

Correction of Excess Contributions Made to a 403(b)

Tax Sheltered Annuity Plan

I. Introduction

This article discusses correction of contributions to a tax-sheltered annuity plan (“403(b) plan”) that are made in excess of the limits imposed by the Internal Revenue Code. There are three annual limits - the section 402(g) limit on Elective Deferrals, the section 415 limit¹, and the maximum exclusion allowance (AMEA) - that apply to 403(b) plans. These limits prescribe the maximum amount that may be contributed annually to the 403(b) plan which is excludable from a participant’s gross income. Amounts contributed to a 403(b) plan that are in excess of the limits are called Excess Contributions and will result in income tax to participants. Thus, Employers and participants must have an understanding of these limits in order to determine whether and to what extent Excess Contributions have been made to the plan. Accordingly, this article will briefly discuss the three contribution limits before turning to correction of excesses.

II. Contribution Limits

A. In General

To understand how the contribution limits work, it is critical to keep in mind the two types of contributions that may be made to a 403(b) plan - Elective Deferrals, and non-elective contributions. Elective Deferrals are also known as Salary reduction contributions, because the contributions are made from the employee’s salary; an employee’s salary is voluntarily reduced by an amount elected by the employee that the employer contributes to the 403(b) plan. Non-elective contributions, which include matching contributions or Employer contributions, are any contributions that are not Elective Deferrals. In general, if a participant makes Elective Deferrals, the maximum excludable amount that may be contributed to the 403(b) plan is the least of the 402(g) limit, 415 limit, or MEA. Each of these limits is discussed separately below.

B. Section 402(g) Limit

Only Elective Deferrals are tested under the 402(g) limit. Section 402(g) limits the amount of Elective Deferrals that may be made by a participant during the taxable year to \$7,000, adjusted for

¹ The terms “402(g),” “415,” and “403(b)” refer to sections of the Internal Revenue Code.

cost of living adjustments (the limit is \$10,500 for 2000). In testing Elective Deferrals under the 402(g) limit, all Elective Deferrals of the employee are counted, even elective deferrals made to a plan of another employer.² An employee of a public educational organization who has completed 15 years of service with the employer may elect to contribute an additional \$3,000 (\$13,500 for the taxable year 2000) for each of five years to a 403(b) plan. This election provides a long-term employee with an additional excludable deferral totaling \$15,000 but which must be made over a period of five or more years.

C. MEA Limit

The MEA is a formula that limits the amount of Elective Deferrals and non-elective contributions made to a 403(b) plan for the taxable year that are excludable from the employee's gross income. The formula is 20 percent of AIncludible compensation multiplied by Ayears of service with the employer less Aamounts previously excludable ((.20 x compensation x years of service) minus amounts previously excludable). AIncludible compensation consists of compensation that is includible in the participant's gross income and also includes a participant's Elective Deferrals contributed to the plan. AYears of service are determined by reference to the number of years an employee has worked for a particular employer (e.g., a single school district). AAmounts previously excludable are all amounts contributed on the employee's behalf in prior years - years prior to the year for which the MEA is being calculated - to the 403(b) plan, or to another plan, including a qualified plan such as a state defined contribution or defined benefit plan.

D. Section 415 Limit

Section 415 limits the amount of excludable Elective Deferrals and non-elective contributions made to a 403(b) plan for the year to the lesser of 25 percent of compensation or \$30,000. ACompensation is the compensation paid by the employer to the participant and includes the participant's Elective Deferrals contributed to the plan. An employee of a public educational organization - regardless of his or her accumulated years of service - may also elect an alternative limit under section 415 . One of these elections allows a yearly contribution of up to the least of the following three amounts: (a) 25 percent of includible compensation plus \$4,000, (b) \$15,000, or (c) the MEA. Another election under section 415 allows the participant to disregard the MEA, and test contributions only under the 402(g) limit (for Elective Deferrals) and the general 415 limit, i.e., the lesser of 25% of compensation or \$30,000 (for both Elective Deferrals and non-elective contributions).

² Elective Deferrals under a 403(b) plan are also counted toward the contribution limit under section 457.

III. Precluding and Correcting Excess Contributions

A. *In General*

Participants cannot correct Excess Contributions, but they can prevent them. Correction will necessarily involve the insurance company or custodian and possibly the employer. However, while correction minimizes the cost of Excess Contributions to affected participants and the employer, it does not eliminate it in all situations. For example, Excess Deferrals may be taxed twice even if corrected, and an excise tax on certain Excess Contributions applies regardless of correction. To preclude Excess Contributions, participants should test contributions before and during the taxable year under the three limits discussed above and, if necessary, reduce their Elective Deferral elections accordingly.

B. *Forum for Correcting Excess Contributions*

To correct Excess Contributions made to a 403(b) plan, it is necessary to fully, properly and timely correct them. Excess Contributions may be corrected through provisions of the Code and regulations, or through the compliance programs developed by the Service, the Administrative Policy Regarding Self-Correction (AAPRSC³), and the Tax Sheltered Annuity Voluntary Correction (ATVC³) Program, which are set forth in Revenue Procedure 2000-16, 2000-6 I.R.B. 518.³ Revenue Procedure 2000-16 may be accessed through the Internal Revenue Service's Web site at <http://ftp.fedworld.gov/pub/irs-irbs/irb00-06.pdf>

Although an individual *participant* is not eligible to correct under APRSC or TVC, an *employer* may wish to utilize one of the programs to eliminate the employer's liability for FICA, FUTA and income tax withholding, and minimize income inclusion for participants.

APRSC allows an eligible employer to correct the excess without having to request consideration by the Service and pay a correction fee. To be eligible, the employer or insurance company must have practices and procedures in place that are reasonably designed to facilitate overall compliance with section 403(b). Under APRSC, if the Excess Contributions for all years (together with any other failures in the 403(b)) are insignificant, they may be corrected at any time, even if the employer or plan is under an examination by the Exempt Organizations or Employee Plans function of the Service. Whether a failure is considered to be insignificant is determined by looking at all of the facts and circumstances (see section 8 of Revenue Procedure 2000-16). For significant failures, the Excess Contributions must be corrected within two years from the year of the failure in order to timely correct under APRSC. If the requirements of APRSC are not satisfied, the employer may submit an application to the Service for correction under TVC.

³ Another program being considered would allow the insurance company or third-party administrator to file a request for correction of failures in a 403(b) plan.

C. Form of Correction

Excess Contributions are grouped into two categories for purposes of determining the appropriate form of correction: Excess Deferrals, which are defined as Elective Deferrals in excess of the 402(g) limit, and Excess Amounts, which consist of any amounts - Elective Deferrals or non-elective contributions - that are in excess of the 415 limit and/or the MEA. Thus, the term Excess Amounts does not include Excess Deferrals under section 402(g), although Excess Amounts may consist of Elective Deferrals in excess of the 415 limit or MEA.

1. Excess Deferrals

Correction under Code and Regulations. The Code and regulations provide that a participant may notify the plan administrator or insurance company of any Excess Deferrals made during the year up until April 15 of the year immediately following the year of the Excess Deferrals and have the excess plus the earnings on the excess distributed to the participant. The advantage of taking a distribution of the excess prior to the April 15 date is that the excess is taxed only once in the year of contribution (although the earnings are taxable in the year distributed). In addition, correction before April 15 does not require APRSC or TVC.

IRS Correction Programs. After the April 15 date, an employer who is eligible for the program may correct Excess Deferrals under APRSC or under TVC with the cooperation of the insurance company or custodian that will make the distribution. However, as provided by regulations issued under the Internal Revenue Code, Excess Deferrals that are corrected after the April 15 date are taxable to the participant both in the year they were originally contributed and in the year they are distributed. Earnings are taxed in the year distributed. The amount of the Excess Deferrals is determined by testing the Elective Deferrals contributed to the plan each year under the 402(g) limit as in effect for that year. Full correction requires that Excess Deferrals for all years be distributed, together with any earnings accrued through to the date of the corrective distribution.

2. Excess Amounts

a. Correction under the regulations

The regulations issued under the Internal Revenue Code provide that amounts in excess of the 415 limit that are attributable to Elective Deferrals may be distributed if the excesses were made because of a reasonable error in determining the amount of Elective Deferrals that may be made under the limits of section 415, a reasonable error in estimating a participant's compensation, or as a result of the allocation of forfeitures under the 403(b) plan. If the excesses are not due to any of the above, APRSC or TVC may be available to correct the excess. Note that the excesses that may be corrected under the regulation are specifically Elective Deferrals in excess of the 415

limit (and not all Excess Amounts) that are attributable to these particular errors. There is no corresponding regulation provision for amounts in excess of the MEA.

b. Correction under IRS Correction Programs

Distribution under APRSC. Excess Amounts may be corrected by an eligible employer through APRSC or TVC. The only available form of correction under APRSC is a distribution of the Excess Amounts plus applicable earnings, so the cooperation of the insurance company or custodian is necessary. The employer, to avail itself of APRSC, is required to inform participants that the distribution is not eligible for rollover and is taxable to the distributee. In calculating future MEAs, participants may disregard all Excess Amounts that are properly distributed by not including the amounts in “amounts previously excludable” (see the formula for the MEA, above). Thus, they do not reduce a participant’s MEA.

Distribution or retention under TVC. Under TVC, the employer may distribute the Excess Amounts plus earnings, as under APRSC, or retain the Excess Amounts and the earnings thereon in the plan. The latter alternative requires that current and future MEA and 415 limits for affected participants be reduced. This reduction is designed to “absorb” or “wear-away” prior years’ Excess Amounts since they will not be currently distributed and taxed. To reduce the 415 limit, prior years’ excess 415 amounts are carried forward and reduce the 415 limit for each affected participant for the year following the year of correction (or for the year of correction, if the employer so chooses), and subsequent years, until the reduction in the 415 limit equals the aggregate amount of the excess 415 amount and earnings. To reduce the MEA, Excess Amounts (415 and/or MEA excesses) in prior years plus earnings are included in “amounts previously excludable” in the MEA formula. Under this form of correction, an excess 415 amount reduces the participant’s future 415 and MEA limit, while an amount in excess of the MEA reduces the future MEA.