity contract** is purchased entirely with **non-salary reduction contributions**. The funds under the annuity may be transferred tax free to a 403(b)(1) **annuity contract** or 403(b)(7) **custodial account**.

EXAMPLE 40: A 403(b)(1) **annuity contract** is purchased with **salary reduction contributions**. Funds may be transferred tax free to a 403(b)(7) **custodial account**, or a 403(b)(1) **annuity contract** if they continue to be subject to identical or more stringent distribution restrictions.

EXAMPLE 41: Employer makes both **salary reduction** and **non-salary reduction contributions** to a **custodial account**. Funds from the 403(b)(7) **custodial account** may be transferred tax free to another 403(b)(7) **custodial account**, or to a 403(b)(1) **annuity contract** if the transferred funds continue to be subject to the same or more stringent distribution restrictions.

(2) 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 non-transferability requirement under ɔ 401(g). See Rev. Rul. 90-24, 1990-1 C.B. 97.

13.9.2 Rollovers

(1) In a rollover from a 403(b) plan or contract, an employee's interest is distributed and reinvested in another arrangement. Under ɔ 403(b)(8), distributions from a 403(b) plan or contract are not currently includible in the employee's gross income if they are properly rolled over.

a. The requirements for a proper rollover are that all or a portion of the balance to the credit of the distributee be paid to the employee in an **eligible rollover distribution**; the employee rolls any portion of the property he or she receives in the distribution to an IRA or another 403(b) investment (<u>not</u> to a qualified plan); and if property other than money is

distributed, that the property transferred is the same as the property distributed.

b. A proper rollover must be completed within 60 days of the employee's receipt of the distribution.

c. Distributions not properly rolled over are currently includible in the employee's gross income and may be subject to additional tax under § 72(t). Unlike transfers, there must be a distribution event under the plan or contract to have an **eligible rollover distribution.**

(2) An **eligible rollover distribution** from a 403(b) plan or contract is any distribution made to an employee of all or a portion of the balance to the credit of the employee, not including required minimum distributions; periodic distributions; hardship distributions that occur after December 31, 1999; or distributions not otherwise includible in gross income. See Notice 99-5, 1999-3 I.R.B. 10.

a. Unless made in the form of a **direct rollover**, all **eligible rollover distributions** are subject to 20% mandatory income tax withholding, even if they are subsequently properly rolled over (and thus excludable from gross income). The payor (i.e., insurer or custodian) is responsible for the withholding.

b. A **direct rollover** is both exempt from withholding and excludable from gross income.

c. A **direct rollover** is an **eligible rollover distribution** from a 403(b) plan or contract that is paid directly from the 403(b) plan or contract to an IRA or another 403(b) plan or contract.

EXAMPLE 42: Employee, age 59 1/2, received a $150,000 **eligible rollover distribution** from a 403(b) plan on May 5, 1997. Twenty percent or $30,000, was withheld by Payor/Insurer. On June 20, 1997, Employee rolled over $120,000 (the amount he actually received from Payor/Insurer) to an IRA. The $30,000 withheld by Payor/Insurer and not rolled over is subject to federal income tax for 1997. Employee could have avoided income tax by rolling over an additional $30,000 from other funds.

EXAMPLE 43: The same facts as Example 42, except that Employee elected a **direct rollover** of the $150,000 **eligible rollover distribution.** The $150,000 is not subject to withholding and is excludable from Employee's gross income.

(3) Under §§ 403(b)(10) and 401(a)(31), a 403(b) contract must permit an employee to elect a **direct rollover** of an **eligible rollover distribution** to a specified IRA or a 403(b) plan or contract. The employee must also have a

meaningful right to elect a **direct rollover**. This means that within a reasonable period of time prior to making the **eligible rollover distribution**, the payor must provide an explanation to the employee of his right to elect a **direct rollover** and the income tax withholding consequences of not electing a **direct rollover.**

(4) 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. The underlying document must be amended to comply with the **direct rollover** provisions by the first day of the first plan year beginning on or after October 1, 1997 and beginning in 1993 a **direct rollover** option must be offered. See Reg. 1.403(b)-2, Q&A 4; Reg. 1.401(a)(31)-1, Q&A 18; and Announcement 96-64.

13.9.2.1
Special Rule for
Rollovers (1) Special rules relate to a rollover from a grandfathered 403(b) **annuity contract** purchased by an Indian tribal government. A grandfathered 403(b) contract is one that is purchased by an Indian tribal government in a plan year beginning prior to January 1, 1995.

(2) Prior to January 1, 1998, a distribution from such a contract may be made absent a distribution event under § 403(b)(7) or (b)(11) if it is rolled over to a cash or deferred arrangement under § 401(k), another 403(b) plan, or an IRA. Such a rollover may be accomplished pursuant to § 403(b)(8) or § 403(b)(10) (regarding a **direct rollover**).

- This also holds true for a distribution after December 31, 1997, except that the rollover must be a **direct rollover** to an IRA or 403(b) annuity.

13.9.3
Examination
Steps (1) See whether transferred funds are accounted for separately and continue to be subject to at least as stringent early distribution restrictions.

(2) Transfers are not distributions and are therefore not reported on the Form 1099-R.

13.10
TAX CONSEQUENCES
OF § 403(b)
FAILURES (1) This section lists typical "§ 403(b) failures" (403(b) failures) or defects and indicates the scope of resulting tax consequences.

(2) In general, there are three categories of failures:

a. plan failures
b. **annuity contract** failures, and
c. transactional failures.

NOTE: Because of overlap, however, these categories should be used as a guide only and any failure discovered on an examination should be analyzed based on the particular facts related to the failure.

(3) In general, plan failures affect the plan as a whole and result in income inclusion with respect to all **annuity contracts** purchased under the plan.

(4) **Annuity contract** failures generally relate to the **annuity contract** and result in income inclusion with respect to the affected **annuity contract.**

(5) Transactional failures generally arise from a transaction with respect to an otherwise valid 403(b) plan or **annuity contract**. They result in income inclusion with respect to a portion of contributions made to purchase the **annuity contract**.

(6) These failures also result in additional income tax withholding, FICA taxes, FUTA taxes (with respect to an ineligible employer), FICA and FUTA withholding, and excise taxes. However, if the failures are corrected pursuant to one of the Service's correction programs (see 13.1.2, which provides an overview of EPCRS), the Service will not pursue the collection of income tax or withholding for income tax resulting from the failure. Corrections of failures may result in their own tax consequences.

Special Note: Unlike a qualified plan under ϑ 401(a), Title II of ERISA does not require that a 403(b) plan have a plan document or that the plan operate in accordance with its written terms. However, employers should be aware that Title I of ERISA may impose such requirements.

13.10.1
Plan Failures

(1) Plan failures cause a plan not to be a 403(b) plan.

a. The "plan" for this purpose is the aggregate **annuity contracts** (including **custodial accounts** and **retirement income accounts**) established by the employer on behalf of its employees, unless the plans are separate or the plans are properly disaggregated.

b. Except with respect to 13.10.1.1, "employer" is defined as the common law employer and any related employer under ϑ 414(b), (c), (m) or (o).

(2) For plan failures, all contributions made to the plan beginning in the taxable year of the failure are includible in the participants' gross income (except contributions

subject to a substantial risk of forfeiture). Contributions made under a defective 403(b) plan may not be rolled over to an eligible retirement plan.

(3) Ineligible employer. If the employer was never eligible to maintain a 403(b) plan, the plan was never a 403(b) and ¤ 403(c) or ¤ 83 governs.

a. If the employer was a 501(c)(3) organization but loses its 501(c)(3) status, the **exclusion allowance** is lost for any contributions made while the employer is ineligible.

b. The plan may regain its status as a 403(b), but **includible compensation** includes only compensation earned during the most recent one-year period of service while the employer was eligible, and only **years of service** performed while the employer was a 501(c)(3) organization are included in **years of service** in calculating the **exclusion allowance.**

(4) **Annuity contracts not purchased until participants reach retirement age or status**. See 13.3.1. In this case, the plan is intended to be funded through **annuity contracts** (and not **custodial accounts**) but the employer fails to purchase the **annuity contracts** (until retirement age). In the absence of appropriate **funding vehicles**, the plan from its inception is not a 403(b) plan.

(5) Discrimination with respect to **non-salary reduction** (including **matching** and **non-matching**) or **salary reduction contributions**. The ¤ 4979 excise tax may apply if the plan has excess aggregate contributions under ¤ 401(m)(6).

(6) Failure to satisfy the minimum participation rules.

(7) Inadequate coverage.

13.10.2 Annuity Contract Failures

(1) Following is a list of failures that generally pertain to the **annuity contract**.

a. These failures cause a participant's **annuity contract** to fail to satisfy the requirements of ¤ 403(b), and consequently, all contributions made under the **annuity contract** beginning in the taxable year of the failure will be includible in the participant's gross income (except contributions that are subject to a substantial risk of forfeiture).

b. The earnings on premiums paid for the purchase of a 403(b)(1) **annuity contract** (and not **custodial accounts**) are not includible in gross income.

(2) **Annuity contract** failures may also cause other problems for the plan. If the failure is systemic, the plan in its entirety may be adversely affected. For example, this might be true in failures a. through e., g. and j. below if a single insurer or custodian is involved.

a. **Annuity contract** not purchased from an insurance company or not a 403(b) annuity contract (for example, the purchase of a life insurance contract).

b. **Custodial account** not maintained by bank or an approved non-bank trustee.

c. Failure of **custodial account** to invest exclusively in regulated investment company stock.

d. Violation of incidental death benefit requirements.

e. Failure of **annuity contract** (and not a **custodial account**) to satisfy the non-transferability requirement of 401(g) (in either form or operation).

f. Impermissible distribution under ֲ 403(b)(7) or (b)(11). This failure includes an improper transfer (see Rev. Rul. 90-24), a distribution disguised as a loan, and the executing on a security in the event of default on a loan. The ֲ 72(t) tax may also apply.

g. Failure to provide a **direct rollover** (in form or operation).

h. Pattern of violating the minimum distribution rules.

i. Uncorrected **excess deferrals**. The **exclusion allowance** does not apply with respect to an **annuity contract** with **excess deferrals** that are not timely corrected. The **excess deferrals** are includible in gross income in both the year contributed and the year distributed. See ֲ 402(g)(7) and text 13.5.

j. Failure of annuity contract to preclude **excess deferrals**. For plan years beginning on or after January 1, 1998, the **exclusion allowance** does not apply with respect to contributions made to purchase the contract.

13.10.3 Transactional Failures

(1) Following is a list of failures that do not adversely affect the 403(b) status of the **annuity contract** or plan as a whole.

a. Contributions in excess of the **exclusion allowance**. In addition to current income inclusion of the excess,

if the contributions are made to a **custodial account**, the § 4973 excise tax also applies. See 13.5.3.

b. Excess 415 amounts. In addition to current income inclusion of the excess, excess 415 amounts also result in a future reduction in the **exclusion allowance**. The **annuity contract** or **custodial account** is bifurcated into a non-qualified annuity (comprised of the excess and earnings thereon) and qualifying 403(b) annuity. If excess 415 amounts are made to a **custodial account**, the § 4973 excise tax also applies. See 13.5.1.

c. Certain loans. The amount of a loan that does not satisfy the requirements of § 72(p) is a deemed distribution that is includible in gross income. (If the participant's account balance is reduced to satisfy the loan balance, there is an actual distribution which could violate §§ 403(b)(11) and (b)(7) and the failure becomes an **annuity contract** failure.)

d. Isolated instance of failure to satisfy minimum distribution requirements. The participant may be subject to the § 4974 excise tax if the tax is not waived by the Service. The required minimums are includible in gross income on distribution.

e. Salary reduction agreement not legally binding. Amounts contributed under the inadequate agreement are includible in gross income. In the absence of **non-salary reduction contributions**, the entire **annuity contract** is adversely affected. This failure may also overlap with a failure to provide **salary reduction contributions** universally to all non-excludable employees. See 13.4.

f. Salary reduction agreement applies to amounts currently available to employee at the effective date of the agreement.

g. Participation of non-employee.

h. Timely corrected **excess deferrals**.

13.9 GLOSSARY

(1) **Amounts previously excludable:** Used in computing the available **exclusion allowance**. Generally they consist of all employer contributions to a 403(b) plan that were either excludable from gross income or in excess of the 415 limit in prior taxable years. They also include prior contributions to a qualified plan of the employer.

(2) **Annuity contract:** Refers either specifically to an

annuity contract under § 403(b)(1), or to any 403(b) funding vehicle, including a **custodial account** or **retirement income account**. It also includes an annuity contract not qualifying under § 403(b). Individual **annuity contracts** purchased by an employer on behalf of an employee are treated as a single **annuity contract** pursuant to § 403(b)(5).

(3) **Compensation:** Refers to compensation under § 415. It is similar to **includible compensation,** except that compensation may be aggregated with compensation from a controlled employer.

(4) **Custodial account:** A type of funding vehicle under which assets are held by a bank or other person approved by the Commissioner and invested in regulated investment company stock (mutual funds) as required by § 403(b)(7). The term also includes custodial accounts not qualifying under § 403(b).

(5) **Direct rollover:** An **eligible rollover distribution** from a 403(b) plan that is paid directly from the plan to an IRA or another 403(b) plan.

(6) **Elective contributions:** Contributions that arise because of an employee's election between current compensation or deferral under the plan.

(7) **Elective deferrals:** Defined in § 402(g)(3), **elective deferrals** are elective contributions by a participant made to a qualified CODA, a SARSEP, a 501(c)(18) plan, a 403(b) plan, a simple individual retirement account, except they do not include contributions made pursuant to one-time irrevocable elections at initial eligibility to participate in the plan nor contributions made as a condition of employment. They are subject to the § 402(g) limit of $10,000 (as indexed for 1998).

(8) **Eligible rollover distribution:** Any distribution from a 403(b) plan made to an employee of all or a portion of the balance to his credit, not including required minimum distributions, periodic distributions and distributions not otherwise includible in gross income.

(9) **Excess contributions:** A term used for purposes of the excise tax under § 4973, they are contributions to a **custodial account** in excess of either the §§ 415 or 403(b)(2) limit.

(10) **Excess deferrals: Elective deferrals** that are in excess of the § 402(g) limit.

(11) **Exclusion allowance:** The amount that may contributed

on a pre-tax basis under § 403(b)(2) to a plan satisfying the requirements of § 403(b).

Note: Due to §§ 415 and 402(g), it may not be possible to contribute the full **exclusion allowance** tax free.

(12) **Funding vehicle**: Refers to the type of investment arrangement for the assets of a 403(b) plan.

(13) **Includible compensation:** Generally all salary, bonuses and other wages from the employer includible in gross income for the employee's most recent one-year period of service ending with or within the taxable year and excluding amounts contributed on the employee's behalf to a 403(b) or qualified plan. However, for years beginning after December 31, 1997, includible compensation includes elective deferrals (and amounts which are not includible in gross income by reason of § 125 or 457).

(14) **Limitation year:** The 12-month period used for applying the 415 limit. It is usually the calendar year, unless the participant elects otherwise or is in control of the employer.

(15) **Matching contributions:** Any employer contributions made to a defined contribution plan or a 403(b) plan on behalf of an employee on account of the employee's **elective deferrals** or employee contributions.

(16) **Non-elective contributions:** Contributions that are not **elective contributions.**

(17) **Non-matching contributions**: **Non-salary reduction contributions** which are not **matching contributions**.

(18) **Non-salary reduction contributions:** Non-salary reduction contributions are contributions that are not **salary reduction contributions**. They include both matching and non-matching employer contributions.

(19) **Qualified organization:** For purposes of the catch-up limits under §§ 402(g) and 415, an educational organization (as defined in § 170(b)(1)(A)(ii)), a church or related organization (as defined in § 414(e)), a hospital, a home health service agency, or a health and welfare service agency (as defined in § 1861(o) of the Social Security Act).

(20) **Required beginning date:** The date at which distributions of a minimum amount must commence.

(21) **Retirement income account:** Generally, a defined contribution program specifically for a church or a related

organization maintaining a 403(b) plan. In rare instances, a **retirement income account** may be a defined benefit plan.

(22) **Salary reduction agreement:** The agreement between the employer and employee under which **salary reduction contributions** are made.

(23) **Salary reduction contributions:** Contributions made by an employer as a result of an agreement with the employee to take a reduction in salary or forego an increase in salary, bonuses or other wages. See also **elective deferrals**.

(24) **Vested amount:** The participant's allocable portion in the 403(b) plan that is nonforfeitable. It is the amount to which the **exclusion allowance** applies.

(25) **Years of service:** Used in computing the **exclusion allowance**, it includes all years of service with the employer ending with or within the taxable year.

MANUAL TRANSMITTAL	**Department of the Treasury**	**Internal Revenue Service**	**7.7.1 Ch. 13**

Purpose

This transmits Table of Contents and text for IRM Handbook 7.7.1, Employee Plans Examination Guidelines Handbook, Chapter 13, Section 403(b) Plans.

Nature of Materials

Guidance is provided in IRM Handbook 7.7.1, Chapter 13, 403(b) Plans, on how to examine a plan described in Internal Revenue Code § 403(b). These types of plans are commonly referred to as "403(b) plans".

This transmittal issues new procedures.

Carol Gold
Director, Employee Plans Division