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Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts; Final Rule

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 31, 54, and 602

[TD 9340]

RIN 1545–BB64

Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document promulgates final regulations under section 403(b) of the Internal Revenue Code and under related provisions of sections 402(b), 402(g), 402A, and 414(c). The regulations provide updated guidance on section 403(b) contracts of public schools and tax-exempt organizations described in section 501(c)(3). These regulations will affect sponsors of section 403(b) contracts, administrators, participants, and beneficiaries.

DATES: Effective Date: July 26, 2007.

Applicability Date: These regulations generally apply for taxable years beginning after December 31, 2008. However, see the ''Applicability date'' section in this preamble for additional information regarding the applicability of these regulations.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, John Tolleris, (202) 622–6060; concerning the regulations as applied to church-related entities, Robert Architect (202) 283–9634 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in § 1.403(b)–10(b)(2)(i)(C) of these final regulations has been approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2068. Responses to this collection of information are required in order to provide certain benefits.

The estimated burden per respondent varies among the plan administrator/payor/recordkeeper, depending upon individual respondents' circumstances, with an estimated average of 4.1 hours. Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

The collection of information in § 1.403(b)–10(b)(2)(i)(C) of these final regulations was not contained in the prior notice of proposed rulemaking. For this reason, this additional collection of information has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2068. Comments concerning this additional collection of information should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503. Comments on the collection of information should be received by September 24, 2007. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see above);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The estimated burden per respondent varies among the plan administrator/payor/recordkeeper, depending upon individual respondents' circumstances, with an estimated average of 4.1 hours.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Regulations (TD 6783) under section 403(b) of the Internal Revenue Code (Code) were originally published in the **Federal Register** (29 FR 18356) on December 24, 1964 (1965–1 CB 180). Those regulations provided guidance for complying with section 403(b), which had been enacted in 1958 in section 23(a) of the Technical Amendments Act of 1958, Public Law 85–866 (1958), relating to tax-sheltered annuity arrangements established for employees by public schools and tax-exempt organizations described in section 501(c)(3). Since 1964, additional regulations were issued under section 403(b) to reflect rules relating to certain eligible rollover distributions [1] and required minimum distributions under section 401(a)(9).[2] See § 601.601(d)(2) relating to objectives and standards for publishing regulations, revenue rulings and revenue procedures in the Internal Revenue Bulletin.

On November 16, 2004, a notice of proposed rulemaking (REG–155608–02) was published in the **Federal Register** (69 FR 67075) that proposed a comprehensive update of the regulations under section 403(b) (2004 proposed regulations), including: amending the 1964 and subsequent regulations to conform them to the numerous amendments made to section 403(b) by subsequent legislation, including section 1022(e) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829), Public Law 93–406; section 251 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (96 Stat. 324, 529), Public Law 97–248; section 1120 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2085, 2463), Public Law 99–514; section 1450(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755, 1814), Public Law 104–188; and sections 632, 646, and 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38, 113, 126, 127), Public Law 107–16. The 2004 proposed regulations also included controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a).

Following publication of the 2004 proposed regulations, comments were received and a public hearing was held on February 15, 2005. After consideration of the comments received, the 2004 proposed regulations are adopted by this Treasury decision,

[1] *See* TD 8619, September 22, 1995 (60 FR 49199).

[2] *See* TD 8987, April 17, 2002 (67 FR 18987).

subject to a number of changes, some of which are summarized below in this preamble.

Section 403(b) was also amended by sections 811, 821, 822, 824, 826, and 829 of the Pension Protection Act of 2006 (PPA '06) (120 Stat. 780), Public Law 109–280. These final regulations reflect these amendments.

Sections 403(b) and 414(c) Statutory Provisions

Section 403(b) provides an exclusion from gross income for certain contributions made by specific types of employers for their employees and by certain ministers to specified types of funding arrangements. The employers are limited to public schools and section 501(c)(3) organizations. There are three categories of funding arrangements to which section 403(b) applies: (1) Annuity contracts (as defined in section 401(g)) issued by an insurance company; (2) custodial accounts that are invested solely in mutual funds; and (3) retirement income accounts, which are only permitted for church employees and certain ministers. Except as otherwise indicated, an annuity contract, for purposes of these final regulations, includes a custodial account that is invested solely in mutual funds.

The exclusion applies to employer nonelective contributions (including matching contributions) and elective deferrals (other than designated Roth contributions) within the meaning of section 402(g)(3)(C) (which applies to section 403(b) contributions made pursuant to a salary reduction agreement). The exclusion applies only if certain requirements relating to availability, nondiscrimination, and distribution are satisfied. Section 403(b) arrangements may also include after-tax employee contributions.

Section 403(b)(1)(C) requires that the contract be nonforfeitable (except for the failure to pay future premiums), regardless of the type of contribution used to purchase the contract. Section 403(b)(1)(E) requires a section 403(b) contract purchased under a salary reduction agreement to satisfy the requirements of section 401(a)(30) relating to limitations on elective deferrals under section 402(g)(1). In addition, all contributions to a section 403(b) arrangement, when expressed as annual additions under section 415(c)(2), must not exceed the applicable limit of section 415.

Section 403(b)(5) provides that all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract for purposes of the requirements of section 403(b). Other aggregation rules apply both on an individual and aggregate basis. For example, the section 402(g) limitations on elective deferrals apply to all elective deferrals during the year with respect to an individual and the limitations of section 401(a)(30) apply to all elective deferrals made by an employer to that employer's plans with respect to an individual during the year. The contribution limitations of section 415 generally apply on an employer-by-employer basis.

Section 403(b)(12) requires a section 403(b) contract that provides for elective deferrals to make elective deferrals available to all employees (the universal availability rule) and requires other contributions to satisfy the general nondiscrimination requirements applicable to qualified plans. These rules are discussed further in this preamble under the heading ''Section 403(b) Nondiscrimination and Universal Availability Rules.''

A section 403(b) contract is also required to provide that it will satisfy the required minimum distribution requirements of section 401(a)(9), the incidental benefit requirements of section 401(a), and the rollover distribution rules of section 402(c).

Many section 403(b) arrangements of employers that are section 501(c)(3) organizations are subject to the Employee Retirement Income Security Act of 1974 (ERISA), which includes rules substantially identical to the rules for qualified plans, including rules parallel to the section 414(l) transfer rules, the section 401(a)(11) qualified joint and survivor annuity (QJSA) transferee plan rules, and the anti-cutback rules of section 411(d)(6) (which apply to transfers). See sections 204(g), 205, and 208 of ERISA. However, as discussed in this preamble under the heading ''Interaction Between Title I of ERISA and Section 403(b) of the Code,'' Title I of ERISA does not apply to governmental plans, certain church plans, or a tax-exempt employer's section 403(b) program that is not considered to constitute the establishment or maintenance of an ''employee pension benefit plan'' under Title I of ERISA.

Section 414(c) authorizes the Secretary of the Treasury to issue regulations treating all employees of trades or businesses which are under common control as employed by a single employer.

Explanation of Provisions

Overview

Like the 2004 proposed regulations, these final regulations are a comprehensive update of the current regulations under section 403(b). These regulations replace the existing final regulations that were adopted in 1964 and reflect the numerous legal changes that have been made in section 403(b) since then and many of the positions that have been taken in interpretive guidance that has been issued under section 403(b).

As was noted in the preamble to the 2004 proposed regulations, the effect of the various amendments made to section 403(b) within the past 40 years has been to diminish the extent to which the rules governing section 403(b) plans differ from the rules governing other tax-favored employer-based retirement plans, including arrangements that include salary reduction contributions, such as section 401(k) plans and section 457(b) plans for state and local governmental entities. However, there remain significant differences between section 403(b) plans and section 401(a) and governmental section 457(b) plans. For example, section 403(b) is limited to certain specific employers and employees (namely, employees of a public school, employees of a section 501(c)(3) organization, and certain ministers) and to certain funding arrangements (namely, an insurance annuity contract, a custodial account that is limited to mutual fund shares, or a church retirement income account). Also, section 403(b) contains the universal availability requirement for section 403(b) elective deferrals and provides consequences for failing to satisfy certain of the section 403(b) rules (described in this preamble under the heading ''Effect of a Failure to Satisfy Section 403(b)'') [3] that differ in significant respects from the consequences applicable to qualified plans.

The final regulations, as did the 2004 proposed regulations, require the section 403(b) contract to satisfy both in form and operation the applicable requirements for exclusion. The final regulations also require that the contract

[3] Other differences between the rules applicable to section 403(b) plans and qualified plans include the following: the definition of compensation (including the five-year rule) in section 403(b)(3); the special section 403(b) catch-up elective deferral in section 402(g)(7); and the section 415 aggregation rules. An additional difference relates to when a severance from employment occurs for purposes of section 403(b) plans maintained by State and local government employers. See § 1.403(b)–6(h) of these regulations.

be maintained pursuant to a written plan as described in the next section.

The final regulations, like the proposed regulations, provide rules under which tax-exempt entities are aggregated and treated as a single employer under section 414(c). These rules apply to plans referenced in section 414(b), (c), (m), (o), and (t), such as plans qualified under section 401(a) or 403(a), as well as section 403(b) plans.

Comments on the 2004 proposed regulations raised a number of questions and concerns about:

- The requirement in the 2004 proposed regulations under which a section 403(b) contract would be required to be maintained pursuant to a written plan;
- The elimination of certain non-statutory exclusions that a section 403(b) plan was permitted to have under Notice 89–23 (1989–1 CB 654) for purposes of the universal availability rule;
- The elimination of Rev. Rul. 90–24 (1990–1 CB 97), which allowed a section 403(b) contract to be exchanged for another contract; and
- The controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a).

These final regulations include a number of revisions to reflect the comments received, as described further in this preamble.

Written Plan Requirement

These regulations retain the requirement from the 2004 proposed regulations that a section 403(b) contract be issued pursuant to a written plan which, in both form and operation, satisfies the requirements of section 403(b) and these regulations. This requirement implements the statutory requirements of section 403(b)(1)(D), which provides that the contract must be purchased ''under a plan'' that satisfies the nondiscrimination requirements delineated in section 403(b)(12).

The existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan. Without such a central document for a comprehensive summary of responsibilities, there is a risk that many of the important responsibilities required under the statute and final regulations may not be allocated to any party. While a section 403(b) contract issued to an employee can provide for the issuer to perform many of these functions by itself, the contract cannot satisfy the function of setting forth the eligibility criteria for other employees, nor can the issuer by itself coordinate those Code requirements that depend on other contracts, such as the loan limitations under section 72(p). The issuer must rely on information or representations provided by either the employer or the employee for employment-based information that is essential for compliance with section 403(b) provisions, such as the limitations on elective deferrals in section 402(g) and the requirements of section 72(p)(2) for a plan loan that is not a taxable deemed distribution. In addition to providing a central locus to coordinate those functions, the maintenance of a written plan also benefits participants by providing a central document setting forth their rights and enables government agencies to determine whether the arrangements satisfy applicable law and, in particular, for determining which employees are eligible to participate in the plan.

The 2004 proposed regulations would have required that the section 403(b) plan include all of the material provisions regarding eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. The proposed regulations would not have required that there be a single plan document. However, under the proposed regulations, the written plan requirement would be satisfied by complying with the plan document rules applicable to qualified plans.

Some comments raised concerns that the written plan requirement would impose additional administrative burdens. In response, the final regulations make a number of clarifications, including that the plan is permitted to allocate to the employer or another person the responsibility for performing functions to administer the plan, including functions to comply with section 403(b). Any such allocation must identify who is responsible for compliance with the requirements of the Code that apply based on the aggregated contracts issued to a participant, including loans under section 72(p) and the requirements for obtaining a hardship withdrawal under § 1.403(b)–6 of these regulations.

Additional comments recommended that certain responsibilities be permitted to be allocated to employees. The IRS and Treasury Department have concluded that it is generally inappropriate to allocate these responsibilities to employees for a number of reasons. First, employees often lack the expertise to systematically meet these responsibilities and may not recognize the importance of performing these actions (including not fully appreciating the tax consequences of failing to perform the responsibility). Second, an individual employee may have a self-interest in a particular transaction. In addition, while there are various factors that will often cause an employer or issuer to have an interest in procedures that ensure that the requirements of section 403(b) are satisfied (including income tax withholding requirements), an employee generally bears the income tax exposure and other risks of failing to comply with rules set forth in the plan. The IRS and Treasury Department believe it is important to prevent failures in advance so as to minimize the cases in which the adverse effects of a failure fall on the employee. See the discussion in this preamble under the heading ''Contract Exchanges.''

In response to comments, the final regulations clarify the requirement that the plan include all of the material provisions by permitting the plan to incorporate by reference other documents, including the insurance policy or custodial account, which as a result of such reference would become part of the plan. As a result, a plan may include a wide variety of documents, but it is important for the employer that adopts the plan to ensure that there is no conflict with other documents that are incorporated by reference. If a plan does incorporate other documents by reference, then, in the event of a conflict with another document, except in rare and unusual cases, the plan would govern. In the case of a plan that is funded through multiple issuers, it is expected that an employer would adopt a single plan document to coordinate administration among the issuers, rather than having a separate document for each issuer.

Finally, comments also indicated that, while section 403(b) contracts that are subject to ERISA are maintained pursuant to written plans, there may be a potential cost associated with satisfying the written plan requirement for those employers that do not have existing plan documents, such as public schools. To address this concern, the IRS and Treasury Department expect to publish guidance which includes model plan provisions that may be used by public school employers for this purpose. Because the requirement for a written plan will not go into effect until 2009 (see the discussion under the heading ''Applicability date''), employers would be expected to adopt a written plan (including applicable amendments) no later than the applicability date of these regulations.

Contract Exchanges, Plan-to-Plan Transfers, and Purchases of Permissive Service Credit

The final regulations, like the 2004 proposed regulations, provide for three specific kinds of non-taxable exchanges or transfers of amounts in section 403(b) contracts. Specifically, under the final regulations, a non-taxable exchange or transfer is permitted for a section 403(b) contract if either: (1) It is a mere change of investment within the same plan (contract exchange); (2) it constitutes a plan-to-plan transfer, so that there is another employer plan receiving the exchange; or (3) it is a transfer to purchase permissive service credit (or a repayment to a defined benefit governmental plan). If an exchange or transfer does not constitute a change of investment within the plan, a plan-to-plan transfer, or a purchase of permissive service credit, the exchange or transfer would be treated as a taxable distribution of benefits in the form of property if the exchange occurs after a distributable event (assuming the distribution is not rolled over to an eligible retirement plan) or as a taxable conversion to a section 403(c) nonqualified annuity contract if a distributable event has not occurred. See the ''Effect of a Failure to Satisfy Section 403(b)'' section in this preamble for discussion of section 403(c) nonqualified annuity contracts. In any case in which a distributable event has occurred, a participant in a section 403(b) plan can always change the investment through a distribution and non-taxable rollover from a section 403(b) contract to an IRA annuity, as long as the distribution is an eligible rollover distribution. Note, however, that an IRA annuity cannot include provisions permitting participant loans. See section 408(e)(3) and (4) and §§ 1.408–1(c)(5) and 1.408–3(c).

Any contract exchange, plan-to-plan transfer, or purchase of permissive service credit that is permitted under the final regulations is not treated as a distribution for purposes of the section 403(b) distribution restrictions (so that such an exchange or transfer may be made before severance from employment or another distribution event).

Contract Exchanges

Rev. Rul. 73–124 (1973–1 CB 200) and Rev. Rul. 90–24 (1990–1 CB 97) dealt with contract exchanges. Rev. Rul. 73–124 had allowed section 403(b) contracts to be exchanged, without income inclusion, if, pursuant to an agreement with the employer, the employee cashed in the first contract and immediately transmitted the cash proceeds for contribution to the successor contract to which all subsequent employer contributions would be made. This ruling was replaced by Rev. Rul. 90–24 which does not provide for the first contract to be cashed in but allows section 403(b) contracts to be exchanged, without income inclusion, so long as the successor contract includes distribution restrictions that are the same or more stringent than the distribution restrictions in the contract that is being exchanged.

The 2004 proposed regulations would have imposed additional restrictions on contract exchanges by limiting tax-free contract exchanges to situations in which the new contract is provided under the plan. The proposal was intended to improve compliance with the Code requirements that apply on an aggregated basis because, without coordination, it is difficult, if not impossible, for a plan to comply with those tax requirements. These requirements include certain distribution restrictions, including the rule that requires the suspension of deferrals for a plan that uses the hardship withdrawal suspension safe harbor rules for elective deferrals, and the section 72(p) rules for loans. In addition, these changes make it easier for employers to respond to an IRS inquiry or audit. For example, where assets have been transferred to an insurance carrier or mutual fund that has no subsequent connection to the plan or the employer, IRS audits and related investigations have revealed that employers encounter substantial difficulty in demonstrating compliance with hardship withdrawal and loan rules. These problems are particularly acute when an individual's benefits are held by numerous carriers. Such multiple contract issuers are commonly associated with plans in which Rev. Rul. 90–24 exchanges have occurred.

Commentators generally objected to the proposal to limit exchanges allowed under Rev. Rul. 90–24. They argued that such exchanges enable participants to change funding arrangements and claimed that these exchanges have generally been responsible for improved efficiency and lower cost in the section 403(b) market. Comments often included specific suggestions, such as limiting any restrictions on exchanges to active employees and effectuating compliance with loan restrictions by alternative methods, such as having the issuer report loans on, for example, a Form 1099–R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts), or notify the employer about loans. Other comments included a recommendation that the employer be involved to ensure that the exchange is within the plan. Comments also suggested that a grandfather may be necessary for exchanges made before the applicability date of the restrictions imposed by the final regulations.

These final regulations include a number of changes to reflect these comments. The regulations allow contract exchanges with certain characteristics associated with Rev. Rul. 90–24, but under rules that are generally similar to those applicable to qualified plans.

Unlike the 2004 proposed regulations, these regulations permit an exchange of one contract for another to constitute a mere change of investment within the same plan, but only if certain conditions are satisfied in order to facilitate compliance with tax requirements. Specifically, the other contract must include distribution restrictions that are not less stringent than those imposed on the contract being exchanged and the employer must enter into an agreement with the issuer of the other contract under which the employer and the issuer will from time to time in the future provide each other with certain information. This includes information concerning the participant's employment and information that takes into account other section 403(b) contracts or qualified employer plans, such as whether a severance from employment has occurred for purposes of the distribution restrictions and whether the hardship withdrawal rules in the regulations are satisfied. Additional information that is required is information necessary for the resulting contract or any other contract to which contributions have been made by the employer to satisfy other tax requirements, such as whether a plan loan constitutes a deemed distribution under section 72(p).

These regulations also authorize the IRS to issue guidance of general applicability allowing exchanges in other cases. This authority is limited to cases in which the resulting contract has procedures that the IRS determines are reasonably designed to ensure compliance with those requirements of section 403(b) or other tax provisions that depend on either information concerning the participant's employment or information that takes into account other section 403(b) contracts or qualified employer plans. For example, the procedures must be reasonably designed to determine whether a severance from employment has occurred for purposes of the

distribution restrictions, whether the hardship withdrawal rules are satisfied, and whether a plan loan constitutes a deemed distribution under section 72(p). By contrast, procedures that rely on an employee certification, such as whether a severance from employment has occurred or whether the participant has other outstanding loans, would generally not be adequate to meet this standard, because such a certification is not disinterested, and also because of the lack of employer oversight in the certification process to ensure accuracy.

Plan-to-Plan Transfers

The final regulations expand the rules in the 2004 proposed regulations under which plan-to-plan transfers would have been permitted only if the participant was an employee of the employer maintaining the receiving plan. Under the final regulations, plan-to-plan transfers are permitted if the participant whose assets are being transferred is an employee or former employee of the employer (or business of the employer) that maintains the receiving plan and certain additional requirements are met. However, the final regulations retain the rules that were in the 2004 proposed regulations prohibiting a plan-to-plan transfer to a qualified plan, an eligible plan under section 457(b), or any other type of plan that is not a section 403(b) plan, except as described in the next paragraph. Similarly, a section 403(b) plan is not permitted to accept a transfer from a qualified plan, an eligible plan under section 457(b), or any other type of plan that is not a section 403(b) plan.

Purchases of Permissive Service Credit and Certain Repayments

The final regulations, like the 2004 proposed regulations, include an exception permitting a section 403(b) plan to provide for the transfer of its assets to a qualified plan under section 401(a) to purchase permissive service credit under a defined benefit governmental plan or to make a repayment to a defined benefit governmental plan.

Limitations on Contributions

The final regulations, like the 2004 proposed regulations, provide that the section 403(b) exclusion applies only to the extent that all amounts contributed by the employer for the purchase of an annuity contract for the participant do not exceed the applicable limits under section 415. The final regulations retain the rule in the 2004 proposed regulations that if an excess annual addition is made to a contract that otherwise satisfies the requirements of section 403(b), then the portion of the contract that includes the excess will fail to be a section 403(b) contract (and instead will be a contract to which section 403(c), relating to nonqualified annuity contracts, applies) and the remaining portion of the contract that includes the contribution that is not in excess of the section 415 limitations is a section 403(b) contract. This rule under which only the excess annual addition is subject to section 403(c) does not apply unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for the portion that includes the excess and for the section 403(b) portion (which is the portion that includes the amount that is not in excess of the section 415 limitations).

With respect to section 403(b) elective deferrals, section 403(b) applies only if the contract is purchased under a plan that includes the elective deferral limits under section 402(g), including aggregation of all plans, contracts, or arrangements of the employer that are subject to the limits of section 402(g). As in the 2004 proposed regulations, the final regulations require a section 403(b) contract to include this limit on section 403(b) elective deferrals, as imposed under sections 401(a)(30) and 402(g). For purposes of the final regulations, the term ''elective deferral'' includes a designated Roth contribution as well as a pre-tax elective contribution. These rules are generally the same as the rules for qualified cash or deferred arrangements (CODAs) under section 401(k).

Any contribution made for a participant to a section 403(b) contract for a taxable year that exceeds either the section 415 maximum annual contribution limits or the section 402(g) elective deferral limit constitutes an excess contribution that is included in gross income for that taxable year (or, if later, the taxable year in which the contract becomes nonforfeitable). The final regulations, like the 2004 proposed regulations, provide that the section 403(b) plan (including contracts under the plan) may provide that any excess deferral as a result of a failure to comply with the section 402(g) elective deferral limit for the taxable year with respect to any section 403(b) elective deferral made for a participant by the employer will be distributed to the participant, with allocable net income, no later than April 15 or otherwise in accordance with section 402(g).

Catch-Up Contributions

A section 403(b) plan may provide for additional catch-up contributions for a participant who is age 50 by the end of the year, provided that those age 50 catch-up contributions do not exceed the catch-up limit under section 414(v) for the taxable year ($5,000 for 2007). In addition, a section 403(b) plan may provide that an employee of a qualified organization who has at least 15 years of service (disregarding any period during which an individual is not an employee of the eligible employer) is entitled to a special section 403(b) catch-up limit. Under the special section 403(b) catch-up limit, the section 402(g) limit is increased by the lowest of the following three amounts: (i) $3,000; (ii) the excess of $15,000 over the amount not included in gross income for prior taxable years by reason of the special section 403(b) catch-up rules, plus elective deferrals that are designated Roth contributions; [4] or (iii) the excess of (A) $5,000 multiplied by the number of years of service of the employee with the qualified organization, over (B) the total elective deferrals made for the employee by the qualified organization for prior taxable years. For this purpose, a qualified organization is an eligible employer that is a school, hospital, health and welfare service agency (including a home health service agency), or a church-related organization.

The 2004 proposed regulations defined a health and welfare service agency as either an organization whose primary activity is to provide medical care as defined in section 213(d)(1) (such as a hospice), or a section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals or which provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that provides meals to needy individuals). In response to several commentators' requests, the final regulations expand this definition to include an adoption agency and an agency that provides either home health services or assistance to individuals with substance abuse problems or that provides help to the disabled.

Like the 2004 proposed regulations, the final regulations provide that any

[4] A technical correction was made to section 402(g)(7)(A)(ii) by section 407(a) the Gulf Opportunity Zone Act of 2005 (119 Stat. 2577), Pub. L 109–135, to clarify that the aggregate $15,000 limit on such contributions was reduced not only by pre-tax elective deferrals made pursuant to the special section 403(b) catch-up rules, but also by designated Roth contributions. Treasury has recommended that this language be further changed to reflect the intent that the reduction for designated Roth contributions at section 402(g)(7)(A)(ii)(II) be limited to designated Roth contributions that have been made pursuant to the special section 403(b) catch-up rules.

catch-up contribution for an employee who is eligible for both an age 50 catch-up and the special section 403(b) catch-up is treated first as a special section 403(b) catch-up to the extent a special section 403(b) catch-up is permitted, and then as an amount contributed as an age 50 catch-up (to the extent the age 50 catch-up amount exceeds the maximum special section 403(b) catch-up).

Timing of Distributions and Benefits

The final regulations, like the 2004 proposed regulations, contain provisions reflecting the statutory rules regarding when distributions can be made from a section 403(b) plan. Distributions of amounts attributable to section 403(b) elective deferrals may not be paid to a participant earlier than when the participant has a severance from employment, has a hardship, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. Hardship is generally defined under regulations issued under section 401(k). In addition, amounts held in a custodial account attributable to employer contributions (that are not section 403(b) elective deferrals) may not be paid to a participant before the participant has a severance from employment, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. This rule also applies to amounts transferred out of a custodial account to an annuity contract or retirement income account, including earnings thereon.

The final regulations, as did the 2004 proposed regulations, include a number of exceptions to the timing restrictions. For example, the rule for elective deferrals does not apply to distributions of section 403(b) elective deferrals (not including earnings thereon) that were contributed before January 1, 1989.

The final regulations, as did the 2004 proposed regulations, reflect the direct rollover rules of section 401(a)(31) and the related requirements of section 402(f) concerning the written explanation requirement for distributions that qualify as eligible rollover distributions, including conforming the timing rule to the rule for qualified plans.

In addition to the restrictions described in this preamble, the final regulations generally retain, with certain modifications, the additional rules from the 2004 proposed regulations relating to when distributions are permitted to be made from a section 403(b) plan, including the restrictions described in this preamble imposed by section 403(b)(7)(A)(ii) and (11) on distribution of amounts held in custodial accounts and elective deferrals, and the tax treatment of distributions from section 403(b) plans. Comments raised no objections to the various rules that were proposed in 2004, other than concerning the general rule requiring the occurrence of a stated event. The 2004 proposed regulations generally would have required the occurrence of a stated event in order to commence distributions of amounts attributable to employer contributions to section 403(b) plans other than elective deferrals or distributions from custodial accounts. The stated event rule is substantially the same as the rule applicable to qualified defined contribution plans that are not money purchase pension plans (under § 1.401–1(b)(1)(ii)), so that a plan is permitted to provide for a distribution upon completion of a fixed number of years (such as five years of participation), the attainment of a stated age, or upon the occurrence of some other identified event (such as the occurrence of a financial need,[5] including a need to buy a home).

However, the final regulations make a number of changes relating to distributions. First, the final regulations clarify that after-tax employee contributions are not subject to any in-service distribution restrictions. Second, the regulations address comments that were made regarding certain disability arrangements by clarifying that, if an insurance contract includes provisions under which contributions will be continued in the event a participant becomes disabled, then that benefit is treated as an incidental benefit that must satisfy the incidental benefit requirement applicable to qualified plans (at § 1.401–1(b)(1)(ii)). Third, changes were made to reflect elective deferrals that are designated Roth contributions, discussed further later in this preamble under the heading, ''Requirement of Certain Separate Accounts Under Section 403(b).'' Fourth, § 1.403(b)–7(b)(5) has been added referencing the automatic rollover rules of section 401(a)(31), in accordance with section 403(b)(10). See Notice 2005–5, 2005–1 CB 337, for rules interpreting this requirement. Fifth, a cross-reference to certain employment tax rules was added, discussed under the heading ''Employment Taxes.'' Sixth, in response to comments, the final regulations provide that the general rule requiring the occurrence of a stated event in order for distributions to commence does not apply to insurance contracts issued before January 1, 2009, and a special rule has been added allowing conforming amendments to be adopted by plans that are subject to ERISA. Section 1.403(b)–10(c) has been clarified to indicate that in order to be treated as a distribution under this section, the distribution must be pursuant to a QDRO as described in section 206(d)(3) of ERISA and the Department of Labor's guidance.

Severance From Employment

The final regulations, like the 2004 proposed regulations, define severance from employment in a manner that is generally the same as the regulations under section 401(k) (see § 1.401(k)–1(d)(2)), but provide that, for purposes of distributions from a section 403(b) plan, a severance from employment occurs on any date on which the employee ceases to be employed by an eligible employer that maintains the section 403(b) plan. Thus, a severance from employment would occur when an employee ceases to be employed by an eligible employer, even though the employee may continue to be employed by an entity that is part of the same controlled group but that is not an eligible employer, or on any date on which the employee works in a capacity that is not employment with an eligible employer. Examples of the situations that constitute a severance from employment include: an employee transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization; an employee ceasing to work for a public school, but continuing to be employed by the same State; and an individual employed as a minister for an entity that is neither a State nor a section 501(c)(3) organization ceasing to perform services as a minister, but continuing to be employed by the same entity.

Section 401(a)(9)

The final regulations, like the 2004 proposed regulations, require section 403(b) plans to comply with rules similar to those in the existing regulations relating to the required minimum distribution requirements of section 401(a)(9), but with some minor changes (for example, omitting the special rules for 5-percent owners). Thus, section 403(b) contracts must satisfy the incidental benefit rules. Guidance concerning the application of the incidental benefit requirements to permissible nonretirement benefits such as life, accident, or health benefits is contained in revenue rulings.[6]

[5] See, for example, Rev. Rul. 56–693 (1956–2 CB 282).

[6] See, for example, Rev. Rul. 61–121 (1961–2 CB 65); Rev. Rul. 68–304 (1968–1 CB 179); Rev. Rul. 72–240 (1972–1 CB 108); Rev. Rul. 72–241 (1972–1 CB 108); Rev. Rul. 73–239 (1973–1 CB 201); and Rev. Rul. 74–115 (1974–1 CB 100).

Loans

The final regulations adopt the provisions in the 2004 proposed regulations relating to loans to participants from a section 403(b) contract.

QDROs

The final regulations also adopt the 2004 proposed regulations'' limited rules relating to QDROs under section 414(p). Section 414(p)(9) provides that the QDRO rules only apply to plans that are subject to the anti-alienation provisions of section 401(a)(13), except that section 414(p)(9) also provides that the section 414(p) QDRO rules apply to a section 403(b) contract. The final regulations, like the proposed regulations, clarify that the QDRO rules under section 414(p) apply to section 403(b) plans. The Secretary of Labor has authority to interpret the QDRO provisions, section 206(d)(3), and its parallel provision at section 414(p) of the Code, and to issue QDRO regulations in consultation with the Secretary of the Treasury. 29 U.S.C. 1056(d)(3)(N). Under section 401(n) of the Internal Revenue Code, the Secretary of the Treasury has authority to issue rules and regulations necessary to coordinate the requirements of section 414(p) (and the regulations issued by the Secretary of Labor thereunder) with the other provisions of Chapter I of Subtitle A of the Code.

Taxation of Distributions and Benefits From a Section 403(b) Contract

The final regulations, like the 2004 proposed regulations, reflect the statutory provisions regarding the taxation of distributions and benefits from section 403(b) contracts, including the provision that generally only amounts actually distributed from a section 403(b) contract are includible in the gross income of the recipient under section 72 for the year in which distributed. The final regulations also reflect the rule that any payment that constitutes an eligible rollover distribution is not taxed in the year distributed to the extent the payment is rolled over to an eligible retirement plan. The payor must withhold 20 percent Federal income tax, however, if an eligible rollover distribution is not rolled over in a direct rollover. Another provision requires the payor to give proper written notice to the section 403(b) participant or beneficiary concerning the eligible rollover distribution provision.

Section 403(b) Nondiscrimination and Universal Availability Rules

Nondiscrimination

Section 403(b)(12)(A)(i) requires that employer contributions, other than elective deferrals, and after-tax employee contributions made under a section 403(b) contract satisfy a specified series of requirements (the nondiscrimination requirements) in the same manner as a qualified plan under section 401(a). These nondiscrimination requirements include rules relating to nondiscrimination in contributions, benefits, and coverage (sections 401(a)(4) and 410(b)), a limitation on the amount of compensation that can be taken into account (section 401(a)(17)), and the average contribution percentage rules of section 401(m) (relating to matching and after-tax employee contributions).

Notice 89–23 discusses these requirements and provides a good faith reasonable standard for satisfying these requirements. The 2004 proposed regulations would have eliminated the good faith reasonable standard for satisfying the nondiscrimination requirements of section 403(b)(12)(A)(i) for non-governmental plans. Comments acknowledged the need for and the IRS's authority to make this change. Accordingly, these final regulations do not include the Notice 89–23 good faith reasonable standard.

However, as discussed in this preamble under the heading ''Treatment of Controlled Groups that Include Certain Entities,'' the Notice 89–23 good faith reasonable standard will continue to apply to State and local public schools (and certain church entities) for determining the controlled group. Although the general nondiscrimination requirements do not apply to governmental plans (within the meaning of section 414(d)), these plans are required to limit the amount of compensation to the amount permitted under section 401(a)(17) for all purposes under the plan, including, for example the amount of compensation taken into account for employer contributions, and are required to satisfy the universal availability rule (described in this preamble under the heading ''Universal Availability for Elective Deferrals''). A non-governmental section 403(b) plan that provides for nonelective employer contributions must satisfy the coverage requirements of section 410(b) and the nondiscrimination requirements of section 401(a)(4) with respect to such contributions.

These final regulations, like the 2004 proposed regulations, require a section 403(b) plan to comply with the nondiscrimination requirements for matching contributions in the same manner as a qualified plan. Thus, a non-governmental section 403(b) plan that provides for matching contribution must satisfy the nondiscrimination requirements of section 401(m). The nondiscrimination requirements are generally tested using compensation as defined in section 414(s) and are applied on an aggregated basis taking into account all plans of the employer. See the discussion under the heading ''Treatment of Controlled Groups that Include Certain Entities.''

The nondiscrimination requirements do not apply to section 403(b) elective deferrals. Instead, a universal availability requirement, discussed further in the next section, applies to all section 403(b) elective deferrals (including elective deferrals made under a governmental section 403(b) plan).

Universal Availability for Elective Deferrals

The universal availability requirement of section 403(b)(12)(A)(ii) provides that all employees of the eligible employer must be permitted to elect to have section 403(b) elective deferrals contributed on their behalf if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals. Under the 2004 proposed regulations, the universal availability requirement would not have been satisfied unless the contributions were made pursuant to a section 403(b) plan and the plan permitted all employees of an employer an opportunity to make elective deferrals if any employee of that employer has the right to make elective deferrals.

The rules in the final regulations relating to the universal availability requirement are substantially similar to those in the 2004 proposed regulations. The final regulations clarify that the employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions (if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals as designated Roth contributions).

The preamble to the 2004 proposed regulations requested comments regarding certain exclusions that have been permitted under transitional guidance issued in 1989. Specifically, Notice 89–23 had allowed, pending issuance of regulatory guidance, the exclusion of the following classes of employees for purposes of the universal availability rule: Employees who are

covered by a collective bargaining agreement; employees who make a one-time election to participate in a governmental plan described in section 414(d), instead of a section 403(b) plan; professors who are providing services on a temporary basis to another public school for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original public school; and employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement.

The comments submitted in response to the request generally requested to have these exclusions continue to be allowed. However, after consideration of the comments received, the IRS and Treasury Department have concluded that these exclusions are inconsistent with the statute and, accordingly, they are not permitted under these regulations. Nonetheless, as described further in the following paragraphs, other rules may provide relief with respect to individuals who are under a vow of poverty and to certain university professors affected.

Rev. Rul. 68–123 (1968–1 CB 35), as clarified by Rev. Rul. 83–127 (1983–2 CB 25), generally excludes from gross income, and from wage withholding, income of an individual working under a vow of poverty for an employer controlled by a church and the individual is treated as working as an agent of the church, not as an employee. While these regulations do not provide an exclusion from the universal availability requirement for individuals working under a vow of poverty, individuals who work for an institution that is controlled by the church organization and whose compensation from the employer is not treated as wages for purposes of income tax withholding under Rev. Rul. 68–123 may be excluded from the section 403(b) plan without violating the universal availability requirement because they are not treated as employees of the entity maintaining the section 403(b) plan.

With respect to an exclusion relating to visiting professors, if an individual is rendering services to a university as a visiting professor, but continues to receive his or her compensation from his or her home university and elective deferrals on his or her behalf are made under the home university's section 403(b) plan, the final regulations do not, for purposes of section 403(b) and in any case in which such treatment is appropriate, preclude the plan maintained by the home university from treating the visiting professor as an eligible employee of the home university.

The discussion in this preamble under the heading ''Applicability date'' describes transition relief for any existing plan that excludes, in accordance with Notice 89–23, collective bargaining employees, visiting professors, government employees who make a one-time election, or employees who work under a vow of poverty.

Rules Relating to Funding Arrangements

These regulations retain, with certain modifications, the rules in the 2004 proposed regulations relating to the permitted investments for a section 403(b) contract. In general, a section 403(b) plan must be funded either by an annuity contract issued by an insurance company qualified to issue annuities in a State or a custodial account held by a bank (or a person who satisfies the conditions in section 401(f)(2)) where all of the amounts in the account are held for the exclusive benefit of plan participants or their beneficiaries in regulated investment companies (mutual funds) and certain other conditions are satisfied (including restrictions on distributions). Additional rules apply with respect to retirement income accounts for plans of a church or a convention or association of churches as discussed in the next section.

Special Rules for Church Plans' Retirement Income Accounts

The final regulations, like the 2004 proposed regulations, include a number of special rules for church plans. Under section 403(b)(9), a retirement income account for employees of a church-related organization is treated as an annuity contract for purposes of section 403(b). Under these regulations, the rules for a retirement income account are based largely on the provisions of section 403(b)(9) and the legislative history of TEFRA. The regulations define a retirement income account as a defined contribution program established or maintained by a church-related organization under which (i) there is separate accounting for the retirement income account's interest in the underlying assets (namely, it must be possible at all times to determine the retirement income account's interest in the underlying assets and to distinguish that interest from any interest that is not part of the retirement income account), (ii) investment performance is based on gains and losses on those assets, and (iii) the assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries. For this purpose, assets are treated as diverted to the employer if the employer borrows assets from the account. A retirement income account must be maintained pursuant to a program which is a plan and the plan document must state (or otherwise evidence in a similarly clear manner) the intent to constitute a retirement income account.

If any asset of a retirement income account is owned or used by a participant or beneficiary, then that ownership or use is treated as a distribution to that participant or beneficiary. The regulations also provide that a retirement income account that is treated as an annuity contract is not a custodial account (even if it is invested in stock of a regulated investment company).

A life annuity can generally only be provided from an individual account by the purchase of an insurance annuity contract. However, in light of the special rules applicable to church retirement income accounts, the final regulations, like the 2004 proposed regulations, permit a life annuity to be paid from such an account if certain conditions are satisfied. The conditions are that the distribution from the account has an actuarial present value, at the annuity starting date, that is equal to the participant's or beneficiary's accumulated benefit, based on reasonable actuarial assumptions, including assumptions regarding interest and mortality, and that the plan sponsor guarantee benefits in the event that a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

Termination of a Section 403(b) Plan

The final regulations adopt the provisions of the 2004 proposed regulations permitting an employer to amend its section 403(b) plan to eliminate future contributions for existing participants, and allowing plan provisions that permit plan termination and a resulting distribution of accumulated benefits, with the associated right to roll over eligible rollover distributions to an eligible retirement plan, such as an individual retirement account or annuity (IRA). Comments on the rules in the 2004 proposed regulations regarding plan termination were favorable. In general, the distribution of accumulated benefits is permitted under these regulations only if the employer (taking into account all entities that are treated as a

single employer under section 414 on the date of the termination) does not make contributions to any section 403(b) contract that is not part of the plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the period beginning 12 months before the termination and ending 12 months after distribution of all assets from the terminated plan, fewer than 2 percent of the employees who were eligible under the section 403(b) plan as of the date of plan termination are eligible under the alternative section 403(b) contract, the other section 403(b) contract is disregarded. In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. A distribution for this purpose includes delivery of a fully paid individual insurance annuity contract.

Effect of a Failure To Satisfy Section 403(b)

These regulations include revisions to the 2004 proposed regulations that address the effects of a failure to satisfy section 403(b). Section 403(b)(5) provides for all of the contracts purchased for an employee by an employer to be treated as a single contract for purposes of section 403(b). Thus, if a contract fails to satisfy any of the section 403(b) requirements, then not only that contract but also any other contract purchased for that individual by that employer would fail to be a contract that qualifies for tax-deferral under section 403(b).

Under these regulations, as under the 2004 proposed regulations, if a contract includes any amount that fails to satisfy the requirements of these regulations, then, except for special rules relating to vesting conditions and excess contributions (under section 415 or section 402(g)), that contract and any other contract purchased for that individual by that employer does not constitute a section 403(b) contract. In addition, if a contract is not established pursuant to a written plan, then the contract does not satisfy section 403(b). Thus, if an employer fails to have a written plan, any contract purchased by that employer would not be a section 403(b) contract. Similarly, if an employer is not an eligible employer for purposes of section 403(b), none of the contracts purchased by that employer is a section 403(b) contract. If a plan fails to satisfy the nondiscrimination rules (including a failure to operate the plan in accordance with its coverage provisions or a failure to operate the plan in a manner that satisfies the nondiscrimination rules), none of the contracts issued under the plan would be section 403(b) contracts.

However, under these regulations, any operational failure, other than those described in the preceding paragraph, that is solely within a specific contract generally will not adversely affect the contracts issued to other employees that qualify in form and operation with section 403(b). Thus, for example, if an employee's elective deferrals under a contract, when aggregated with any other contract, plan, or arrangement of the employer for that employee during a calendar year, exceed the maximum deferral amount permitted under section 402(g)(1)(A) (as made applicable by section 403(b)(1)(E)), the failure would adversely affect the contracts issued to the employee by that employer, but would not adversely affect any other employee's contracts.

Requirement of Certain Separate Accounts Under Section 403(b)

The final regulations, like the 2004 proposed regulations, include technical provisions addressing certain situations in which a separate account [7] is necessary under section 403(b). For example, a separate bookkeeping account is required for any contract in which only a portion of the employee's interest is vested because, in such a case, separate accounting for each type of contribution (and earnings thereon) that is subject to a different vesting schedule is necessary to determine which vested contributions, including earnings thereon, are treated as held under a section 403(b) contract. In addition, the final regulations also clarify that if the section 403(b) plan fails to establish a separate account for contributions in excess of the section 415(c) limitation under section 403(c) (relating to nonqualified annuity contracts whose present values are generally subject to current taxation), so that such excess contributions are commingled in a single insurance contract with contributions intended to qualify under section 403(b) without maintaining a separate account for each amount, then none of the amounts held under the insurance contract qualify for tax deferral under section 403(b). Any such separate account must be established by the time the excess contribution is made to the plan. The separate account for excess contributions under section 415(c) is necessary to effectuate differences in the tax treatment of distributions (for example, because of the need to properly allocate basis under section 72 and separately identify amounts that can be rolled over). Similarly, a separate account is required for elective deferrals to be treated as held in a designated Roth account, as described in the following paragraph.

Designated Roth Accounts

These regulations also include final regulations relating to elective deferrals that are designated Roth contributions under a section 403(b) plan. These regulations, however, do not address the taxation of a distribution of designated Roth contributions from a section 403(b) plan. See § 1.402A–1 for those rules. The final regulations relating to elective deferrals under a section 403(b) plan that are designated Roth contributions are substantially unchanged from the proposed regulations that were issued in January of 2006 regarding designated Roth accounts under a section 403(b) plan.[8]

Interaction Between Title I of ERISA and Section 403(b) of the Code

The Treasury Department and the IRS consulted with the Department of Labor in connection with both the 2004 proposed regulations and these final regulations concerning the interaction between Title I of ERISA and section 403(b) of the Internal Revenue Code. In particular, the consultation focused on whether the requirements imposed on employers in these regulations would exceed the scope of the Department of Labor's safe harbor regulation at 29 CFR 2510.3–2(f) and result in all section 403(b) programs sponsored by tax-exempt employers (other than governmental plans and certain church plans) falling under the purview of ERISA.

According to the Department of Labor, Title I of ERISA generally applies to ''any plan, fund, or program * * * established or maintained by an employer or by an employee organization, or by both, to the extent that * * * such plan, fund, or program * * * provides retirement income to employees, or * * * results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.'' ERISA section 3(2)(A). However, governmental plans and church plans are generally excluded from coverage under Title I of ERISA. ERISA section 4(b)(1) and (2). Therefore,

[7] These rules are not related to segregated asset accounts under section 817(h).

[8] REG–146459–05, published in the **Federal Register** (71 FR 4320) on January 26, 2006.

contracts purchased or provided under a program that is either a ''governmental plan'' under section 3(32) of ERISA or a ''church plan'' under section 3(33) of ERISA are not generally covered under Title I. However, section 403(b) of the Internal Revenue Code is also available with respect to contracts purchased or provided by employers for employees of a section 501(c)(3) organization, and many programs for the purchase of section 403(b) contracts offered by such employers are covered under Title I of ERISA as part of an ''employee pension benefit plan'' within the meaning of section 3(2)(A) of ERISA. The Department of Labor promulgated a regulation in 1975, 29 CFR 2510.3–2(f), describing circumstances under which an employer's program for the purchase of section 403(b) contracts for its employees, which is not otherwise excluded from coverage under Title I, will not be considered to constitute the establishment or maintenance of an ''employee pension benefit plan'' under Title I of ERISA.

As described in the preamble to the 2004 proposed regulations, the Department of Labor advised the Treasury Department and the IRS that the proposed regulations did not appear to require, but left open the possibility that an employer may undertake, responsibilities in connection with a section 403(b) program that would exceed the limits in the safe harbor and constitute establishing and maintaining an ERISA-covered plan. Comments submitted on the proposal supported the continued availability of non-Title I section 403(b) programs to employees of tax-exempt employers and asked for additional guidance for employers who offer their employees access to such programs.

According to the Department of Labor, review of the final section 403(b) regulations has not led the Department of Labor to change its view on the principles that apply in determining whether any given section 403(b) program is covered by Title I of ERISA. Even though the differences between the tax rules for section 403(b) programs and those governing other ERISA-covered pension plans may have diminished as a result of the final section 403(b) regulations, the Department of Labor continues to be of the view that tax-exempt employers can comply with the requirements in the section 403(b) regulations and remain within the Department of Labor's safe harbor for tax-sheltered annuity programs funded solely by salary deferrals. The Department of Labor notes, however, that the new section 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement. The question of whether any particular employer, in complying with the section 403(b) regulations, has established or maintained a plan covered under Title I of ERISA must be analyzed on a case-by-case basis applying the criteria set forth in 29 CFR § 2510.3–2(f) and section 3(2) of ERISA. To assist employers interested in offering their employees access to a tax sheltered annuity program that would not be an ERISA-covered plan, the Department of Labor is issuing, in conjunction with the final publication of this regulation, a Field Assistance Bulletin to provide additional guidance on the interaction of the safe harbor and the requirements in these final regulations. The Field Assistance Bulletin can be found at *http://www.dol.gov/ebsa*.

Treatment of Controlled Groups That Include Tax-Exempt Entities

The final regulations retain the basic rules in the 2004 proposed regulations regarding controlled groups for entities that are tax-exempt under section 501(a), but with a number of modifications to reflect the comments that were made. As in the 2004 proposed regulations, these rules are not limited to section 403(b) plans, but apply more broadly for purposes of determining when tax-exempt entities are treated as a single employer under section 414(b), (c), (m), and (o). Thus, for example, these rules apply for purposes of plans maintained by a tax-exempt entity that are intended to be qualified under section 401(a). These rules can apply to treat two section 501(c) organizations as a single employer, or a section 501(c) organization and a non-section 501(c) organization as a single employer, if the organizations are under common control. For a section 501(c)(3) organization that makes contributions to a section 403(b) plan, these rules would be generally relevant for purposes of the nondiscrimination requirements, as well as for the section 415 contribution limitations, the special section 403(b) catch-up contributions, and the section 401(a)(9) minimum distribution rules.

Under the rules in the 2004 proposed regulations, the employer for a plan maintained by a section 501(c) organization would include not only the organization whose employees participate in the plan, but also any other organization that is under common control with the tax-exempt organization. Under the 2004 proposed regulations, the existence of control would be determined based on the facts and circumstances. For this purpose, common control would exist between a tax-exempt organization and another organization if at least 80 percent of the directors or trustees of one organization were either representatives of, or directly or indirectly controlled by, the other organization.[9] The 2004 proposed regulations permitted tax-exempt organizations to choose to be aggregated (permissive aggregation) if they maintained a single plan covering one or more employees from each organization and the organizations regularly coordinated their day-to-day exempt activities. These rules were subject to an overall anti-abuse rule. The final regulations retain the basic rules in the 2004 proposed regulations and the anti-abuse rule, and add an example to illustrate when the anti-abuse rule might apply.

Comments on the 2004 proposed regulations generally approved of the proposed controlled group rules, but some comments argued for expanding the category of entities that can use the permissive aggregation rules. These comments typically did not recommend an overall standard for when permissive aggregation should be permitted, but identified certain specific practices which would be facilitated by permissive aggregation. In response, these regulations authorize the IRS to issue published guidance permitting other types of combinations of entities that include tax-exempt entities to elect to be treated as under common control for one or more specified purposes. This authority is limited to situations in which there are substantial business reasons for maintaining each entity in a separate trust, corporation, or other form, and under which common control treatment would be consistent with the anti-abuse standards in the regulations. It is expected that this authority would not be exercised unless the IRS determines that the organizations are so integrated in their operations as to effectively constitute a single coordinated employer for purposes of sections 414(b), (c), (m), and (o), including common employee benefit plans.

A comment was also received stating that a legally required trusteeship for a labor union that has been imposed in order to correct corruption or financial malpractice[10] should not constitute control. In response, a change was made to the regulations to reflect the intent

[9] Treas. Reg. § 1.512(b)–1(1)(4)(i)(*b*) uses a similar test to determine control of a non-stock organization. Note that those regulations do not reflect amendments that were made in section 512(b)(13) by section 1041(a) of the Taxpayer Relief Act of 1997 (111 Stat. 788).

[10] See 29 U.S.C. 462.

that whether a person has the power to appoint and replace a trustee or director is based on facts and circumstances. For example, that power would generally not exist if that power was extremely limited due to the application of other laws, such as where a labor union was put under trusteeship pursuant to a court order, the trusteeship is for the sole purpose of correcting corruption, financial malpractice, or similar circumstances, and the replacement trustees were permitted to serve only for the time necessary for that purpose.

These controlled group rules for tax-exempt entities generally do not apply to certain church entities under section 3121(w)(3). These rules also do not apply to a State or local government or a federal government entity. Until further guidance is issued, church entities under section 3121(w)(3)(A) and (B) and State or local government public schools that sponsor section 403(b) plans can continue to rely on the rules in Notice 89–23 for determining the controlled group.

Employment Taxes

These regulations include several new cross-references to certain rules concerning the application of employment taxes. For example, the definition of an elective deferral at § 1.403(b)–2(a)(7) of these regulations refers to § 1.402(g)(3)–1 of these regulations, which in turn refers to section 3121(a)(5)(D). See § 31.3121(a)(5)–2T of the temporary regulations for additional guidance on section 3121(a)(5)(D) (defining salary reduction agreement for purposes of the Federal Insurance Contributions Act (FICA)).

As another example, § 1.403(b)–7(f) of these regulations generally references the special income tax withholding rules under section 3405 for purposes of income tax withholding on distributions from section 403(b) contracts and also references the special rules at § 1.72(p)–l, Q&A–15, and § 35.3405(c)–1, Q&A–11, relating to income tax withholding for loans deemed distributed from qualified employer plans, including section 403(b) contracts. However, the general income tax withholding rules apply for purposes of income tax withholding for annuity contracts or custodial accounts that are not section 403(b) contracts, as well as for cases in which an annuity contract or custodial account ceases to qualify as a section 403(b) contract. See section 3401 and §§ 1.83–8(a) and 35.3405–1T, Q&A–18.

Effect of These Regulations on Other Guidance

Since the existing regulations were issued in 1964, a number of revenue rulings and other items of guidance under section 403(b) have become outdated as a result of changes in law. In addition, as a result of the inclusion in these regulations of much of the guidance that the IRS has issued regarding section 403(b), these regulations effectively supersede or substantially modify a number of revenue rulings and notices that have been issued under section 403(b). Thus, as indicated in the preamble to the 2004 proposed regulations, the IRS anticipates taking action in the future to obsolete many revenue rulings, notices, and other guidance under section 403(b).[11]

However, the positions taken in certain rulings and other outstanding guidance are expected to be retained. For example, it is intended that the existing rules [12] for determining when employees are performing services for a public school will continue to apply. Further, as discussed above in the preamble under the heading, ''Treatment of Controlled Groups that Include Tax-Exempt Entities,'' church entities under section 3121(w)(3)(A) and (B) and public schools that sponsor section 403(b) plans can continue to rely on the rules in Notice 89–23 for determining the controlled group. In addition, certain positions taken in prior guidance are expected to be reevaluated in light of these regulations, such as Rev. Rul. 2004–67 (2004–28 IRB 28), which revised the group trust rules of Rev. Rul. 81–100 (1981–1 CB 326). With the issuance of these regulations, a number of conforming changes will be considered for the compliance programs maintained by the IRS, as most recently published in Rev. Proc. 2006–27 (2006–22 IRB 945) (EPCRS), including, for example, to reflect the written plan requirement and the positions described above in this preamble under the heading, ''Effect of a Failure to Satisfy Section 403(b).''

The prior regulations under section 403(b) had included certain rules for determining the amount of the contributions made for an employee under a defined benefit plan, based on the employee's pension under the plan. These rules are generally no longer applicable for section 403(b) because the limitations on contributions to a section 403(b) contract under section 415(c) are no longer coordinated with accruals under a defined benefit plan.[13] However, the rules for determining the amount of contributions made for an employee under a defined benefit plan in the prior regulations under section 403(b) had also been used for purposes of section 402(b) (relating to nonqualified plans funded through trusts). These regulations replace those rules with regulations under section 402(b) that provide for the same rules (those in the section 403(b) regulations that were in effect prior to these regulations) to continue to apply for purposes of section 402(b). However, these section 402(b) regulations also authorize the Commissioner to issue guidance for determining the amount of the contributions made for an employee under a defined benefit plan under section 402(b).

Applicability Date

These regulations are generally applicable for taxable years beginning after December 31, 2008. Thus, because individuals will almost uniformly be on a calendar taxable year, these regulations will generally apply on January 1, 2009. However, these regulations include a number of explicit transition rules.

For a section 403(b) plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on July 26, 2007, the regulations do not apply until the earlier of: (1) The date on which the last of such collective bargaining agreements terminates (determined

[11] When these regulations go into effect, the following guidance will be outdated or superseded by these regulations and it is expected that guidance will be issued in the future to formally supersede these items: Rev. Rul. 64–333 (1964–2 CB 114); Rev. Rul. 65–200 (1965–2 CB 141); Rev. Rul. 66–254 (1966–2 CB. 125); Rev. Rul. 66–312 (1966–2 CB 127); Rev. Rul. 67–78 (1967–1 CB 94); Rev. Rul. 67–69 (1967–1 CB 93); Rev. Rul. 67–361 (1967–2 CB 153); Rev. Rul. 67–387 (1967–2 CB 153); Rev. Rul. 67–388 (1967–2 CB 153); Rev. Rul. 68–179 (1968–1 CB 179); Rev. Rul. 68–482 (1968–2 CB 186); Rev. Rul. 68–487 (1968–2 CB 187); Rev. Rul. 68–488 (1968–2 CB 188); Rev. Rul. 69–629 (1969–2 CB 101)_; Rev. Rul. 70–243 (1970–1 CB 107); Rev. Rul. 87–114 (1987–2 CB 116); Rev. Rul. 90–24 (1990–1 CB 97); Notice 90–73 (1990–2 CB 353); Notice 92–36 (1992–2 CB 364); and Announcement 95–48 (1995–23 IRB 13). In addition, Notice 89–23 (1989–1 CB 654) is likewise superseded as a result of these regulations, except to the extent described above under the heading ''Treatment of Controlled Groups that Include Tax-Exempt Entities.'' It is expected that the following guidance will not be superseded when these regulations are issued in final form: Rev. Rul. 66–254 (1966–2 CB 125); Rev. Rul. 68–33 (1968–1 CB 175); Rev. Rul 68–58 (1968–1 CB 176); Rev. Rul. 68–116 (1968–1 CB 177); Rev. Rul. 68–648 (1968–2 CB 49); Rev. Rul. 68–488 (1968–2 CB 188); and Rev. Rul. 69–146 (1969–1 CB 132).

[12] Rev. Rul. 73–607 (1973–2 CB 145) and Rev. Rul. 80–139 (1980–1 CB 88).

[13] However, see § 1.403(b)–10(f)(2) of these regulations for a special rule applicable to certain church defined benefit plans that were in effect on September 3, 1982.

without regard to any extension thereof after July 26, 2007); or (2) July 26, 2010. For a section 403(b) plan maintained by a church-related organization for which the authority to amend the plan is held by a church convention (within the meaning of section 414(e)), the regulations do not apply before the beginning of the first plan year following December 31, 2009.

There are also special applicability dates for several of the specific provisions in these regulations. First, special rules apply to plans which may have included one or more of the exclusions that Notice 89–23 permitted for the universal availability rule, but which are no longer permitted under these regulations. Specifically, a special rule applies if a plan has eligibility conditions for elective deferrals relating to employees who make a one-time election to participate in a governmental plan described in section 414(d) instead of a section 403(b) plan, professors who are providing services on a temporary basis to another school for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original school, or employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement. If, as permitted by Notice 89–23, a plan excludes any of these three classes of employees from eligibility to make elective deferrals on July 26, 2007, the plan is permitted to continue that exclusion until taxable years beginning on or after January 1, 2010. In addition, if a plan excludes employees covered by a collective bargaining agreement from eligibility to make elective deferrals on July 26, 2007, the plan is permitted to continue that exclusion until the later of (i) the first day of the first taxable year that begins after December 31, 2008, or (ii) the earlier of (I) the date that such agreement terminates (determined without regard to any extension thereof after July 26, 2007) or (II) July 26, 2010. In the case of a governmental plan (as defined in section 414(d)) for which the authority to amend the plan is held by a legislative body that meets in legislative session, the plan is permitted to continue the exclusion until the earlier of: (i) The close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009; or (ii) January 1, 2011.

These regulations (at § 1.403(b)–6(b)) also provide that a section 403(b) contract is permitted to distribute retirement benefits to the participant no earlier than the earliest of the participant's severance from employment or upon the prior occurrence of some event, subject to a number of exceptions (relating to distributions from custodial accounts, distributions attributable to section 403(b) elective deferrals, correction of excess deferrals, distributions at plan termination, and payment of after-tax employee contributions). This rule does not apply for contracts issued before January 1, 2009. In addition, in order to permit plans to comply with the rules relating to in-service distributions for contracts issued before January 1, 2009, the regulations provide that an amendment adopted before January 1, 2009, to comply with these rules does not violate the anti-cutback rules of section 204(g) of ERISA.

These regulations (at § 1.403(b)–8(c)(2)) also do not permit a life insurance contract, an endowment contract, a health or accident insurance contract, or a property, casualty, or liability insurance contract to constitute an annuity contract for purposes of section 403(b). This rule does not apply for contracts issued before September 24, 2007.

These regulations also include specific rules relating to contract exchanges that were permitted under Rev. Rul. 90–24. These new rules do not apply to contracts received in an exchange that occurred on or before September 24, 2007, assuming that the exchange (including the contract received in the exchange) satisfies applicable pre-existing legal requirements (including Rev. Rul. 90–24).

Finally, these regulations include special applicability date rules to coordinate with recently issued regulations under sections 402A and 415.

For periods following July 26, 2007 and before the applicable date, taxpayers can rely on these regulations, except that (1) such reliance must be on a consistent and reasonable basis and (2) the special rule at § 1.403(b)–10(a) of these regulations permitting accumulated benefits to be distributed on plan termination can be relied upon only if all of the contracts issued under the plan at that time satisfy all of the applicable requirements of these regulations (other than the requirement at § 1.403(b)–3(b)(3)(i) of these regulations that there be a written plan).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the determination that respondents will need to spend minimal time (an average of 4.1 hours per year) complying with the contract exchange requirements in these regulations, and small entities are generally expected to spend much less time. Thus, the cost of complying with this statutory requirement is small, even for small entities. Therefore, a Regulatory Flexibility Analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal authors of these regulations are R. Lisa Mojiri-Azad and John Tolleris, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

26 CFR Part 54

Excise taxes, Pensions, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR parts 1, 31, 54, and 602 are amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by removing the entry for § 1.403(b)–3 and adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.403(b)–6 also issued under 26 U.S.C. 403(b)(10). * * *

Section 1.414(c)–5 also issued under 26 U.S.C. 414(b), (c), and (o). * * *

■ **Par. 2.** Section 1.402(b)–1 is amended by revising paragraphs (a)(2) and (b)(2)(ii) to read as follows:

§ 1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).

(a) * * *

(2) *Determination of amount of employer contributions.* If, for an employee, the actual amount of employer contributions referred to in paragraph (a)(1) of this section for any taxable year of the employee is not determinable or for any other reason is not known, then, except as set forth in rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), such amount shall be either—

(i) The excess of—

(A) The amount determined as of the end of such taxable year in accordance with the formula described in § 1.403(b)–1(d)(4), as it appeared in the April 1, 2006, edition of 26 CFR Part 1; over

(B) The amount determined as of the end of the prior taxable year in accordance with the formula described in paragraph (a)(2)(i)(A) of this section; or

(ii) The amount determined under any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan.

(b) * * *

(2) * * *

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of the employee's interest in such trust is determined in accordance with rules prescribed by the Commissioner under the authority in paragraph (a)(2) of this section.

* * * * *

■ **Par. 3.** Section 1.402(g)(3)–1 is added to read as follows:

§ 1.402(g)(3)–1 Employer contributions to purchase a section 403(b) contract under a salary reduction agreement.

(a) *General rule.* With respect to an annuity contract under section 403(b), except as provided in paragraph (b) of this section, an elective deferral means an employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement within the meaning of section 3121(a)(5)(D).

(b) *Special rule.* Notwithstanding paragraph (a) of this section, for purposes of section 403(b), an elective deferral only includes a contribution that is made pursuant to a cash or deferred election (as defined at § 1.401(k)–1(a)(3)). Thus, for purposes of section 402(g)(3)(C), an elective deferral does not include a contribution that is made pursuant to an employee's one-time irrevocable election made on or before the employee's first becoming eligible to participate under the employer's plans or a contribution made as a condition of employment that reduces the employee's compensation.

(c) *Applicable date.* This section is applicable for taxable years beginning after December 31, 2008.

■ **Par. 4.** Section 1.402A–1, A–1 is revised to read as follows:

§ 1.402A–1 Designated Roth Accounts.

* * * * *

A–1. A designated Roth account is a separate account under a qualified cash or deferred arrangement under a section 401(a) plan, or under a section 403(b) plan, to which designated Roth contributions are permitted to be made in lieu of elective contributions and that satisfies the requirements of § 1.401(k)–1(f) (in the case of a section 401(a) plan) or § 1.403(b)–3(c) (in the case of a section 403(b) plan).

* * * * *

■ **Par. 5.** Section 1.403(b)–0 is added to read as follows:

§ 1.403(b)–0 Taxability under an annuity purchased by a section 501(c)(3) organization or a public school.

This section lists the headings that appear in §§ 1.403(b)–1 through 1.403(b)–11.

§ 1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.

§ 1.403(b)–2 Definitions.

(a) Application of definitions.
(b) Definitions.

§ 1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.

(a) Exclusion for section 403(b) contracts.
(b) Application of requirements.
(c) Special rules for designated Roth section 403(b) contributions.
(d) Effect of failure.

§ 1.403(b)–4 Contribution limitations.

(a) Treatment of contributions in excess of limitations.
(b) Maximum annual contribution.
(c) Section 403(b) elective deferrals.
(d) Employer contributions for former employees.
(e) Special rules for determining years of service.
(f) Excess contributions of deferrals.

§ 1.403(b)–5 Nondiscrimination rules.

(a) Nondiscrimination rules for contributions other than section 403(b) elective deferrals.
(b) Universal availability required for section 403(b) elective deferrals.
(c) Plan required.
(d) Church plans exception.
(e) Other rules.

§ 1.403(b)–6 Timing of distributions and benefits.

(a) Distributions generally.
(b) Distributions from contracts other than custodial accounts or amounts attributable to section 403(b) elective deferrals.
(c) Distributions from custodial accounts that are not attributable to section 403(b) elective deferrals.
(d) Distribution of section 403(b) elective deferrals.
(e) Minimum required distributions for eligible plans.
(f) Loans.
(g) Death benefits and other incidental benefits.
(h) Special rule regarding severance from employment.

§ 1.403(b)–7 Taxation of distributions and benefits.

(a) General rules for when amounts are included in gross income.
(b) Rollovers to individual retirement arrangements and other eligible retirement plans.
(c) Special rules for certain corrective distributions.
(d) Amounts taxable under section 72(p)(1).
(e) Special rules relating to distributions from a designated Roth account.
(f) Certain rules relating to employment taxes.

§ 1.403(b)–8 Funding.

(a) Investments.
(b) Contributions to the plan.
(c) Annuity contracts.
(d) Custodial accounts.
(e) Retirement income accounts.
(f) Combining assets.

§ 1.403(b)–9 Special rules for church plans.

(a) Retirement income accounts.
(b) Retirement income account defined.
(c) Special deduction rule for self-employed ministers.

§ 1.403(b)–10 Miscellaneous provisions.

(a) Plan terminations and frozen plans.
(b) Contract exchanges and plan-to-plan transfers.
(c) Qualified domestic relations orders.
(d) Rollovers to a section 403(b) contract.
(e) Deemed IRAs.
(f) Defined benefit plans.
(g) Other rules relating to section 501(c)(3) organizations.

§ 1.403(b)–11 Applicable date.

(a) General rule.
(b) Collective bargaining agreements.
(c) Church conventions.
(d) Special rules for plans that exclude certain types of employees from elective deferrals.
(e) Special rules for plans that permit in-service distributions.
(f) Special rule for life insurance contracts.
(g) Special rule for contracts received in an exchange.

■ **Par. 6.** Sections 1.403(b)–1, 1.403(b)–2, and 1.403(b)–3 are revised to read as follows:

§ 1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.

Section 403(b) and §§ 1.403(b)–2 through 1.403(b)–10 provide rules for the Federal income tax treatment of an annuity purchased for an employee by an employer that is either a tax-exempt entity under section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) or a public school, or for a minister described in section 414(e)(5)(A). See section 403(a) (relating to qualified annuities) for rules regarding the taxation of an annuity purchased under a qualified annuity plan that meets the requirements of section 404(a)(2), and see section 403(c) (relating to nonqualified annuities) for rules regarding the taxation of other types of annuities.

§ 1.403(b)–2 Definitions.

(a) *Application of definitions.* The definitions set forth in this section are applicable for purposes of § 1.403(b)–1, this section and §§ 1.403(b)–3 through 1.403(b)–11.

(b) *Definitions*—(1) *Accumulated benefit* means the total benefit to which a participant or beneficiary is entitled under a section 403(b) contract, including all contributions made to the contract and all earnings thereon.

(2) *Annuity contract* means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. See § 1.401(f)–1(d)(2) and (e) for the definition of an annuity, and see § 1.403(b)–8(c)(3) for a special rule for certain State plans. See also §§ 1.403(b)–8(d) and 1.403(b)–9(a) for additional rules regarding the treatment of custodial accounts and retirement income accounts as annuity contracts.

(3) *Beneficiary* means a person who is entitled to benefits in respect of a participant following the participant's death or an alternate payee pursuant to a qualified domestic relations order, as described in § 1.403(b)–10(c).

(4) *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means a section 403(b) elective deferral permitted under section 414(v) (as described in § 1.403(b)–4(c)(2)) or section 402(g)(7) (as described in § 1.403(b)–4(c)(3)).

(5) *Church* means a church as defined in section 3121(w)(3)(A) and a qualified church-controlled organization as defined in section 3121(w)(3)(B).

(6) *Church-related organization* means a church or a convention or association of churches, including an organization described in section 414(e)(3)(A).

(7) *Elective deferral* means an elective deferral under § 1.402(g)–1 (with respect to an employer contribution to a section 403(b) contract) and any other amount that constitutes an elective deferral under section 402(g)(3).

(8) (i) *Eligible employer* means—

(A) A State, but only with respect to an employee of the state performing services for a public school;

(B) A section 501(c)(3) organization with respect to any employee of the section 501(c)(3) organization;

(C) Any employer of a minister described in section 414(e)(5)(A), but only with respect to the minister; or

(D) A minister described in section 414(e)(5)(A), but only with respect to a retirement income account established for the minister.

(ii) An entity is not an eligible employer under paragraph (a)(8)(i)(A) of this section if it treats itself as not being a State for any other purpose of the Internal Revenue Code, and a subsidiary or other affiliate of an eligible employer is not an eligible employer under paragraph (a)(8)(i) of this section if the subsidiary or other affiliate is not an entity described in paragraph (a)(8)(i) of this section.

(9) *Employee* means a common-law employee performing services for the employer, and does not include a former employee or an independent contractor. Subject to any rules in § 1.403(b)–1, this section and §§ 1.403(b)–3 through 1.403(b)–11 that are specifically applicable to ministers, an employee also includes a minister described in section 414(e)(5)(A) when performing services in the exercise of his or her ministry.

(10) *Employee performing services for a public school* means an employee performing services as an employee for a public school of a State. This definition is not applicable unless the employee's compensation for performing services for a public school is paid by the State. Further, a person occupying an elective or appointive public office is not an employee performing services for a public school unless such office is one to which an individual is elected or appointed only if the individual has received training, or is experienced, in the field of education. The term *public office* includes any elective or appointive office of a State.

(11) *Includible compensation* means the employee's compensation received from an eligible employer that is includible in the participant's gross income for Federal income tax purposes (computed without regard to section 911) for the most recent period that is a year of service. Includible compensation for a minister who is self-employed means the minister's earned income as defined in section 401(c)(2) (computed without regard to section 911) for the most recent period that is a year of service. Includible compensation does not include any compensation received during a period when the employer is not an eligible employer. Includible compensation also includes any elective deferral or other amount contributed or deferred by the eligible employer at the election of the employee that would be includible in the gross income of the employee but for the rules of section 125, 132(f)(4), 402(e)(2), 402(h)(1)(B), 402(k), or 457(b). The amount of includible compensation is determined without regard to any community property laws. See section 415(c)(3)(A) through (D) for additional rules, and see § 1.403(b)–4(d) for a special rule regarding former employees.

(12) *Participant* means an employee for whom a section 403(b) contract is currently being purchased, or an employee or former employee for whom a section 403(b) contract has previously been purchased and who has not received a distribution of his or her entire accumulated benefit under the contract.

(13) *Plan* means a plan as described in § 1.403(b)–3(b)(3).

(14) *Public school* means a State-sponsored educational organization described in section 170(b)(1)(A)(ii) (relating to educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where educational activities are regularly carried on).

(15) *Retirement income account* means a defined contribution program established or maintained by a church-related organization to provide benefits under section 403(b) for its employees or their beneficiaries as described in § 1.403(b)–9.

(16) *Section 403(b) contract; section 403(b) plan*—(i) *Section 403(b) contract* means a contract that satisfies the requirements of § 1.403(b)–3. If for any taxable year an employer contributes to more than one section 403(b) contract for a participant or beneficiary, then, under section 403(b)(5), all such contracts are treated as one contract for purposes of section 403(b) and § 1.403(b)–1, this section, and §§ 1.403(b)–3 through 1.403(b)–11. See also § 1.403(b)–3(b)(1).

(ii) *Section 403(b) plan* means the plan of the employer under which the section 403(b) contracts for its employees are maintained.

(17) *Section 403(b) elective deferral; designated Roth contribution*—(i) *Section 403(b) elective deferral* means an elective deferral that is an employer contribution to a section 403(b) plan for an employee. See § 1.403(b)–5(b) for additional rules with respect to a section 403(b) elective deferral.

(ii) *Designated Roth contribution* under a section 403(b) plan means a section 403(b) elective deferral that satisfies § 1.403(b)–3(c).

(18) *Section 501(c)(3) organization* means an organization that is described in section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) and exempt from tax under section 501(a).

(19) *Severance from employment* means that the employee ceases to be employed by the employer maintaining the plan. See § 1.401(k)–1(d) for additional guidance concerning severance from employment. See also § 1.403(b)–6(h) for a special rule under which severance from employment is determined by reference to employment with the eligible employer.

(20) *State* means a State, a political subdivision of a State, or any agency or instrumentality of a State. For this purpose, the District of Columbia is treated as a State. In addition, for purposes of determining whether an individual is an employee performing services for a public school, an Indian tribal government is treated as a State, as provided under section 7871(a)(6)(B). See also section 1450(b) of the Small Business Job Protection Act of 1996 (110 Stat. 1755, 1814) for special rules treating certain contracts purchased in a plan year beginning before January 1, 1995, that include contributions by an Indian tribal government as section 403(b) contracts, whether or not those contributions are for employees performing services for a public school.

(21) *Year of service* means each full year during which an individual is a full-time employee of an eligible employer, plus fractional credit for each part of a year during which the individual is either a full-time employee of an eligible employer for a part of the year or a part-time employee of an eligible employer. See § 1.403(b)–4(e) for rules for determining years of service.

§ 1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.

(a) *Exclusion for section 403(b) contracts.* Amounts contributed by an eligible employer for the purchase of an annuity contract for an employee are excluded from the gross income of the employee under section 403(b) only if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied. In addition, amounts contributed by an eligible employer for the purchase of an annuity contract for an employee pursuant to a cash or deferred election (as defined at § 1.401(k)–1(a)(3)) are not includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election) if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied. However, the preceding two sentences generally do not apply to designated Roth contributions; see paragraph (c) of this section and § 1.403(b)–7(e) for special taxation rules that apply with respect to designated Roth contributions under a section 403(b) plan.

(1) *Not a contract issued under qualified plan or eligible governmental plan.* The annuity contract is not purchased under a qualified plan (under section 401(a) or 403(a)) or an eligible governmental plan under section 457(b).

(2) *Nonforfeitability.* The rights of the employee under the annuity contract (disregarding rights to future premiums) are nonforfeitable. An employee's rights under a contract fail to be nonforfeitable unless the employee for whom the contract is purchased has at all times a fully vested and nonforfeitable right (as defined in regulations under section 411) to all benefits provided under the contract. See paragraph (d)(2) of this section for additional rules regarding the nonforfeitability requirement of this paragraph (a)(2).

(3) *Nondiscrimination.* In the case of an annuity contract purchased by an eligible employer other than a church, the contract is purchased under a plan that satisfies section 403(b)(12) (relating to nondiscrimination requirements, including universal availability). See § 1.403(b)–5.

(4) *Limitations on elective deferrals.* In the case of an elective deferral, the contract satisfies section 401(a)(30) (relating to limitations on elective deferrals). A contract does not satisfy section 401(a)(30) as required under this paragraph (a)(4) unless the contract requires that all elective deferrals for an employee not exceed the limits of section 402(g)(1), including elective deferrals for the employee under the contract and any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer. See § 1.401(a)–30.

(5) *Nontransferability.* The contract is not transferable. This paragraph (a)(5) does not apply to a contract issued before January 1, 1963. See section 401(g).

(6) *Minimum required distributions.* The contract satisfies the requirements of section 401(a)(9) (relating to minimum required distributions). See § 1.403(b)–6(e).

(7) *Rollover distributions.* The contract provides that, if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, as defined in section 402(c)(8)(B), and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. See § 1.403(b)–7(b)(2).

(8) *Limitation on incidental benefits.* The contract satisfies the incidental benefit requirements of section 401(a). See § 1.403(b)–6(g).

(9) *Maximum annual additions.* The annual additions to the contract do not exceed the applicable limitations of section 415(c) (treating contributions and other additions as annual additions). See paragraph (b) of this section and § 1.403(b)–4(b) and (f).

(b) *Application of requirements*—(1) Aggregation of contracts. In accordance with section 403(b)(5), for purposes of determining whether this section is satisfied, all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Additional

aggregation rules apply under section 402(g) for purposes of satisfying paragraph (a)(4) of this section and under section 415 for purposes of satisfying paragraph (a)(9) of this section.

(2) *Disaggregation for excess annual additions.* In accordance with the last sentence of section 415(a)(2), if an excess annual addition is made to a contract that otherwise satisfies the requirements of this section, then the portion of the contract that includes such excess annual addition fails to be a section 403(b) contract (as further described in paragraph (d)(1) of this section) and the remaining portion of the contract is a section 403(b) contract. This paragraph (b)(2) is not satisfied unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for each such portion. Thus, the entire contract fails to be a section 403(b) contract if an excess annual addition is made and a separate account is not maintained with respect to the excess.

(3) *Plan in form and operation.* (i) A contract does not satisfy paragraph (a) of this section unless it is maintained pursuant to a plan. For this purpose, a plan is a written defined contribution plan, which, in both form and operation, satisfies the requirements of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11. For purposes of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11, the plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. For purposes of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11, a plan may contain certain optional features that are consistent with but not required under section 403(b), such as hardship withdrawal distributions, loans, plan-to-plan or annuity contract-to-annuity contract transfers, and acceptance of rollovers to the plan. However, if a plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 403(b), this section and §§ 1.403(b)–4 through 1.403(b)–11.

(ii) The plan may allocate responsibility for performing administrative functions, including functions to comply with the requirements of section 403(b) and other tax requirements. Any such allocation must identify responsibility for compliance with the requirements of the Internal Revenue Code that apply on the basis of the aggregated contracts issued to a participant under a plan, including loans under section 72(p) and the conditions for obtaining a hardship withdrawal under § 1.403(b)–6. A plan is permitted to assign such responsibilities to parties other than the eligible employer, but not to participants (other than employees of the employer a substantial portion of whose duties are administration of the plan), and may incorporate by reference other documents, including the insurance policy or custodial account, which thereupon become part of the plan.

(iii) This paragraph (b)(3) applies to contributions to an annuity contract by a church only if the annuity is part of a retirement income account, as defined in § 1.403(b)–9.

(4) *Exclusion limited for former employees*—(i) *General rule.* Except as provided in paragraph (b)(4)(ii) of this section and in § 1.403(b)–4(d), the exclusion from gross income provided by section 403(b) does not apply to contributions made for former employees. For this purpose, a contribution is not made for a former employee if the contribution is with respect to compensation that would otherwise be paid for a payroll period that begins before severance from employment.

(ii) *Exceptions.* The exclusion from gross income provided by section 403(b) applies to contributions made for former employees with respect to compensation described in § 1.415(c)–2(e)(3)(i) (relating to certain compensation paid by the later of 2½ months after severance from employment or the end of the limitation year that includes the date of severance from employment), and compensation described in § 1.415(c)–2(e)(4), § 1.415(c)–2(g)(4), or § 1.415(c)–2(g)(7) (relating to compensation paid to participants who are permanently and totally disabled or relating to qualified military service under section 414(u)).

(c) *Special rules for designated Roth section 403(b) contributions.* (1) The rules of § 1.401(k)–1(f)(1) and (2) for designated Roth contributions under a qualified cash or deferred arrangement apply to designated Roth contributions under a section 403(b) plan. Thus, a designated Roth contribution under a section 403(b) plan is a section 403(b) elective deferral that is designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the section 403(b) elective deferrals the employee is otherwise eligible to make under the plan; that is treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the cash or deferred election (such as by treating the contributions as wages subject to applicable withholding requirements); and that is maintained in a separate account (within the meaning of § 1.401(k)–1(f)(2)).

(2) A designated Roth contribution under a section 403(b) plan must satisfy the requirements applicable to section 403(b) elective deferrals. Thus, for example, designated Roth contributions under a section 403(b) plan must satisfy the requirements of § 1.403(b)–6(d). Similarly, a designated Roth account under a section 403(b) plan is subject to the rules of section 401(a)(9)(A) and (B) and § 1.403(b)–6(e).

(d) *Effect of failure*—(1) *General rules.* (i) If a contract includes any amount that fails to satisfy the requirements of section 403(b), § 1.403(b)–1, § 1.403(b)–2, this section, or §§ 1.403(b)–4 through 1.403(b)–11, then, except as otherwise provided in paragraph (d)(2) of this section (relating to failure to satisfy nonforfeitability requirements) or § 1.403(b)–4(f) (relating to excess contributions under section 415 and excess deferrals under section 402(g)), the contract is not a section 403(b) contract. In addition, section 403(b)(5) and paragraph (b)(1) of this section provide that, for purposes of determining whether a contract satisfies section 403(b), all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Thus, except as provided in paragraph (b)(2) of this section or as otherwise provided in this paragraph (d), a failure to satisfy section 403(b) with respect to any contract issued to an individual by an employer adversely affects all contracts issued to that individual by that employer.

(ii) In accordance with paragraph (b)(3) of this section, a failure to operate in accordance with the terms of a plan adversely affects all of the contracts issued by the employer to the employee or employees with respect to whom the operational failure occurred. Such a failure does not adversely affect any other contract if the failure is neither a failure to satisfy the nondiscrimination requirements of § 1.403(b)–5 (a nondiscrimination failure) nor a failure of the employer to be an eligible employer as defined in § 1.403(b)–2 (an employer eligibility failure). However, any failure that is not an operational failure adversely affects all contracts issued under the plan, including: a failure to have contracts issued pursuant to a written defined contribution plan

which, in form, satisfies the requirements of § 1.403(b)–1, § 1.403(b)–2, this section and §§ 1.403(b)–4 through 1.403(b)–11 (a written plan failure); a nondiscrimination failure; or an employer eligibility failure.

(iii) See other applicable Internal Revenue Code provisions for the treatment of a contract that is not a section 403(b) contract, such as sections 61, 83, 402(b), and 403(c). Thus, for example, section 403(c) (relating to nonqualified annuities) applies if any annuity contract issued by an insurance company fails to satisfy section 403(b), based on the value of the contract at the time of the failure. However, see paragraph (d)(2) of this section for special rules with respect to the nonforfeitability requirement of paragraph (a)(2) of this section.

(2) *Failure to satisfy nonforfeitability requirement*—(i) *Treatment before contract becomes nonforfeitable.* If an annuity contract issued by an insurance company would qualify as a section 403(b) contract but for the failure to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section, then the contract is treated as a contract to which section 403(c) applies. See § 1.403(b)–8(d)(4) for a rule under which a custodial account that fails to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section is treated as a section 401(a) qualified plan for certain purposes.

(ii) *Treatment when contract becomes nonforfeitable*—(A) *In general.* Notwithstanding paragraph (d)(2)(i) of this section, on or after the date on which the participant's interest in a contract described in paragraph (d)(2)(i) of this section becomes nonforfeitable, the contract may be treated as a section 403(b) contract if no election has been made under section 83(b) with respect to the contract, the participant's interest in the contract has been subject to a substantial risk of forfeiture (as defined in section 83) before becoming nonforfeitable, each contribution under the contract that is subject to a different vesting schedule is maintained in a separate account, and the contract has at all times satisfied the requirements of paragraph (a) of this section other than the nonforfeitability requirement of paragraph (a)(2) of this section. Thus, for example, for the current year and each prior year, no contribution can have been made to the contract that would cause the contract to fail to be a section 403(b) contract as a result of contributions exceeding the limitations of section 415 (except to the extent permitted under paragraph (b)(2) of this section) or to fail to satisfy the nondiscrimination rules described in § 1.403(b)–5. See also § 1.403(b)–10(a)(1) for a special rule in connection with termination of a section 403(b) plan.

(B) *Partial vesting.* For purposes of applying this paragraph (d), if only a portion of a participant's interest in a contract becomes nonforfeitable in a year, then the portion that is nonforfeitable and the portion that fails to be nonforfeitable are each treated as separate contracts. In addition, for purposes of applying this paragraph (d), if a contribution is made to an annuity contract in excess of the limitations of section 415(c) and the excess is maintained in a separate account, then the portion of the contract that includes the excess contributions account and the remainder are each treated as separate contracts. Thus, if an annuity contract that includes an excess contributions account changes from forfeitable to nonforfeitable during a year, then the portion that is not attributable to the excess contributions account constitutes a section 403(b) contract (assuming it otherwise satisfies the requirements to be a section 403(b) contract) and is not included in gross income, and the portion that is attributable to the excess contributions account is included in gross income in accordance with section 403(c). See § 1.403(b)–4(f) for additional rules.

■ **Par. 7.** Sections 1.403(b)–4, 1.403(b)–5, 1.403(b)–6, 1.403(b)–7, 1.403(b)–8, 1.403(b)–9, 1.403(b)–10, and 1.403(b)–11 are added to read as follows:

§ 1.403(b)–4 Contribution limitations.

(a) *Treatment of contributions in excess of limitations.* The exclusion provided under § 1.403(b)–3(a) applies to a participant only if the amounts contributed by the employer for the purchase of an annuity contract for the participant do not exceed the applicable limit under sections 415 and 402(g), as described in this section. Under § 1.403(b)–3(a)(4), a section 403(b) contract is required to include the limits on elective deferrals imposed by section 402(g), as described in paragraph (c) of this section. See paragraph (f) of this section for special rules concerning excess contributions and deferrals. Rollover contributions made to a section 403(b) contract, as described in § 1.403(b)–10(d), are not taken into account for purposes of the limits imposed by section 415, § 1.403(b)–3(a)(9), section 402(g), § 1.403(b)–3(a)(4), and this section, but after-tax employee contributions are taken into account under section 415, § 1.403(b)–3(a)(9), and paragraph (b) of this section.

(b) *Maximum annual contribution*—(1) *General rule.* In accordance with section 415(a)(2) and § 1.403(b)–3(a)(9), the contributions for any participant under a section 403(b) contract (namely, employer nonelective contributions (including matching contributions), section 403(b) elective deferrals, and after-tax employee contributions) are not permitted to exceed the limitations imposed by section 415. Under section 415(c), contributions are permitted to be made for participants in a defined contribution plan, subject to the limitations set forth therein (which are generally the lesser of a dollar limit for a year or the participant's compensation for the year). For purposes of section 415, contributions made for a participant are aggregated to the extent applicable under section 414(b), (c), (m), (n), and (o). For purposes of section 415(a)(2), §§ 1.403(b)–1 through 1.403(b)–3, this section, and §§ 1.403(b)–5 through 1.403(b)–11, a contribution means any annual addition, as defined in section 415(c).

(2) *Special rules.* See section 415(k)(4) for a special rule under which contributions to section 403(b) contracts are generally aggregated with contributions under other arrangements in applying section 415. For purposes of applying section 415(c)(1)(B) (relating to compensation) with respect to a section 403(b) contract, except as provided in section 415(c)(3)(C), a participant's includible compensation (as defined in § 1.403(b)–2) is substituted for the participant's compensation, as described in section 415(c)(3)(E). Any age 50 catch-up contributions under paragraph (c)(2) of this section are disregarded in applying section 415.

(c) *Section 403(b) elective deferrals*—(1) *Basic limit under section 402(g)(1).* In accordance with section 402(g)(1)(A), the section 403(b) elective deferrals for any individual are included in the individual's gross income to the extent the amount of such deferrals, plus all other elective deferrals for the individual, for the taxable year exceeds the applicable dollar amount under section 402(g)(1)(B). The applicable annual dollar amount under section 402(g)(1)(B) is $15,000, adjusted for cost-of-living after 2006 in the manner described in section 402(g)(4). See § 1.403(b)–5(b) for a universal availability rule that applies if any employee is permitted to have any section 403(b) elective deferrals made on his or her behalf.

(2) *Age 50 catch-up*—(i) *In general.* In accordance with section 414(v) and the regulations thereunder, a section 403(b) contract may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under

section 414(v)(2) for the taxable year. The maximum amount of additional age 50 catch-up contributions for a taxable year under section 414(v) is $5,000, adjusted for cost-of-living after 2006 in the manner described in section 414(v)(2)(C). For additional requirements, see regulations under section 414(v).

(ii) *Coordination with special section 403(b) catch-up.* In accordance with sections 414(v)(6)(A)(ii) and 402(g)(7)(A), the age 50 catch-up described in this paragraph (c)(2) may apply for any taxable year in which a participant also qualifies for the special section 403(b) catch-up under paragraph (c)(3) of this section.

(3) *Special section 403(b) catch-up for certain organizations*—(i) *Amount of the special section 403(b) catch-up.* In the case of a qualified employee of a qualified organization for whom the basic section 403(b) elective deferrals for any year are not less than the applicable dollar amount under section 402(g)(1)(B), the section 403(b) elective deferral limitation of section 402(g)(1) for the taxable year of the qualified employee is increased by the least of—

(A) $3,000;

(B) The excess of—

(*1*) $15,000, over

(*2*) The total elective deferrals described in section 402(g)(7)(A)(ii) made for the qualified employee by the qualified organization for prior years, or

(C) The excess of—

(*1*) $5,000 multiplied by the number of years of service of the employee with the qualified organization, over

(*2*) The total elective deferrals (as defined at § 1.403(b)–2) made for the employee by the qualified organization for prior years.

(ii) Qualified organization. (A) For purposes of this paragraph (c)(3), *qualified organization* means an eligible employer that is—

(*1*) An educational organization described in section 170(b)(1)(A)(ii);

(*2*) A hospital;

(*3*) A health and welfare service agency (including a home health service agency);

(*4*) A church-related organization; or

(*5*) Any organization described in section 414(e)(3)(B)(ii).

(B) All entities that are in a church-related organization or an organization controlled by a church-related organization under section 414(e)(3)(B)(ii) are treated as a single qualified organization (so that years of service and any special section 403(b) catch-up elective deferrals previously made for a qualified employee for a church or other entity within a church-related organization or an organization controlled by the church-related organization are taken into account for purposes of applying this paragraph (c)(3) to the employee with respect to any other entity within the same church-related organization or organization controlled by a church-related organization).

(C) For purposes of this paragraph (c)(3)(ii), a *health and welfare service agency* means—

(*1*) An organization whose primary activity is to provide services that constitute medical care as defined in section 213(d)(1) (such as a hospice);

(*2*) A section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals;

(*3*) An adoption agency; or

(*4*) An agency that provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that either provides meals to needy individuals, is a home health service agency, provides services to help individuals who have substance abuse, or provides help to the disabled).

(iii) *Qualified employee.* For purposes of this paragraph (c)(3), *qualified employee* means an employee who has completed at least 15 years of service (as defined under paragraph (e) of this section) taking into account only employment with the qualified organization. Thus, an employee who has not completed at least 15 years of service (as defined under paragraph (e) of this section) taking into account only employment with the qualified organization is not a qualified employee.

(iv) *Coordination with age 50 catch-up.* In accordance with sections 402(g)(1)(C) and 402(g)(7), any catch-up amount contributed by an employee who is eligible for both an age 50 catch-up and a special section 403(b) catch-up is treated first as an amount contributed as a special section 403(b) catch-up to the extent a special section 403(b) catch-up is permitted, and then as an amount contributed as an age 50 catch-up (to the extent the catch-up amount exceeds the maximum special section 403(b) catch-up after taking into account sections 402(g) and 415(c), this paragraph (c)(3), and any limitations on the special section 403(b) catch-up that are imposed by the terms of the plan).

(4) *Coordination with designated Roth contributions.* See regulations under section 402A for rules for determining whether an elective deferral is a pre-tax elective deferral or a designated Roth contribution.

(5) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts illustrating application of the basic dollar limit.* Participant B, who is 45, is eligible to participate in a State university section 403(b) plan in 2006. B is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, B will receive includible compensation of $42,000 from the eligible employer. B desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000.

(ii) *Conclusion.* B is not eligible for the age 50 catch-up in 2006 because B is 45 in 2006. B is also not eligible for the special section 403(b) catch-up under paragraph (c)(3) of this section because B is not a qualified employee. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $15,000.

Example 2. (i) *Facts illustrating application of the includible compensation limitation.* The facts are the same as in *Example 1,* except B's includible compensation is $14,000.

(ii) *Conclusion.* Under section 415(c), contributions may not exceed 100 percent of includible compensation. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $14,000.

Example 3. (i) *Facts illustrating application of the age 50 catch-up.* Participant C, who is 55, is eligible to participate in a State university section 403(b) plan in 2006. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (c)(3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, C will receive includible compensation of $48,000 from the eligible employer. C desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000. C does not have 15 years of service and thus is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section.

(ii) *Conclusion.* C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. C is not eligible for the special section 403(b) catch-up under paragraph (c)(3) of this section because C is not a qualified employee (as defined in paragraph (c)(3)(iii) of this section). Accordingly, the maximum section 403(b) elective deferral that C may elect for 2006 is $20,000 ($15,000 plus $5,000).

Example 4. (i) *Facts illustrating application of both the age 50 and the special section*

403(b) catch-up. The facts are the same as in *Example 3*, except that C is a qualified employee for purposes of the special section 403(b) catch-up provisions in paragraph (c)(3) of this section. For 2006, the maximum additional section 403(b) elective deferral for which C qualifies under the special section 403(b) catch-up under paragraph (c)(3) of this section is $3,000.

(ii) *Conclusion.* The maximum section 403(b) elective deferrals that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000.

Example 5. (i) *Facts illustrating calculation of years of service with a predecessor organization for purposes of the special section 403(b) catch-up.* Participant A is an employee of hospital H and is eligible to participate in a section 403(b) plan of H in 2006. A does not have 15 years of service with H, but A has previously made special section 403(b) catch-up deferrals to a section 403(b) plan maintained by hospital P which has since been acquired by H.

(ii) *Conclusion.* The special section 403(b) catch-up amount for which A qualifies under paragraph (c)(3) of this section must be calculated taking into account A's prior years of service and section 403(b) elective deferrals with the predecessor hospital if and only if A did not have any severance from service in connection with the acquisition.

Example 6. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 4*, except that the employer makes a nonelective contribution for each employee equal to 20 percent of C's compensation (which is $48,000). Thus, the employer makes a nonelective contribution for C for 2006 equal to $9,600. The plan provides that a participant is not permitted to make section 403(b) elective deferrals to the extent the section 403(b) elective deferrals would result in contributions in excess of the maximum permitted under section 415 and provides that contributions are reduced in the following order: the special section 403(b) catch-up elective deferrals under paragraph (c)(3) of this section are reduced first; the age 50 catch-up elective deferrals under paragraph (c)(2) of this section are reduced second; and then the basic section 403(b) elective deferrals under paragraph (c)(1) of this section are reduced. For 2006, the applicable dollar limit under section 415(c)(1)(A) is $44,000.

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limit in paragraph (b) of this section would not be exceeded because the sum of the $9,600 nonelective contribution and the $23,000 section 403(b) elective deferrals does not exceed the lesser of $49,000 (which is the sum of $44,000 plus the $5,000 additional age 50 catch-up amount) or $53,000 (which is the sum of C's includible compensation for 2006 ($48,000) plus the $5,000 additional age 50 catch-up amount).

Example 7. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 6,* except that C's includible compensation for 2006 is $58,000 and the plan provides for a nonelective contribution equal to 50 percent of includible compensation, so that the employer nonelective contribution for C for 2006 is $29,000 (50 percent of $58,000).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $20,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount, because the sum of the employer's nonelective contribution of $29,000 plus a section 403(b) elective deferral in excess of $20,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount). (Note that a section 403(b) elective deferral in excess of $20,000 would also exceed the limitations of section 402(g) unless a special section 403(b) catch-up were permitted.)

Example 8. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 7,* except that the plan provides for a nonelective contribution for C equal to $44,000 (which is the limit in section 415(c)(1)(A)).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $5,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount ($5,000), because the sum of the employer's nonelective contribution of $44,000 plus a section 403(b) elective deferral in excess of $5,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount).

Example 9. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) includible compensation limitation.* The facts are the same as in *Example 7,* except that C's includible compensation for 2006 is $28,000, so that the employer nonelective contribution for C for 2006 is $14,000 (50 percent of $28,000).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $19,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(B) plus the additional age 50 catch-up amount, because C's includible compensation is $28,000 and the sum of the employer's nonelective contribution of $14,000 plus a section 403(b) elective deferral in excess of $19,000 would exceed $33,000 (which is the sum of 100 percent of C's includible compensation plus the $5,000 additional age 50 catch-up amount).

Example 10. (i) *Facts illustrating that section 403(b) elective deferrals cannot exceed compensation otherwise payable.* Employee D is age 60, has includible compensation of $14,000, and wishes to contribute section 403(b) elective deferrals of $20,000 for the year. No nonelective contributions are made for Employee D.

(ii) *Conclusion.* Because a contribution is a section 403(b) elective deferral only if it relates to an amount that would otherwise be included in the participant's compensation, the effective limitation on section 403(b) elective deferrals for a participant whose compensation is less than the basic dollar limit for section 403(b) elective deferrals is the participant's compensation. Thus, D cannot make section 403(b) elective deferrals in excess of D's actual compensation, which is $14,000, even though the basic dollar limit exceeds that amount.

Example 11. (i) *Facts illustrating calculation of the special section 403(b) catch-up.* For 2006, employee E, who is age 53, is eligible to participate in a section 403(b) plan of hospital H, which is a section 501(c)(3) organization. H's plan permits section 403(b) elective deferrals and provides for an employer contribution of 10 percent of a participant's compensation. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1), (2), and (3) of this section. For 2006, E's includible compensation is $50,000. E wishes to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. E has previously made $62,000 of section 403(b) elective deferrals under the plan, but has never made an election for a special section 403(b) catch-up elective deferral. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000, the additional dollar amount permitted under the age 50 catch-up is $5,000, E's employer will make a nonelective contribution of $5,000 (10% of $50,000 compensation), and E is a qualified employee of a qualified employer as defined in paragraph (c)(3) of this section.

(ii) *Conclusion.* The maximum section 403(b) elective deferrals that E may elect under H's section 403(b) plan for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals for 2006 under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 maximum additional special section 403(b) catch-up amount for which D qualifies in 2006 under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limitation on the additional special section 403(b) catch-up amount is not less than $3,000 because the limitation at paragraph (c)(3)(i)(B) of this section is $15,000 ($15,000 minus zero) and the limitation at paragraph (c)(3)(i)(C) of this section is $13,000 ($5,000 times 15, minus $62,000 of total deferrals in prior years). These conclusions would be unaffected if H were an eligible governmental employer under section 457(b) that has a section 457(b) eligible governmental plan and E were in the past to have made annual deferrals to that plan, because contributions to a section 457(b) eligible governmental plan do not

constitute elective deferrals; and these conclusions would also be the same if H had a section 401(k) plan and E were in the past to have made elective deferrals to that plan, assuming that those elective deferrals did not exceed $10,000 ($5,000 times 15, minus the sum of $62,000 plus $10,000, equals $3,000), so as to result in the limitation at paragraph (c)(3)(i)(C) of this section being less than $3,000.

Example 12. (i) Facts illustrating calculation of the special section 403(b) catch-up in the next calendar year. The facts are the same as in *Example 11,* except that, for 2007, E has includible compensation of $60,000. For 2007, E now has previously made $85,000 of section 403(b) elective deferrals ($62,000 deferred before 2006, plus the $15,000 in basic section 403(b) elective deferrals in 2006, the $3,000 maximum additional special section 403(b) catch-up amount in 2006, plus the $5,000 age 50 catch-up amount in 2006). However, the $5,000 age 50 catch-up amount deferred in 2006 is disregarded for purposes of applying the limitation at paragraph (c)(3)(i)(B) of this section to determine the special section 403(b) catch-up amount. Thus, for 2007, only $80,000 of section 403(b) elective deferrals are taken into account in applying the limitation at paragraph (c)(3)(i)(B) of this section. For 2007, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is assumed to be $16,000, the additional dollar amount permitted under the age 50 catch-up is assumed to be $5,000, and E's employer contributes $6,000 (10% of $60,000) as a non-elective contribution.

(ii) *Conclusion.* The maximum section 403(b) elective deferral that D may elect under H's section 403(b) plan for 2007 is $21,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $16,000, plus the additional age 50 catch-up amount of $5,000. E is not entitled to any additional special section 403(b) catch-up amount for 2007 under paragraph (c)(3) of this section due to the limitation at paragraph (c)(3)(i)(C) of this section (16 times $5,000 equals $80,000, minus D's total prior section 403(b) elective deferrals of $80,000 equals zero).

(d) *Employer contributions for former employees*—(1) *Includible compensation deemed to continue for nonelective contributions.* For purposes of applying paragraph (b) of this section, a former employee is deemed to have monthly includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of each of the next five taxable years. The amount of the monthly includible compensation is equal to one twelfth of the former employee's includible compensation during the former employee's most recent year of service. Accordingly, nonelective employer contributions for a former employee must not exceed the limitation of section 415(c)(1) up to the lesser of the dollar amount in section 415(c)(1)(A) or the former employee's annual includible compensation based on the former employee's average monthly compensation during his or her most recent year of service.

(2) *Examples.* The provisions of paragraph (d)(1) of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Private college M is a section 501(c)(3) organization operated on the basis of a June 30 fiscal year that maintains a section 403(b) plan for its employees. In 2004, M amends the plan to provide for a temporary early retirement incentive under which the college will make a nonelective contribution for any participant who satisfies certain minimum age and service conditions and who retires before June 30, 2006. The contribution will equal 110 percent of the participant's rate of pay for one year and will be payable over a period ending no later than the end of the fifth fiscal year that begins after retirement. It is assumed for purposes of this *Example 1* that, in accordance with § 1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions and retire before June 30, 2006, do not discriminate in favor of former employees who are highly compensated employees. Employee A retires under the early retirement incentive on March 12, 2006, and A's annual includible compensation for the period from March 1, 2005, through February 28, 2006 (which is A's most recent one year of service) is $30,000. The applicable dollar limit under section 415(c)(1)(A) is assumed to be $44,000 for 2006 and $45,000 for 2007. The college contributes $30,000 for A for 2006 and $3,000 for A for 2007 (totaling $33,000 or 110 percent of $30,000). No other contributions are made to a section 403(b) contract for A for those years.

(ii) *Conclusion.* The contributions made for A do not exceed A's includible compensation for 2006 or 2007.

Example 2. (i) *Facts.* Private college N is a section 501(c)(3) organization that maintains a section 403(b) plan for its employees. The plan provides for N to make monthly nonelective contributions equal to 20 percent of the monthly includible compensation for each eligible employee. In addition, the plan provides for contributions to continue for 5 years following the retirement of any employee after age 64 and completion of at least 20 years of service (based on the employee's average annual rate of base salary in the preceding 3 calendar years ended before the date of retirement). It is assumed for purposes of this *Example 2* that, in accordance with § 1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions do not discriminate in favor of former employees who are highly compensated employees. Employee B retires on July 1, 2006, at age 64 after completion of 20 or more years of service. At that date, B's annual includible compensation for the most recently ended fiscal year of N is $72,000 and B's average monthly rate of base salary for 2003 through 2005 is $5,000. N contributes $1,200 per month (20 percent of 1/12th of $72,000) from January of 2006 through June of 2006 and contributes $1,000 (20 percent of $5,000) per month for B from July of 2006 through June of 2011. The applicable dollar limit under section 415(c)(1)(A) is $44,000 for 2006 through 2011. No other contributions are made to a section 403(b) contract for B for those years.

(ii) *Conclusion.* The contributions made for B do not exceed B's includible compensation for any of the years from 2006 through 2010.

Example 3. (i) *Facts.* A public university maintains a section 403(b) under which it contributes annually 10% of compensation for participants, including for the first 5 calendar years following the date on which the participant ceases to be an employee. The plan provides that if a participant who is a former employee dies during the first 5 calendar years following the date on which the participant ceases to be an employee, a contribution is made that is equal to the lesser of—

(A) The excess of the individual's includible compensation for that year over the contributions previously made for the individual for that year; or

(B) The total contributions that would have been made on the individual's behalf thereafter if he or she had survived to the end of the 5-year period.

(ii) Individual C's annual includible compensation is $72,000 (so that C's monthly includible compensation is $6,000). A $600 contribution is made for C for January of the first taxable year following retirement (10% of individual C's monthly includible compensation of $6,000). Individual C dies during February of that year. The university makes a contribution for individual C for February equal to $11,400 (C's monthly includible compensation for January and February, reduced by $600).

(iii) *Conclusion.* The contribution does not exceed the amount of individual C's includible compensation for the taxable year for purposes of section 415(c), but any additional contributions would exceed C's includible compensation for purposes of section 415(c).

(3) *Disabled employees.* See also section 415(c)(3)(C) which sets forth a special rule under which compensation may be treated as continuing for purposes of section 415 for certain former employees who are disabled.

(e) *Special rules for determining years of service*—(1) *In general.* For purposes of determining a participant's includible compensation under paragraph (b)(2) of this section and a participant's years of service under paragraphs (c)(3) (special section 403(b) catch-up for qualified employees of certain organizations) and (d) (employer contributions for former employees) of this section, an employee must be credited with a full year of service for each year during which the individual is a full-time employee of the eligible employer for the entire work period, and a fraction of a year for each

part of a work period during which the individual is a full-time or part-time employee of the eligible employer. An individual's number of years of service equals the aggregate of the annual work periods during which the individual is employed by the eligible employer.

(2) *Work period.* A year of service is based on the employer's annual work period, not the employee's taxable year. For example, in determining whether a university professor is employed full time, the annual work period is the school's academic year. However, in no case may an employee accumulate more than one year of service in a twelve-month period.

(3) *Service with more than one eligible employer*—(i) *General rule.* With respect to any section 403(b) contract of an eligible employer, except as provided in paragraph (e)(3)(ii) of this section, any period during which an individual is not an employee of that eligible employer is disregarded for purposes of this paragraph (e).

(ii) *Special rule for church employees.* With respect to any section 403(b) contract of an eligible employer that is a church-related organization, any period during which an individual is an employee of that eligible employer and any other eligible employer that is a church-related organization that has an association (as defined in section 414(e)(3)(D)) with that eligible employer is taken into account on an aggregated basis, but any period during which an individual is not an employee of a church-related organization or is an employee of a church-related organization that does not have an association with that eligible employer is disregarded for purposes of this paragraph (e).

(4) *Full-time employee for full year.* Each annual work period during which an individual is employed full time by the eligible employer constitutes one year of service. In determining whether an individual is employed full-time, the amount of work which he or she actually performs is compared with the amount of work that is normally required of individuals performing similar services from which substantially all of their annual compensation is derived.

(5) *Other employees.* (i) An individual is treated as performing a fraction of a year of service for each annual work period during which he or she is a full-time employee for part of the annual work period and for each annual work period during which he or she is a part-time employee either for the entire annual work period or for a part of the annual work period.

(ii) In determining the fraction that represents the fractional year of service for an individual employed full time for part of an annual work period, the numerator is the period of time (such as weeks or months) during which the individual is a full-time employee during that annual work period, and the denominator is the period of time that is the annual work period.

(iii) In determining the fraction that represents the fractional year of service of an individual who is employed part time for the entire annual work period, the numerator is the amount of work performed by the individual, and the denominator is the amount of work normally required of individuals who perform similar services and who are employed full time for the entire annual work period.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of an annual work period, the fractional year of service that would apply if the individual were a part-time employee for a full annual work period is multiplied by the fractional year of service that would apply if the individual were a full-time employee for the part of an annual work period.

(6) *Work performed.* For purposes of this paragraph (e), in measuring the amount of work of an individual performing particular services, the work performed is determined based on the individual's hours of service (as defined under section 410(a)(3)(C)), except that a plan may use a different measure of work if appropriate under the facts and circumstances. For example, a plan may provide for a university professor's work to be measured by the number of courses taught during an annual work period in any case in which that individual's work assignment is generally based on a specified number of courses to be taught.

(7) *Most recent one-year period of service.* For purposes of paragraph (d) of this section, in the case of a part-time employee or a full-time employee who is employed for only part of the year determined on the basis of the employer's annual work period, the employee's most recent periods of service are aggregated to determine his or her most recent one-year period of service. In such a case, there is first taken into account his or her service during the annual work period for which the last year of service's includible compensation is being determined; then there is taken into account his or her service during his next preceding annual work period based on whole months; and so forth, until the employee's service equals, in the aggregate, one year of service.

(8) *Less than one year of service considered as one year.* If, at the close of a taxable year, an employee has, after application of all of the other rules in this paragraph (e), some portion of one year of service (but has accumulated less than one year of service), the employee is deemed to have one year of service. Except as provided in the previous sentence, fractional years of service are not rounded up.

(9) *Examples.* The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual G is employed half-time in 2004 and 2005 as a clerk by H, a hospital which is a section 501(c)(3) organization. G earns $20,000 from H in each of those years, and retires on December 31, 2005.

(ii) *Conclusion.* For purposes of determining G's includible compensation during G's last year of service under paragraph (d) of this section, G's most recent periods of service are aggregated to determine G's most recent one-year period of service. In this case, since D worked half-time in 2004 and 2005, the compensation D earned in those two years are aggregated to produce D's includible compensation for D's last full year in service. Thus, in this case, the $20,000 that D earned in 2004 and 2005 for D's half-time work are aggregated, so that D has $40,000 of includible compensation for D's most recent one-year of service for purposes of applying paragraphs (b)(2), (c)(3), and (d) of this section.

Example 2. (i) *Facts.* Individual H is employed as a part-time professor by public University U during the first semester of its two-semester 2004–2005 academic year. While H teaches one course generally for 3 hours a week during the first semester of the academic year, U's full-time faculty members generally teach for 9 hours a week during the full academic year.

(ii) *Conclusion.* For purposes of calculating how much of a year of service H performs in the 2004–2005 academic year (before application of the special rules of paragraphs (e)(7) and (8) of this section concerning less than one year of service), paragraph (e)(5)(iv) of this section is applied as follows: since H teaches one course at U for 3 hours per week for 1 semester and other faculty members at U teach 9 hours per week for 2 semesters, H is considered to have completed 3/18 or 1/6 of a year of service during the 2004–2005 academic year, determined as follows:

(A) The fractional year of service if H were a part-time employee for a full year is 3/9 (number of hours employed divided by the usual number of hours of work required for that position).

(B) The fractional year of service if H were a full-time employee for half of a year is ½ (one semester, divided by the usual 2-semester annual work period).

(C) These fractions are multiplied to obtain the fractional year of service: 3/9 times ½, or 3/18, equals 1/6 of a year of service.

(f) *Excess contributions or deferrals*—(1) *Inclusion in gross income.* Any contribution made for a participant to a section 403(b) contract for the taxable year that exceeds either the maximum annual contribution limit set forth in paragraph (b) of this section or the maximum annual section 403(b) elective deferral limit set forth in paragraph (c) of this section constitutes an excess contribution that is included in gross income for that taxable year. See § 1.403(b)–3(d)(1)(iii) and (2)(i) for additional rules, including special rules relating to contracts that fail to be nonforfeitable. See also section 4973 for an excise tax applicable with respect to excess contributions to a custodial account and section 4979(f)(2)(B) for a special rule applicable if excess matching contributions, excess after-tax employee contributions, and excess section 403(b) elective deferrals do not exceed $100.

(2) *Separate account required for certain excess contributions; distribution of excess elective deferrals.* A contract to which a contribution is made that exceeds the maximum annual contribution limit set forth in paragraph (b) of this section is not a section 403(b) contract unless the excess contribution is held in a separate account which constitutes a separate account for purposes of section 72. See also § 1.403(b)–3(a)(4) and paragraph (f)(4) of this section for additional rules with respect to the requirements of section 401(a)(30) and any excess deferral.

(3) *Ability to distribute excess contributions.* A contract does not fail to satisfy the requirements of § 1.403(b)–3, the distribution rules of § 1.403(b)–6 or 1.403(b)–9, or the funding rules of § 1.403(b)–8 solely by reason of a distribution made from a separate account under paragraph (f)(2) of this section or made under paragraph (f)(4) of this section.

(4) *Excess section 403(b) elective deferrals.* A section 403(b) contract may provide that any excess deferral as a result of a failure to comply with the limitation under paragraph (c) of this section for a taxable year with respect to any section 403(b) elective deferral made for a participant by the employer will be distributed to the participant, with allocable net income, no later than April 15 of the following taxable year or otherwise in accordance with section 402(g). See section 402(g)(2)(A) for rules permitting the participant to allocate excess deferrals among the plans in which the participant has made elective deferrals, and see section 402(g)(2)(C) for special rules to determine the tax treatment of such a distribution.

(5) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual D's employer makes a $46,000 contribution for 2006 to an individual annuity insurance policy for Individual D that would otherwise be a section 403(b) contract. The contribution does not include any elective deferrals and the applicable limit under section 415(c) is $44,000 for 2006. The $2,000 section 415(c) excess is put into a separate account under the policy. Employer includes $2,000 in D's gross income as wages for 2006 and, to the extent of the amount held in the separate account for the section 415(c) excess contribution, does not treat the account as a contract to which section 403(b) applies.

(ii) *Conclusion.* The separate account for the section 415(c) excess contribution is a contract to which section 403(c) applies, but the excess contribution does not cause the rest of the contract to fail section 403(b).

Example 2. (i) *Facts.* Same facts as *Example 1*, except that the contribution is made to purchase mutual funds that are held in a custodial account, instead of an individual annuity insurance policy.

(ii) *Conclusion.* The conclusion is the same as in *Example 1,* except that the purchase constitutes a transfer described in section 83.

Example 3. (i) *Facts.* Same facts as *Example 1*, except that the amount held in the separate account for the section 415(c) excess contribution is subsequently distributed to D.

(ii) *Conclusion.* The distribution is included in gross income to the extent provided under section 72 relating to distributions from a section 403(c) contract.

Example 4. (i) *Facts.* Individual E makes section 403(b) elective deferrals totaling $15,500 for 2006, when E is age 45 and the applicable limit on section 403(b) elective deferrals is $15,000. On April 14, 2007, the plan refunds the $500 excess along with applicable earnings of $65.

(ii) *Conclusion.* The $565 payment constitutes a distribution of an excess deferral under paragraph (f)(4) of this section. Under section 402(g), the $500 excess deferral is included in E's gross income for 2006. The additional $65 is included in E's gross income for 2007 and, because the distribution is made by April 15, 2007 (as provided in section 402(g)(2)), the $65 is not subject to the additional 10 percent income tax on early distributions under section 72(t).

§ 1.403(b)–5 Nondiscrimination rules.

(a) *Nondiscrimination rules for contributions other than section 403(b) elective deferrals*—(1) *General rule.* Under section 403(b)(12)(A)(i), employer contributions and after-tax employee contributions to a section 403(b) plan must satisfy all of the following requirements (the nondiscrimination requirements) in the same manner as a qualified plan under section 401(a):

(i) Section 401(a)(4) (relating to nondiscrimination in contributions and benefits), taking section 401(a)(5) into account.

(ii) Section 401(a)(17) (limiting the amount of compensation that can be taken into account).

(iii) Section 401(m) (relating to matching and after-tax employee contributions).

(iv) Section 410(b) (relating to minimum coverage).

(2) *Nonapplication to section 403(b) elective deferrals.* The requirements of this paragraph (a) do not apply to section 403(b) elective deferrals.

(3) *Compensation for testing.* Except as may otherwise be specifically permitted under the provisions referenced in paragraph (a)(1) of this section, compliance with those provisions is tested using compensation as defined in section 414(s) (and without regard to section 415(c)(3)(E)). In addition, for purposes of paragraph (a)(1) of this section, there may be excluded employees who are permitted to be excluded under paragraph (b)(4)(ii)(D) and (E) of this section. However, as provided in paragraph (b)(4)(i) of this section, the exclusion of any employee listed in paragraph (b)(4)(ii)(D) or (E) of this section is subject to the conditions applicable under section 410(b)(4).

(4) *Employer aggregation rules.* See regulations under section 414(b), (c), (m), and (o) for rules treating entities as a single employer for purposes of the nondiscrimination requirements.

(5) *Special rules for governmental plans.* Paragraphs (a)(1)(i), (iii), and (iv) of this section do not apply to a governmental plan as defined in section 414(d) (but contributions to a governmental plan must comply with paragraphs (a)(1)(ii) and (b) of this section).

(b) *Universal availability required for section 403(b) elective deferrals—(1) General rule.* Under section 403(b)(12)(A)(ii), all employees of the eligible employer must be permitted to have section 403(b) elective deferrals contributed on their behalf if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals. Further, the employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions.

(2) *Effective opportunity required.* For purposes of paragraph (b)(1) of this section, an employee is not treated as being permitted to have section 403(b) elective deferrals contributed on the employee's behalf unless the employee is provided an effective opportunity that satisfies the requirements of this

paragraph (b)(2). Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. A section 403(b) plan satisfies the effective opportunity requirement of this paragraph (b)(2) only if, at least once during each plan year, the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election (as defined at § 1.401(k)–1(a)(3)) between cash or a contribution to the plan. Further, an effective opportunity includes the right to have section 403(b) elective deferrals made on his or her behalf up to the lesser of the applicable limits in § 1.403(b)–4(c) (including any permissible catch-up elective deferrals under § 1.403(b)–4(c)(2) and (3)) or the applicable limits under the contract with the largest limitation, and applies to part-time employees as well as full-time employees. An effective opportunity is not considered to exist if there are any other rights or benefits (other than rights or benefits listed in § 1.401(k)–1(e)(6)(i)(A), (B), or (D)) that are conditioned (directly or indirectly) upon a participant making or failing to make a cash or deferred election with respect to a contribution to a section 403(b) contract.

(3) *Special rules.* (i) In the case of a section 403(b) plan that covers the employees of more than one section 501(c)(3) organization, the universal availability requirement of this paragraph (b) applies separately to each common law entity (that is, applies separately to each section 501(c)(3) organization). In the case of a section 403(b) plan that covers the employees of more than one State entity, this requirement applies separately to each entity that is not part of a common payroll. An eligible employer may condition the employee's right to have section 403(b) elective deferrals made on his or her behalf on the employee electing a section 403(b) elective deferral of more than $200 for a year.

(ii) For purposes of this paragraph (b)(3), an employer that historically has treated one or more of its various geographically distinct units as separate for employee benefit purposes may treat each unit as a separate organization if the unit is operated independently on a day-to-day basis. Units are not geographically distinct if such units are located within the same Standard Metropolitan Statistical Area (SMSA).

(4) *Exclusions*—(i) *Exclusions for special types of employees.* A plan does not fail to satisfy the universal availability requirement of this paragraph (b) merely because it excludes one or more of the types of employees listed in paragraph (b)(4)(ii) of this section. However, the exclusion of any employee listed in paragraph (b)(4)(ii)(D) or (E) of this section is subject to the conditions applicable under section 410(b)(4). Thus, if any employee listed in paragraph (b)(4)(ii)(D) of this section has the right to have section 403(b) elective deferrals made on his or her behalf, then no employee listed in that paragraph (b)(4)(ii)(D) of this section may be excluded under this paragraph (b)(4) and, if any employee listed in paragraph (b)(4)(ii)(E) of this section has the right to have section 403(b) elective deferrals made on his or her behalf, then no employee listed in that paragraph (b)(4)(ii)(E) of this section may be excluded under this paragraph (b)(4).

(ii) *List of special types of excludible employees.* The following types of employees are listed in this paragraph (b)(4)(ii):

(A) Employees who are eligible under another section 403(b) plan, or a section 457(b) eligible governmental plan, of the employer which permits an amount to be contributed or deferred at the election of the employee.

(B) Employees who are eligible to make a cash or deferred election (as defined at § 1.401(k)–1(a)(3)) under a section 401(k) plan of the employer.

(C) Employees who are non-resident aliens described in section 410(b)(3)(C).

(D) Subject to the conditions applicable under section 410(b)(4) (including section 410(b)(4)(B) permitting separate testing for employees not meeting minimum age and service requirements), employees who are students performing services described in section 3121(b)(10).

(E) Subject to the conditions applicable under section 410(b)(4), employees who normally work fewer than 20 hours per week (or such lower number of hours per week as may be set forth in the plan).

(iii) *Special rules.* (A) A section 403(b) plan is permitted to take into account coverage under another plan, as permitted in paragraphs (b)(4)(ii)(A) and (B) of this section, only if the rights to make elective deferrals with respect to that coverage would satisfy paragraphs (b)(2) and (4)(i) of this section if that coverage were provided under the section 403(b) plan.

(B) For purposes of paragraph (b)(4)(ii)(E) of this section, an employee normally works fewer than 20 hours per week if and only if—

(*1*) For the 12-month period beginning on the date the employee's employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours of service (as defined in section 410(a)(3)(C)) in such period; and

(*2*) For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period. (See, however, section 202(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829) Public Law 93–406, and regulations under section 410(a) of the Internal Revenue Code applicable with respect to plans that are subject to Title I of ERISA.)

(c) *Plan required.* Contributions to an annuity contract do not satisfy the requirements of this section unless the contributions are made pursuant to a plan, as defined in § 1.403(b)–3(b)(3), and the terms of the plan satisfy this section.

(d) *Church plans exception.* This section does not apply to a section 403(b) contract purchased by a church (as defined in § 1.403(b)–2).

(e) *Other rules.* This section only reflects requirements of the Internal Revenue Code applicable for purposes of section 403(b) and does not include other requirements. Specifically, this section does not reflect the requirements of ERISA that may apply with respect to section 403(b) arrangements, such as the vesting requirements at 29 U.S.C. 1053.

§ 1.403(b)–6 Timing of distributions and benefits.

(a) *Distributions generally.* This section provides special rules regarding the timing of distributions from, and the benefits that may be provided under, a section 403(b) contract, including limitations on when early distributions can be made (in paragraphs (b) through (d) of this section), required minimum distributions (in paragraph (e) of this section), and special rules relating to loans (in paragraph (f) of this section) and incidental benefits (in paragraph (g) of this section).

(b) *Distributions from contracts other than custodial accounts or amounts attributable to section 403(b) elective deferrals.* Except as provided in paragraph (c) of this section relating to distributions from custodial accounts, paragraph (d) of this section relating to distributions attributable to section 403(b) elective deferrals, § 1.403(b)–4(f) (relating to correction of excess deferrals), or § 1.403(b)–10(a) (relating to

plan termination), a section 403(b) contract is permitted to distribute retirement benefits to the participant no earlier than upon the earlier of the participant's severance from employment or upon the prior occurrence of some event, such as after a fixed number of years, the attainment of a stated age, or disability. See § 1.401–1(b)(1)(ii) for additional guidance. This paragraph (b) does not apply to after-tax employee contributions or earnings thereon.

(c) *Distributions from custodial accounts that are not attributable to section 403(b) elective deferrals.* Except as provided in § 1.403(b)–4(f) (relating to correction of excess deferrals) or § 1.403(b)–10(a) (relating to plan termination), distributions from a custodial account, as defined in § 1.403(b)–8(d)(2), may not be paid to a participant before the participant has a severance from employment, dies, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. Any amounts transferred out of a custodial account to an annuity contract or retirement income account, including earnings thereon, continue to be subject to this paragraph (c). This paragraph (c) does not apply to distributions that are attributable to section 403(b) elective deferrals.

(d) *Distribution of section 403(b) elective deferrals*—(1) *Limitation on distributions*—(i) *General rule*. Except as provided in § 1.403(b)–4(f) (relating to correction of excess deferrals) or § 1.403(b)–10(a) (relating to plan termination), distributions of amounts attributable to section 403(b) elective deferrals may not be paid to a participant earlier than the earliest of the date on which the participant has a severance from employment, dies, has a hardship, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½.

(ii) *Special rule for pre-1989 section 403(b) elective deferrals.* For special rules relating to amounts held as of the close of the taxable year beginning before January 1, 1989 (which does not apply to earnings thereon), see section 1123(e)(3) of the Tax Reform Act of 1986 (100 Stat. 2085, 2475) Public Law 99–514, and section 1011A(c)(11) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342, 3476) Public Law 100–647.

(2) *Hardship rules.* A hardship distribution under this paragraph (d) has the same meaning as a distribution on account of hardship under § 1.401(k)–1(d)(3) and is subject to the rules and restrictions set forth in § 1.401(k)–1(d)(3) (including limiting the amount of a distribution in the case of hardship to the amount necessary to satisfy the hardship). In addition, a hardship distribution is limited to the aggregate dollar amount of the participant's section 403(b) elective deferrals under the contract (and may not include any income thereon), reduced by the aggregate dollar amount of the distributions previously made to the participant from the contract.

(3) *Failure to keep separate accounts*. If a section 403(b) contract includes both section 403(b) elective deferrals and other contributions and the section 403(b) elective deferrals are not maintained in a separate account, then distributions may not be made earlier than the later of—

(i) Any date permitted under paragraph (d)(1) of this section; and

(ii) Any date permitted under paragraph (b) or (c) of this section with respect to contributions that are not section 403(b) elective deferrals (whichever applies to the contributions that are not section 403(b) elective deferrals).

(e) *Minimum required distributions for eligible plans*—(1) *In general*. Under section 403(b)(10), a section 403(b) contract must meet the minimum distribution requirements of section 401(a)(9) (in both form and operation). See section 401(a)(9) for these requirements.

(2) *Treatment as IRAs*. For purposes of applying the distribution rules of section 401(a)(9) to section 403(b) contracts, the minimum distribution rules applicable to individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a) apply to section 403(b) contracts. Consequently, except as otherwise provided in paragraphs (e)(3) through (e)(5) of this section, the distribution rules in section 401(a)(9) are applied to section 403(b) contracts in accordance with the provisions in § 1.408–8 for purposes of determining required minimum distributions.

(3) *Required beginning date*. The required beginning date for purposes of section 403(b)(10) is April 1 of the calendar year following the later of the calendar year in which the employee attains 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan. However, for any section 403(b) contract that is not part of a governmental plan or church plan, the required beginning date for a 5-percent owner is April 1 of the calendar year following the calendar year in which the employee attains 70½.

(4) *Surviving spouse rule does not apply*. The special rule in § 1.408–8, A–5 (relating to spousal beneficiaries), does not apply to a section 403(b) contract. Thus, the surviving spouse of a participant is not permitted to treat a section 403(b) contract as the spouse's own section 403(b) contract, even if the spouse is the sole beneficiary.

(5) *Retirement income accounts*. For purposes of § 1.401(a)(9)–6, A–4 (relating to annuity contracts), annuity payments provided with respect to retirement income accounts do not fail to satisfy the requirements of section 401(a)(9) merely because the payments are not made under an annuity contract purchased from an insurance company, provided that the relationship between the annuity payments and the retirement income accounts is not inconsistent with any rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). See also § 1.403(b)–9(a)(5 for additional rules relating to annuities payable from a retirement income account).

(6) *Special rules for benefits accruing before December 31, 1986*. (i) The distribution rules provided in section 401(a)(9) do not apply to the undistributed portion of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-'87 account balance). The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-'86 account balance), including earnings after December 31, 1986. Consequently, the post-'86 account balance includes earnings after December 31, 1986, on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986, and earnings thereon.

(ii) The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-'87 account balance and subsequent changes as set forth in paragraph (d)(6)(iii) of this section and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer or custodian does not keep such records, the entire account balance is treated as subject to section 401(a)(9).

(iii) In applying the distribution rules in section 401(a)(9), only the post-'86 account balance is used to calculate the required minimum distribution for a calendar year. The amount of any distribution from a contract is treated as being paid from the post-'86 account balance to the extent the distribution is required to satisfy the minimum

distribution requirement with respect to that contract for a calendar year. Any amount distributed in a calendar year from a contract in excess of the required minimum distribution for a calendar year with respect to that contract is treated as paid from the pre-'87 account balance, if any, of that contract.

(iv) If an amount is distributed from the pre-'87 account balance and rolled over to another section 403(b) contract, the amount is treated as part of the post-'86 account balance in that second contract. However, if the pre-'87 account balance under a section 403(b) contract is directly transferred to another section 403(b) contract (as permitted under § 1.403(b)–10(b)), the amount transferred retains its character as a pre-'87 account balance, provided the issuer of the transferee contract satisfies the recordkeeping requirements of paragraph (e)(6)(ii) of this section.

(v) The distinction between the pre-'87 account balance and the post-'86 account balance provided for under this paragraph (e)(6) of this section has no relevance for purposes of determining the portion of a distribution that is includible in income under section 72.

(vi) The pre-'87 account balance must be distributed in accordance with the incidental benefit requirement of § 1.401–1(b)(1)(i). Distributions attributable to the pre-'87 account balance are treated as satisfying this requirement if all distributions from the section 403(b) contract (including distributions attributable to the post-'86 account balance) satisfy the requirements of § 1.401–1(b)(1)(i) without regard to this section, and distributions attributable to the post-'86 account balance satisfy the rules of this paragraph (e) (without regard to this paragraph (e)(6)). Distributions attributable to the pre-'87 account balance are treated as satisfying the incidental benefit requirement if all distributions from the section 403(b) contract (including distributions attributable to both the pre-'87 account balance and the post-'86 account balance) satisfy the rules of this paragraph (e) (without regard to this paragraph (e)(6)).

(7) *Application to multiple contracts for an employee.* The required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, because, as provided in paragraph (e)(2) of this section, the distribution rules in section 401(a)(9) apply to section 403(b) contracts in accordance with the provisions in § 1.408–8, the required minimum distribution from one section 403(b) contract of an employee is permitted to be distributed from another section 403(b) contract in order to satisfy section 401(a)(9). Thus, as provided in § 1.408–8, A–9, with respect to IRAs, the required minimum distribution amount from each contract is then totaled and the total minimum distribution taken from any one or more of the individual section 403(b) contracts. However, consistent with the rules in § 1.408–8, A–9, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts do not satisfy the minimum distribution requirements for IRAs, nor do distributions from IRAs satisfy the minimum distribution requirements for section 403(b) contracts.

(f) *Loans.* The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from an issuer of a section 403(b) contract to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 403(b) and §§ 1.403(b)–1 through 1.403(b)–5, this section, and §§ 1.403(b)–7 through 1.403(b)–11, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to be treated as not being a distribution. However, a plan loan offset is a distribution for purposes of this section. See § 1.72(p)–1, Q&A–13. See also § 1.403(b)–7(d) relating to the application of section 72(p) with respect to the taxation of a loan made under a section 403(b) contract. (Further, see section 408(b)(1) of Title I of ERISA and 29 CFR 2550.408b–1 of the Department of Labor regulations concerning additional requirements applicable with respect to plans that are subject to Title I of ERISA.)

(g) *Death benefits and other incidental benefits.* An annuity is not a section 403(b) contract if it fails to satisfy the incidental benefit requirement of § 1.401–1(b)(1)(ii) (in form or in operation). For purposes of this paragraph (g), to the extent the incidental benefit requirement of § 1.401–1(b)(1)(ii) requires a distribution of the participant's or beneficiary's accumulated benefit, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution requirements of section 401(a)(9). In addition, if a contract issued by an insurance company qualified to issue annuities in a State includes provisions under which, in the event a participant becomes disabled, benefits will be provided by the insurance carrier as if employer contributions were continued until benefit distribution commences, then that benefit is treated as an incidental benefit (as insurance for a deferred annuity benefit in the event of disability) that must satisfy the incidental benefit requirement of § 1.401–1(b)(1)(ii) (taking into account any other incidental benefits provided under the plan).

(h) *Special rule regarding severance from employment.* For purposes of this section, severance from employment occurs on any date on which an employee ceases to be an employee of an eligible employer, even though the employee may continue to be employed either by another entity that is treated as the same employer where either that other entity is not an entity that can be an eligible employer (such as transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization) or in a capacity that is not employment with an eligible employer (for example, ceasing to be an employee performing services for a public school but continuing to work for the same State employer). Thus, this paragraph (h) does not apply if an employee transfers from one section 501(c)(3) organization to another section 501(c)(3) organization that is treated as the same employer or if an employee transfers from one public school to another public school of the same State employer.

(i) *Certain limitations do not apply to rollover contributions.* The limitations on distributions in paragraphs (b) through (d) of this section do not apply to amounts held in a separate account for eligible rollover distributions as described in § 1.403(b)–10(d).

§ 1.403(b)–7 Taxation of distributions and benefits.

(a) *General rules for when amounts are included in gross income.* Except as provided in this section (or in § 1.403(b)–10(c) relating to payments pursuant to a qualified domestic relations order), amounts actually

distributed from a section 403(b) contract are includible in the gross income of the recipient participant or beneficiary (in the year in which so distributed) under section 72 (relating to annuities). For an additional income tax that may apply to certain early distributions that are includible in gross income, see section 72(t).

(b) *Rollovers to individual retirement arrangements and other eligible retirement plans*—(1) *Timing of taxation of rollovers.* In accordance with sections 402(c), 403(b)(8), and 403(b)(10), a direct rollover in accordance with section 401(a)(31) is not includible in the gross income of a participant or beneficiary in the year rolled over. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is contributed to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the contribution to the eligible retirement plan of any property distributed. For this purpose, the rules of section 402(c)(2) through (7) and (c)(9) apply. Thus, to the extent that a portion of a distribution (including a distribution from a designated Roth account) would be excluded from gross income if it were not rolled over, if that portion of the distribution is to be rolled over into an eligible retirement plan that is not an IRA, the rollover must be accomplished through a direct rollover of the entire distribution to a plan qualified under section 401(a) or section 403(b) plan and that plan must agree to separately account for the amount not includible in income (so that a 60-day rollover to a plan qualified under section 401(a) or another section 403(b) plan is not available for this portion of the distribution). Any direct rollover under this paragraph (b)(1) is a distribution that is subject to the distribution requirements of § 1.403(b)–6.

(2) *Requirement that contract provide rollover options for eligible rollover distributions.* As required in § 1.403(b)–3(a)(7), an annuity contract is not a section 403(b) contract unless the contract provides that if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in section 402(c)(8)(B)) and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. For purposes of determining whether a contract satisfies this requirement, the provisions of section 401(a)(31) apply to the annuity as though it were a plan qualified under section 401(a) unless otherwise provided in section 401(a)(31). Thus, the special rule in § 1.401(k)–1(f)(3)(ii) with respect to distributions from a designated Roth account that are expected to total less than $200 during a year applies to designated Roth accounts under a section 403(b) plan. In applying the provisions of this paragraph (b)(2), the payor of the eligible rollover distribution from the contract is treated as the plan administrator.

(3) *Requirement that contract payor provide notice of rollover option to distributees.* To ensure that the distributee of an eligible rollover distribution from a section 403(b) contract has a meaningful right to elect a direct rollover, section 402(f) requires that the distributee be informed of the option. Thus, within a reasonable time period before making the initial eligible rollover distribution, the payor must provide an explanation to the distributee of his or her right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover. For purposes of satisfying the reasonable time period requirement, the plan timing rule provided in section 402(f)(1) and § 1.402(f)–1 applies to section 403(b) contracts.

(4) *Mandatory withholding upon certain eligible rollover distributions from contracts.* If a distributee of an eligible rollover distribution from a section 403(b) contract does not elect to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover, the eligible rollover distribution is subject to 20–percent income tax withholding imposed under section 3405(c). See section 3405(c) and § 31.3405(c)–1 of this chapter for provisions regarding the withholding requirements relating to eligible rollover distributions.

(5) *Automatic rollover for certain mandatory distributions under section 401(a)(31).* In accordance with section 403(b)(10), a section 403(b) plan is required to comply with section 401(a)(31) (including automatic rollover for certain mandatory distributions) in the same manner as a qualified plan.

(c) *Special rules.* See section 402(g)(2)(C) for special rules to determine the tax treatment of a distribution of excess deferrals, and see § 1.401(m)–1(e)(3)(v) for the tax treatment of corrective distributions of after-tax employee contributions and matching contributions to comply with section 401(m). See sections 402(l) and 403(b)(2) for a special rule regarding distributions for certain retired public safety officers made from a governmental plan for the direct payment of certain premiums.

(d) *Amounts taxable under section 72(p)(1).* In accordance with section 72(p), the amount of any loan from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the contract under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and § 1.72(p)–1. See generally § 1.72(p)–1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. A deemed distribution is not an actual distribution for purposes of § 1.403(b)–6, as provided at § 1.72(p)–1, Q&A–12 and Q&A–13. (Further, see section 408(b)(1) of Title I of ERISA concerning the effect of noncompliance with Title I loan requirements for plans that are subject to Title I of ERISA.)

(e) *Special rules relating to distributions from a designated Roth account.* If an amount is distributed from a designated Roth account under a section 403(b) plan, the amount, if any, that is includible in gross income and the amount, if any, that may be rolled over to another section 403(b) plan is determined under § 1.402A–1. Thus, the designated Roth account is treated as a separate contract for purposes of section 72. For example, the rules of section 72(b) must be applied separately to annuity payments with respect to a designated Roth account under a section 403(b) plan and separately to annuity payments with respect to amounts attributable to any other contributions to the section 403(b) plan.

(f) *Aggregation of contracts.* In accordance with section 403(b)(5), the rules of this section are applied as if all annuity contracts for the employee by the employer are treated as a single contract.

(g) *Certain rules relating to employment taxes.* With respect to contributions under the Federal Insurance Contributions Act (FICA) under Chapter 21, see section 3121(a)(5)(D) for a special rule relating to section 403(b) contracts. With respect to income tax withholding on distributions from section 403(b) contracts, see section 3405 generally. However, see section 3401 for income

tax withholding applicable to annuity contracts or custodial accounts that are not section 403(b) contracts or for cases in which an annuity contract or custodial account ceases to be a section 403(b) contract. See also § 1.72(p)–1, Q&A–15, and § 35.3405(c)–1, Q&A–11 of this chapter, for special rules relating to income tax withholding for loans made from certain employer plans, including section 403(b) contracts.

§ 1.403(b)–8 Funding.

(a) *Investments.* Section 403(b) and § 1.403(b)–3(a) only apply to amounts held in an annuity contract (as defined in § 1.403(b)–2), including a custodial account that is treated as an annuity contract under paragraph (d) of this section, or a retirement income account that is treated as an annuity contract under § 1.403(b)–9.

(b) *Contributions to the plan.* Contributions to a section 403(b) plan must be transferred to the insurance company issuing the annuity contract (or the entity holding assets of any custodial or retirement income account that is treated as an annuity contract) within a period that is not longer than is reasonable for the proper administration of the plan. For purposes of this requirement, the plan may provide for section 403(b) elective deferrals for a participant under the plan to be transferred to the annuity contract within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for section 403(b) elective deferrals under the plan to be contributed within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(c) *Annuity contracts*—(1) *Generally.* As defined in § 1.403(b)–2, and except as otherwise permitted under this section, an annuity contract means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. This paragraph (c) sets forth additional rules regarding annuity contracts.

(2) *Certain insurance contracts.* Neither a life insurance contract, as defined in section 7702, an endowment contract, a health or accident insurance contract, nor a property, casualty, or liability insurance contract meets the definition of an annuity contract. See § 1.401(f)–4(e). If a contract issued by an insurance company qualified to issue annuities in a State provides death benefits as part of the contract, then that coverage is permitted, assuming that those death benefits do not cause the contract to fail to satisfy any requirement applicable to section 403(b) contracts, for example, assuming that those benefits satisfy the incidental benefit requirement of § 1.401–1(b)(1)(i), as required by § 1.403(b)–6(g).

(3) *Special rule for certain contracts.* This paragraph (c)(3) applies in the case of a contract issued under a State section 403(b) plan established on or before May 17, 1982, or for an employee who becomes covered for the first time under the plan after May 17, 1982, unless the Commissioner had before that date issued any written communication (either to the employer or financial institution) to the effect that the arrangement under which the contract was issued did not meet the requirements of section 403(b). The requirement that the contract be issued by an insurance company qualified to issue annuities in a State does not apply to a contract described in the preceding sentence if one of the following two conditions is satisfied and that condition has been satisfied continuously since May 17, 1982—

(i) Benefits under the contract are provided from a separately funded retirement reserve that is subject to supervision of the State insurance department; or

(ii) Benefits under the contract are provided from a fund that is separate from the fund used to provide statutory benefits payable under a state retirement system and that is part of a State teachers retirement system (including a state university retirement system) to purchase benefits that are unrelated to the basic benefits provided under the retirement system, and the death benefit provided under the contract does not at any time exceed the larger of the reserve or the contribution made for the employee.

(d) *Custodial accounts*—(1) *Treatment as a section 403(b) contract.* Under section 403(b)(7), a custodial account is treated as an annuity contract for purposes of §§ 1.403(b)–1 through 1.403(b)–7, this section and §§ 1.403(b)–9 through 1.403(b)–11. See section 403(b)(7)(B) for special rules regarding the tax treatment of custodial accounts and section 4973(c) for an excise tax that applies to excess contributions to a custodial account.

(2) *Custodial account defined.* A custodial account means a plan, or a separate account under a plan, in which an amount attributable to section 403(b) contributions (or amounts rolled over to a section 403(b) contract, as described in § 1.403(b)–10(d)) is held by a bank or a person who satisfies the conditions in section 401(f)(2), if—

(i) All of the amounts held in the account are invested in stock of a regulated investment company (as defined in section 851(a) relating to mutual funds);

(ii) The requirements of § 1.403(b)–6(c) (imposing restrictions on distributions with respect to a custodial account) are satisfied with respect to the amounts held in the account;

(iii) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (for which purpose, assets are treated as diverted to the employer if the employer borrows assets from the account); and

(iv) The account is not part of a retirement income account.

(3) *Effect of definition.* The requirement in paragraph (d)(2)(i) of this section is not satisfied if the account includes any assets other than stock of a regulated investment company.

(4) *Treatment of custodial account.* A custodial account is treated as a section 401 qualified plan solely for purposes of subchapter F of subtitle A and subtitle F of the Internal Revenue Code with respect to amounts received by it (and income from investment thereof). This treatment only applies to a custodial account that constitutes a section 403(b) contract under §§ 1.403(b)–1 through 1.403(b)–7, this section and §§ 1.403(b)–9 through 1.403(b)–11 or that would constitute a section 403(b) contract under §§ 1.403(b)–1 through 1.403(b)–7, this section and §§ 1.403(b)–9 through 1.403(b)–11 if the amounts held in the account were to satisfy the nonforfeitability requirement of § 1.403(b)–3(a)(2).

(e) *Retirement income accounts.* See § 1.403(b)–9 for special rules under which a retirement income account for employees of a church-related organization is treated as a section 403(b) contract for purposes of §§ 1.403(b)–1 through 1.403(b)–7, this section and §§ 1.403(b)–9 through 1.403(b)–11.

(f) *Combining assets.* To the extent permitted by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), trust assets held under a custodial account and trust assets held under a retirement income account, as described in § 1.403(b)–9(a)(6), may be invested in a group trust with trust assets held under a qualified plan or individual retirement plan. For this purpose, a trust includes a custodial account that is treated as a trust under section 401(f).

§ 1.403(b)–9 Special rules for church plans.

(a) *Retirement income accounts*—(1) *Treatment as a section 403(b) contract.* Under section 403(b)(9), a retirement income account for employees of a church-related organization (as defined in § 1.403(b)–2) is treated as an annuity contract for purposes of §§ 1.403(b)–1 through 1.403(b)–8, this section, § 1.403(b)–10 and § 1.403(b)–11.

(2) *Retirement income account defined*—(i) *In general.* A retirement income account means a defined contribution program established or maintained by a church-related organization under which—

(A) There is separate accounting for the retirement income account's interest in the underlying assets (namely, there must be sufficient separate accounting in order for it to be possible at all times to determine the retirement income account's interest in the underlying assets and to distinguish that interest from any interest that is not part of the retirement income account);

(B) Investment performance is based on gains and losses on those assets; and

(C) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (and for this purpose, assets are treated as diverted to the employer if there is a loan or other extension of credit from assets in the account to the employer).

(ii) *Plan required.* A retirement income account must be maintained pursuant to a program which is a plan (as defined in § 1.403(b)–3(b)(3)) and the plan document must state (or otherwise evidence in a similarly clear manner) the intent to constitute a retirement income account.

(3) *Ownership or use constitutes distribution.* Any asset of a retirement income account that is owned or used by a participant or beneficiary is treated as having been distributed to that participant or beneficiary. See §§ 1.403(b)–6 and 1.403(b)–7 for rules relating to distributions.

(4) *Coordination of retirement income account with custodial account rules.* A retirement income account that is treated as an annuity contract is not a custodial account (as defined in § 1.403(b)–8(d)(2)), even if it is invested solely in stock of a regulated investment company.

(5) *Life annuities.* A retirement income account may distribute benefits in a form that includes a life annuity only if—

(i) The amount of the distribution form has an actuarial present value, at the annuity starting date, equal to the participant's or beneficiary's accumulated benefit, based on reasonable actuarial assumptions, including regarding interest and mortality; and

(ii) The plan sponsor guarantees benefits in the event that a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

(6) *Combining retirement income account assets with other assets.* For purposes of § 1.403(b)–8(f) relating to combining assets, retirement income account assets held in trust (including a custodial account that is treated as a trust under section 401(f)) are subject to the same rules regarding combining of assets as custodial account assets. In addition, retirement income account assets are permitted to be commingled in a common fund with amounts devoted exclusively to church purposes (such as a fund from which unfunded pension payments are made to former employees of the church). However, unless otherwise permitted by the Commissioner, no assets of the plan sponsor, other than retirement income account assets, may be combined with custodial account assets or any other assets permitted to be combined under § 1.403(b)–8(f). This paragraph (a)(6) is subject to any additional rules issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(7) *Trust treated as tax exempt.* A trust (including a custodial account that is treated as a trust under section 401(f)) that includes no assets other than assets of a retirement income account is treated as an organization that is exempt from taxation under section 501(a).

(b) *No compensation limitation up to $10,000.* See section 415(c)(7) for special rules regarding certain annual additions not exceeding $10,000.

(c) *Special deduction rule for self-employed ministers.* See section 404(a)(10) for a special rule regarding the deductibility of a contribution made by a self-employed minister.

§ 1.403(b)–10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans*—(1) *In general.* An employer is permitted to amend its section 403(b) plan to eliminate future contributions for existing participants or to limit participation to existing participants and employees (to the extent consistent with § 1.403(b)–5). A section 403(b) plan is permitted to contain provisions that provide for plan termination and that allow accumulated benefits to be distributed on termination. However, in the case of a section 403(b) contract that is subject to the distribution restrictions in § 1.403(b)–6(c) or (d) (relating to custodial accounts and section 403(b) elective deferrals), termination of the plan and the distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the same employer under section 414(b), (c), (m), or (o) on the date of the termination) does not make contributions to any section 403(b) contract that is not part of the plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the period beginning 12 months before the termination and ending 12 months after distribution of all assets from the terminated plan, fewer than 2 percent of the employees who were eligible under the section 403(b) plan as of the date of plan termination are eligible under the alternative section 403(b) contract, the alternative section 403(b) contract is disregarded. To the extent a contract fails to satisfy the nonforfeitability requirement of § 1.403(b)–3(a)(2) at the date of plan termination, the contact is not, and cannot later become, a section 403(b) contract. In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. For this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution. The mere provision for, and making of, distributions to participants or beneficiaries upon plan termination does not cause a contract to cease to be a section 403(b) contract. See § 1.403(b)–7 for rules regarding the tax treatment of distributions, including § 1.403(b)–7(b)(1) under which an eligible rollover distribution is not included in gross income if paid in a direct rollover to an eligible retirement plan or if transferred to an eligible retirement plan within 60 days.

(2) *Employers that cease to be eligible employers.* An employer that ceases to be an eligible employer may no longer contribute to a section 403(b) contract for any subsequent period, and the contract will fail to satisfy § 1.403(b)–3(a) if any further contributions are made with respect to a period after the employer ceases to be an eligible employer.

(b) *Contract exchanges and plan-to-plan transfers*—(1) *Contract exchanges and transfers*—(i) *General rule.* If the conditions in paragraph (b)(2) of this section are met, a section 403(b) contract held under a section 403(b)

plan is permitted to be exchanged for another section 403(b) contract held under that section 403(b) plan. Further, if the conditions in paragraph (b)(3) of this section are met, a section 403(b) plan is permitted to provide for the transfer of its assets (including any assets held in a custodial account or retirement income account that are treated as section 403(b) contracts) to another section 403(b) plan. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive service credit and repayments under section 415) are met, a section 403(b) plan is permitted to provide for the transfer of its assets to a qualified plan under section 401(a). However, neither a qualified plan nor an eligible governmental plan under section 457(b) may transfer assets to a section 403(b) plan, and a section 403(b) plan may not accept such a transfer. In addition, a section 403(b) contract may not be exchanged for an annuity contract that is not a section 403(b) contract. Neither a plan-to-plan transfer nor a contract exchange permitted under this paragraph (b) is treated as a distribution for purposes of the distribution restrictions at § 1.403(b)–6. Therefore, such a transfer or exchange may be made before severance from employment or another distribution event. Further, no amount is includible in gross income by reason of such a transfer or exchange.

(ii) *ERISA rules.* See § 1.414(l)–1 for other rules that are applicable to section 403(b) plans that are subject to section 208 of the Employee Retirement Income Security Act of 1974 (88 Stat. 829, 865).

(2) *Requirements for contract exchange within the same plan*—(i) *General rule.* A section 403(b) contract of a participant or beneficiary may be exchanged under paragraph (b)(1) of this section for another section 403(b) contract of that participant or beneficiary under the same section 403(b) plan if each of the following conditions are met:

(A) The plan under which the contract is issued provides for the exchange.

(B) The participant or beneficiary has an accumulated benefit immediately after the exchange that is at least equal to the accumulated benefit of that participant or beneficiary immediately before the exchange (taking into account the accumulated benefit of that participant or beneficiary under both section 403(b) contracts immediately before the exchange).

(C) The other contract is subject to distribution restrictions with respect to the participant that are not less stringent than those imposed on the contract being exchanged, and the employer enters into an agreement with the issuer of the other contract under which the employer and the issuer will from time to time in the future provide each other with the following information:

(*1*) Information necessary for the resulting contract, or any other contract to which contributions have been made by the employer, to satisfy section 403(b), including information concerning the participant's employment and information that takes into account other section 403(b) contracts or qualified employer plans (such as whether a severance from employment has occurred for purposes of the distribution restrictions in § 1.403(b)–6 and whether the hardship withdrawal rules of § 1.403(b)–6(d)(2) are satisfied).

(*2*) Information necessary for the resulting contract, or any other contract to which contributions have been made by the employer, to satisfy other tax requirements (such as whether a plan loan satisfies the conditions in section 72(p)(2) so that the loan is not a deemed distribution under section 72(p)(1)).

(ii) *Accumulated benefit.* The condition in paragraph (b)(2)(i)(B) of this section is satisfied if the exchange would satisfy section 414(l)(1) if the exchange were a transfer of assets.

(iii) *Authority for future guidance.* Subject to such conditions as the Commissioner determines to be appropriate, the Commissioner may issue rules of general applicability, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permitting an exchange of one section 403(b) contract for another section 403(b) contract for an exchange that does not satisfy paragraph (b)(2)(i)(C) of this section. Any such rules must require the resulting contract to set forth procedures that the Commissioner determines are reasonably designed to ensure compliance with those requirements of section 403(b) or other tax provisions that depend on either information concerning the participant's employment or information that takes into account other section 403(b) contracts or other employer plans (such as whether a severance from employment has occurred for purposes of the distribution restrictions in § 1.403(b)–6, whether the hardship withdrawal rules of § 1.403(b)–6(d)(2) are satisfied, and whether a plan loan constitutes a deemed distribution under section 72(p)).

(3) *Requirements for plan-to-plan transfers.* (i) A plan-to-plan transfer under paragraph (b)(1) of this section from a section 403(b) plan to another section 403(b) plan is permitted if each of the following conditions are met—

(A) In the case of a transfer for a participant, the participant is an employee or former employee of the employer (or the business of the employer) for the receiving plan.

(B) In the case of a transfer for a beneficiary of a deceased participant, the participant was an employee or former employee of the employer (or business of the employer) for the receiving plan.

(C) The transferor plan provides for transfers.

(D) The receiving plan provides for the receipt of transfers.

(E) The participant or beneficiary whose assets are being transferred has an accumulated benefit immediately after the transfer that is at least equal to the accumulated benefit of that participant or beneficiary immediately before the transfer.

(F) The receiving plan provides that, to the extent any amount transferred is subject to any distribution restrictions under § 1.403(b)–6, the receiving plan imposes restrictions on distributions to the participant or beneficiary whose assets are being transferred that are not less stringent than those imposed on the transferor plan.

(G) If a plan-to-plan transfer does not constitute a complete transfer of the participant's or beneficiary's interest in the section 403(b) plan, the transferee plan treats the amount transferred as a continuation of a pro rata portion of the participant's or beneficiary's interest in the section 403(b) plan (for example, a pro rata portion of the participant's or beneficiary's interest in any after-tax employee contributions).

(ii) *Accumulated benefit.* The condition in paragraph (b)(3)(i)(D) of this section is satisfied if the transfer would satisfy section 414(l)(1).

(4) *Purchases of permissive service credit by contract-to-plan transfers from a section 403(b) contract to a qualified plan*—(i) *General rule.* If the conditions in paragraph (b)(4)(ii) of this section are met, a section 403(b) plan may provide for the transfer of assets held in the plan to a qualified defined benefit plan that is a governmental plan (as defined in section 414(d)).

(ii) *Conditions for plan-to-plan transfers.* A transfer may be made under this paragraph (b)(4) only if the transfer is either—

(A) For the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(c) *Qualified domestic relations orders.* In accordance with the second sentence of section 414(p)(9), any distribution from an annuity contract under section 403(b) (including a distribution from a custodial account or retirement income account that is treated as a section 403(b) contract) pursuant to a qualified domestic relations order is treated in the same manner as a distribution from a plan to which section 401(a)(13) applies. Thus, for example, a section 403(b) plan does not fail to satisfy the distribution restrictions set forth in § 1.403(b)–6(b), (c), or (d) merely as a result of distribution made pursuant to a qualified domestic relations order under section 414(p), so that such a distribution is permitted without regard to whether the employee from whose contract the distribution is made has had a severance from employment or another event permitting a distribution to be made under section 403(b). In the case of a plan that is subject to Title I of ERISA, see also section 206(d)(3) of ERISA under which the prohibition against assignment or alienation of plan benefits under section 206(d)(1) of ERISA does not apply to an order that is determined to be a qualified domestic relations order.

(d) *Rollovers to a section 403(b) contract*—(1) *General rule.* A section 403(b) contract may accept a contribution that is an eligible rollover distribution (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)). Any amount contributed to a section 403(b) contract as an eligible rollover distribution is not taken into account for purposes of the limits in § 1.403(b)–4, but, except as otherwise specifically provided (for example, at § 1.403(b)–6(i)), is otherwise treated in the same manner as an amount held under a section 403(b) contract for purposes of §§ 1.403(b)–3 through 1.403(b)–9 and this section.

(2) *Special rules relating to after-tax employee contributions and designated Roth contributions.* A section 403(b) plan that receives an eligible rollover distribution that includes after-tax employee contributions or designated Roth contributions is required to obtain information regarding the employee's section 72 basis in the amount rolled over. A section 403(b) plan is permitted to receive an eligible rollover distribution that includes designated Roth contributions only if the plan permits employees to make elective deferrals that are designated Roth contributions.

(e) *Deemed IRAs.* See regulations under section 408(q) for special rules relating to deemed IRAs.

(f) *Defined benefit plans*—(1) *Defined benefit plans generally.* Except for a TEFRA church defined benefit plan as defined in paragraph (f)(2) of this section, section 403(b) does not apply to any contributions or accrual under a defined benefit plan.

(2) *TEFRA church defined benefit plans.* See section 251(e)(5) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97–248, for a provision permitting certain arrangements established by a church-related organization and in effect on September 3, 1982 (a TEFRA church defined benefit plan) to be treated as section 403(b) contract even though it is a defined benefit arrangement. In accordance with section 403(b)(1), for purposes of applying section 415 to a TEFRA church defined benefit plan, the accruals under the plan are limited to the maximum amount permitted under section 415(c) when expressed as an annual addition, and, for this purpose, the rules at § 1.402(b)–1(a)(2) for determining the present value of an accrual under a nonqualified defined benefit plan also apply for purposes of converting the accrual under a TEFRA church defined benefit plan to an annual addition. See section 415(b) for additional limits applicable to TEFRA church defined benefit plans.

(g) *Other rules relating to section 501(c)(3) organizations.* See section 501(c)(3) and regulations thereunder for the substantive standards for tax-exemption under that section, including the requirement that no part of the organization's net earnings inure to the benefit of any private shareholder or individual. See also sections 4941 (self dealing), 4945 (taxable expenditures), and 4958 (excess benefit transactions), and the regulations thereunder, for rules relating to excise taxes imposed on certain transactions involving organizations described in section 501(c)(3).

§ 1.403(b)–11 Applicable dates.

(a) *General rule.* Except as otherwise provided in this section, §§ 1.403(b)–1 through 1.403(b)–10 apply for taxable years beginning after December 31, 2008.

(b) *Collective bargaining agreements.* In the case of a section 403(b) plan maintained pursuant to one or more collective bargaining agreements that have been ratified and in effect on July 26, 2007, §§ 1.403(b)–1 through 1.403(b)–10 do not apply before the earlier of—

(1) The date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after July 26, 2007); or

(2) July 26, 2010.

(c) *Church conventions; retirement income account.* (1) In the case of a section 403(b) plan maintained by a church-related organization for which the authority to amend the plan is held by a church convention (within the meaning of section 414(e)), §§ 1.403(b)–1 through 1.403(b)–10 do not apply before the first day of the first plan year that begins after December 31, 2009.

(2) In the case of a loan or other extension of credit to the employer that was entered into under a retirement income account before July 26, 2007 the plan does not fail to satisfy § 1.403(b)–9(a)(2)(C) on account of the loan or other extension of credit if the plan takes reasonable steps to eliminate the loan or other extension of credit to the employer before the applicable date for § 1.403(b)–9(a)(2) or as promptly as practical thereafter (including taking steps after July 26, 2007 and before the applicable date).

(d) *Special rules for plans that exclude certain types of employees from elective deferrals.* (1) If, on July 26, 2007, a plan excludes any of the following categories of employees, then the plan does not fail to satisfy § 1.403(b)–5(b) as a result of that exclusion before the first day of the first taxable year that begins after December 31, 2009:

(i) Employees who make a one-time election to participate in a governmental plan described in section 414(d) that is not a section 403(b) plan.

(ii) Professors who are providing services on a temporary basis to another educational organization (as defined under section 170(b)(1)(A)(ii)) for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original educational organization.

(iii) Employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement from eligibility to make elective deferrals.

(2) If, on July 26, 2007, a plan excludes employees who are covered by a collective bargaining agreement from eligibility to make elective deferrals, the plan does not fail to satisfy § 1.403(b)–5(b) (relating to universal availability) as

a result of that exclusion before the later of—

(i) The first day of the first taxable year that begins after December 31, 2008; or

(ii) The earlier of—

(A) The date on which the related collective bargaining agreement terminates (determined without regard to any extension thereof after July 26, 2007); or

(B) July 26, 2010.

(3) In the case of a governmental plan (as defined in section 414(d)) for which the authority to amend the plan is held by a legislative body that meets in legislative session, the plan does not fail to satisfy § 1.403(b)–5(b) as a result of any exclusion in paragraph (d)(1)(i), (d)(1)(ii),(d)(1)(iii), or (d)(2) of this section before the earlier of —

(i) The close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009; or

(ii) January 1, 2011.

(e) *Special rules for plans that permit in-service distributions.* (1) Section 1.403(b)–6(b) does not apply to a contract issued by an insurance company before January 1, 2009.

(2) Any amendment to comply with the requirements of § 1.403(b)–6 (disregarding paragraph (e)(1) of this section) that is adopted before January 1, 2009, or such later date as may be permitted under guidance issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), does not violate section 204(g) of the Employee Retirement Income Security Act of 1974 to the extent the amendment eliminates or reduces a right to receive benefit distributions during employment.

(f) *Special rule for life insurance contracts.* Section 1.403(b)–8(c)(2) does not apply to a contract issued before September 24, 2007.

(g) *Special rule for contracts received in an exchange.* Section 1.403(b)–10(b)(2) does not apply to a contract received in an exchange that occurred on or before September 24, 2007 if the exchange (including the contract received in the exchange) satisfies such rules as the Commissioner has prescribed in guidance of general applicability at the time of the exchange.

(h) *Special rule for coordination with regulations under section 415.* Section 1.403(b)–3(b)(4)(ii) is applicable for taxable years beginning on or after July 1, 2007.

(i) *Special rule for coordination with regulations under section 402A.* Sections 1.403(b)–3(c), 1.403(b)–7(e), and 1.403(b)–10(d)(2) are applicable with respect to taxable years beginning on or after January 1, 2007.

§ 1.403(d)–1 [Removed]

■ **Par. 8.** Section 1.403(d)–1 is removed.

■ **Par. 9.** Section 1.414(c)–5 is redesignated as § 1.414(c)–6 and new § 1.414(c)–5 is added to read as follows:

§ 1.414(c)–5 Certain tax-exempt organizations.

(a) *Application.* This section applies to an organization that is exempt from tax under section 501(a). The rules of this section only apply for purposes of determining when entities are treated as the same employer for purposes of section 414(b), (c), (m), and (o) (including the sections referred to in section 414(b), (c), (m), (o), and (t)), and are in addition to the rules otherwise applicable under section 414(b), (c), (m), and (o) for determining when entities are treated as the same employer. Except to the extent set forth in paragraphs (d), (e), and (f) of this section, this section does not apply to any church, as defined in section 3121(w)(3)(A), or any qualified church-controlled organization, as defined in section 3121(w)(3)(B).

(b) *General rule.* In the case of an organization that is exempt from tax under section 501(a) (an exempt organization) whose employees participate in a plan, the employer with respect to that plan includes the exempt organization whose employees participate in the plan and any other organization that is under common control with that exempt organization. For this purpose, common control exists between an exempt organization and another organization if at least 80 percent of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the general power to remove such trustee or director and designate a new trustee or director. Whether a person has the power to remove or designate a trustee or director is based on facts and circumstances. To illustrate the rules of this paragraph (b), if exempt organization A has the power to appoint at least 80 percent of the trustees of exempt organization B (which is the owner of the outstanding shares of corporation C, which is not an exempt organization) and to control at least 80 percent of the directors of exempt organization D, then, under this paragraph (b) and § 1.414(b)–1, entities A, B, C, and D are treated as the same employer with respect to any plan maintained by A, B, C, or D for purposes of the sections referenced in section 414(b), (c), (m), (o), and (t).

(c) *Permissive aggregation with entities having a common exempt purpose*—(1) *General rule.* For purposes of this section, exempt organizations that maintain a plan to which section 414(c) applies that covers one or more employees from each organization may treat themselves as under common control for purposes of section 414(c) (and, thus, as a single employer for all purposes for which section 414(c) applies) if each of the organizations regularly coordinates their day-to-day exempt activities. For example, an entity that provides a type of emergency relief within one geographic region and another exempt organization that provides that type of emergency relief within another geographic region may treat themselves as under common control if they have a single plan covering employees of both entities and regularly coordinate their day-to-day exempt activities. Similarly, a hospital that is an exempt organization and another exempt organization with which it coordinates the delivery of medical services or medical research may treat themselves as under common control if there is a single plan covering employees of the hospital and employees of the other exempt organization and the coordination is a regular part of their day-to-day exempt activities.

(2) *Authority to permit aggregation.* (i) For determining when entities are treated as the same employer under section 414(b), (c), (m), and (o), the Commissioner may issue rules of general applicability, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permitting other types of combinations of entities that include exempt organizations to elect to be treated as under common control for one or more specified purposes if:

(A) There are substantial business reasons for maintaining each entity in a separate trust, corporation, or other form; and

(B) Such treatment would be consistent with the anti-abuse standards in paragraph (f) of this section.

(ii) For example, this authority might be exercised in any situation in which

the organizations are so integrated in their operations as to effectively constitute a single coordinated employer for purposes of section 414(b), (c), (m), and (o), including common employee benefit plans.

(d) *Permissive disaggregation between qualified church controlled organizations and other entities.* In the case of a church plan (as defined in section 414(e)) to which contributions are made by more than one common law entity, any employer may apply paragraphs (b) and (c) of this section to those entities that are not a church (as defined in section 403(b)(12)(B) and § 1.403(b)–2) separately from those entities that are churches. For example, in the case of a group of entities consisting of a church (as defined in section 3121(w)(3)(A)), a secondary school (that is treated as a church under § 1.403(b)–2), and several nursing homes each of which receives more than 25 percent of its support from fees paid by residents (so that none of them is a qualified church-controlled organization under § 1.403(b)–2 and section 3121(w)(3)(B)), the nursing homes may treat themselves as being under common control with each other, but not as being under common control with the church and the school, even though the nursing homes would be under common control with the school and the church under paragraph (b) of this section.

(e) *Application to certain church entities under section 3121(w)(3).* [Reserved].

(f) *Anti-abuse rule.* In any case in which the Commissioner determines that the structure of one or more exempt organizations (which may include an exempt organization and an entity that is not exempt from income tax) or the positions taken by those organizations has the effect of avoiding or evading any requirements imposed under section 401(a), 403(b), or 457(b), or any applicable section (as defined in section 414(t)), or any other provision for which section 414(c) applies, the Commissioner may treat an entity as under common control with the exempt organization.

(g) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Organization A is a tax-exempt organization under section 501(c)(3) which owns 80% or more of the total value of all classes of stock of corporation B, which is a for profit organization.

(ii) *Conclusion.* Under paragraph (a) of this section, this section does not alter the rules of section 414(b) and (c), so that organization A and corporation B are under common control under § 1.414(c)–2(b).

Example 2. (i) *Facts.* Organization M is a hospital which is a tax-exempt organization under section 501(c)(3) and organization N is a medical clinic which is also a tax-exempt organization under section 501(c)(3). N is located in a city and M is located in a nearby suburb. There is a history of regular coordination of day-to-day activities between M and N, including periodic transfers of staff, coordination of staff training, common sources of income, and coordination of budget and operational goals. A single section 403(b) plan covers professional and staff employees of both the hospital and the medical clinic. While a number of members of the board of directors of M are also on the board of directors of N, there is less than 80% overlap in board membership. Both organizations have approximately the same percentage of employees who are highly compensated and have appropriate business reasons for being maintained in separate entities.

(ii) *Conclusion.* M and N are not under common control under this section, but, under paragraph (c) of this section, may chose to treat themselves as under common control, assuming both of them act in a manner that is consistent with that choice for purposes of § 1.403(b)–5(a), sections 401(a), 403(b), and 457(b), and any other applicable section (as defined in section 414(t)), or any other provision for which section 414(c) applies.

Example 3. (i) *Facts.* Organization O and P are each tax-exempt organizations under section 501(c)(3). Each organization maintains a qualified plan for its employees, but one of the plans would not satisfy section 410(b) (or section 401(a)(4)) if the organizations were under common control. The two organizations are closely related and, while the organizations have several trustees in common, the common trustees constitute fewer than 80 percent of the trustees of either organization. Organization O has the power to remove any of the trustees of P and to select the slate of replacement nominees.

(ii) *Conclusion.* Under these facts, pursuant to paragraphs (b) and (f) of this section, the Commissioner treats the entities as under common control.

(h) *Applicable date.* This section applies for plan years beginning after December 31, 2008.

■ **Par. 10.** For each entry listed in the ''Location'' column, remove the language in the ''Remove'' column and add the language in the ''Add'' column in its place.

Location	Remove	Add
§ 1.101–1(a)(2)(ii)	paragraph (a) or (b) of § 1.403(b)–1	§ 1.403(b)–3.
§ 1.101–1(a)(2)(ii)	paragraph (c)(3) of § 1.403(b)–1	§ 1.403(b)–7.
§ 1.401(a)(9)–1, A–1	§ 1.403(b)–3	§ 1.403(b)–6(e).
§ 1.401(a)(31)–1. introductory text	§ 1.403(b)–2	§ 1.403(b)–7(b).
§ 1.401(a)(31)–1, A–1(b)(3)	§ 1.403(b)–2	§ 1.403(b)–7(b).
§ 1.402(c)–2, introductory text	§ 1.403(b)–2	§ 1.403(b)–7(b).
§ 1.402(c)–2, A–1(b)(4)	§ 1.403(b)–2	§ 1.403(b)–7(b).
§ 1.402(f)–1, introductory text	§ 1.403(b)–2	§ 1.403(b)–7(b).
§ 1.403(a)–1(a)	§ 1.403(b)–1	§§ 1.403(b)–1 through 1.403(b)–10.
§ 1.403(c)–1, all locations	§ 1.403(b)–1(b)	§ 1.403(b)–3.
§ 1.403(c)–1, all locations	§ 1.403(b)–1(b)(2)	§ 1.403(b)–3(c).

PART 31—EMPLOYMENT TAXES, INCOME TAXES, PENALTIES, PENSIONS, RAILROAD RETIREMENT, REPORTING AND RECORDKEEPING REQUIREMENTS, SOCIAL SECURITY, UNEMPLOYMENT COMPENSATION

■ **Par. 11.** The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 12.** For each entry listed in the ''Location'' column, remove the language in the ''Remove'' column and add the language in the ''Add'' column in its place.

Location	Remove	Add
§ 31.3405(c)–1, all locations	§ 1.403(b)–2, Q&A–1	§ 1.403(b)–7(b).
§ 31.3405(c)–1, A–1(b)	§ 1.403(b)–2, Q&A–3	§ 1.403(b)–7(b).
§ 31.3405(c)–1, A–1(b)	§ 1.403(b)–2, Q&A–1 and Q&A–2	§ 1.403(b)–7(b).
§ 31.3405(c)–1, A–2	§ 1.403(b)–2, Q&A–2	§ 1.403(b)–7(b).

PART 54—EXCISE TAXES. PENSIONS, REPORTING AND RECORDKEEPING REQUIREMENTS

■ **Par. 13.** The authority citation for part 54 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 14.** For the entry listed in the ''Location'' column, remove the language in the ''Remove'' column and add the language in the ''Add'' column in its place.

Location	Remove	Add
§ 54.4974–2, A–3(a)(2)	§ 1.403(b)–3	§ 1.403(b)–6(e).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par 15.** The authority citation for part 602 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

■ **Par 16.** In § 602.101, paragraph (b) is amended by removing the entry for § 1.403(b)–2 and adding entries to the table for §§ 1.403(b)–7 and 1.402(b)–10 to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
1.403(b)–7	1545–1341
* * * * *	
1.403(b)–10	1545–2068
* * * * *	

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: July 2, 2007.

Eric Solomon,

Assistant Secretary of Treasury (Tax Policy).

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