PURPOSE

(1) This transmits a complete reprint with changes for IRM 4.72.13, Employee Plans Technical Guidance 403(b) Plans.

NATURE OF MATERIAL

(1) IRM 4.72.13 reissues existing procedures for examining 403(b) Plans. These procedures have been updated to include legislative and regulatory changes since the last issuance.

AUDIENCE

TE/GE (Employee Plans)

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4.72.13.1
(03-01-2005)
Overview

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

a. 4.72.13.1 defines a 403(b) plan and provides a technical overview and historical background of 403(b) plans.
b. 4.72.13.2 discusses the types of employers eligible to maintain a 403(b) plan.
c. 4.72.13.3 describes the various funding vehicles for 403(b) plans.
d. 4.72.13.4 addresses the requirements of salary reduction contributions.
e. 4.72.13.5 addresses the contribution limits applicable to 403(b) plans.
f. 4.72.13.6 discusses the applicable nondiscrimination rules.
g. 4.72.13.7 - 4.72.13.9 address distributions from a 403(b) plan.
h. 4.72.13.10 provides a list of possible defects in a 403(b) plan or annuity contract and resulting tax consequences.
i. 4.72.13.11 is a glossary of terms.

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

a. The agent may need to consult the Code and federal Income Tax Regulations for further development of a particular issue. Accordingly, cites are provided where appropriate.
b. These guidelines are designed to help the examiner key in on the issues that should be raised in a particular plan. It is not expected that every issue raised in the guidelines will be relevant or should be raised in every examination.
c. The techniques identified may be modified based on the actual examination issues encountered.
d. Given the purpose of these guidelines, they cannot be, nor are they intended to be, a precedential or comprehensive statement of the legal position of the Service on the issues covered.
e. These guidelines are not to be relied on or cited as authority by taxpayers.
f. These guidelines reflect changes to the Code made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) and the technical corrections made thereto. For examinations of years beginning prior to January 1, 2002, please consult prior examination guidelines for enforcement of laws then in effect.
g. These guidelines are subject to change in accordance with future developments in the law.

4.72.13.1.1
(03-01-2005)
Technical Overview

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

a. *IRC section 403(b)* was first added to the Code in 1958.
b. In 1964, pre-ERISA regulations were issued detailing some of the basic statutory provisions of *IRC section 403(b)*. These regulations were later amended as new provisions were added to *IRC section 403(b)*.
c. Final regulations were issued under *IRC section 415* in 1980.
d. In addition, there are proposed, temporary, and final regulations pertaining to the minimum distribution requirements and final regulations regarding direct rollovers. (Bold font indicates the term or phrase is defined in the Glossary). Currently, there are no nondiscrimination regulations under IRC section 403(b).

4.72.13.1.1.1
(03-01-2005)
General Requirements

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

a. Comply with certain nondiscrimination and coverage rules (including *IRC sections 401(a)(4)*, 401(m) and 410(b)),
b. Ensure that elective deferrals do not exceed the *IRC section 402(g)* limit,
c. Conform to the minimum distribution rules of *IRC section 403(b)(10)*, and
d. Provide a participant with a meaningful opportunity to elect a direct rollover to another eligible retirement plan.

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

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

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

(3) The plans in Examples (1) and (2) above are subject to the requirements of 403(b). A 403(b) plan is always subject to Title II (relating to the Code) but may not be subject to Title I, the Labor Title of ERISA.

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

4.72.13.1.1.2
(03-01-2005)
General Characteristics

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

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

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

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

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

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

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

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

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

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

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

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

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

4.72.13.1.1.3
(03-01-2005)
Aggregated Annuity Contracts

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

4.72.13.1.1.4
(03-01-2005)
403(b) and Qualified Plans

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

a. Only certain types of tax-exempt employers, governments and ministers may contribute to a 403(b) plan.
b. Suitable funding vehicles for a 403(b) plan are limited to annuity contracts and custodial accounts (and retirement income accounts for churches).
c. Salary reduction contributions to a 403(b) plan are subject to their own special nondiscrimination rules and not the average deferral percentage (ADP) test under *IRC section 401(k)(3)*.
d. There is no special averaging for lump sum distributions from 403(b) plans.
e. Section 402(g) provides an increased limit on elective deferrals for certain participants in a 403(b) plan.
f. Compensation under 415 is defined as includible compensation under 403(b)(3).

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

a. nontransferability requirement for 403(b)(1) annuity contracts under *IRC section 401(g)*
b. direct rollover requirements under Reg. 1.403(b)-2, Q&A 4, (see 4.72.13.9)
c. 402(g) limit (see 4.72.13.5).

4.72.13.1.2
(03-01-2005)
Correction Programs

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

- Self-Correction Procedure (SCP)
- Voluntary Correction of Tax-Sheltered Annuity Failures (VCP) program
- Audit CAP for 403(b) Plans

(2) These programs are set forth and described in the following revenue procedures (see also, *IRM 7.2.2*, Employee Plans Compliance Resolution System):

- *Rev. Proc. 2003-44, 2003 –25 I.R.B. 1051*

4.72.13.1.2.1
(03-01-2005)
SCP

(1) SCP is designed to further the Service's voluntary compliance initiatives by providing a self-correction procedure that applies to 403(b) plans. In general, under SCP, an employer (either directly or through the insurer or custodian) that has established compliance practices and procedures which are reasonably designed to facilitate overall plan compliance may correct Operational Failures (as defined in Section 5.02a of *Rev. Proc. 2003-44*) in its 403(b) plan within two plan years following the plan year of the failure.

a. Eligible employers may also correct insignificant Operational Failures at any time.
b. SCP permits correction of Operational Failures relating to contributions in excess of the limitation under *IRC section 415*.

c. In general, SCP is not available to correct significant Operational Failures if either the plan or the employer is Under Examination (within the meaning of Section 5.03 of *Rev. Proc. 2003-44*).

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

4.72.13.1.2.2
(03-01-2005)
VCP

(1) The VCP Program generally allows an employer to correct any Operational, Demographic, or Eligibility Failure (as defined in Section 5.02 of *Rev. Proc. 2003-44*) in its 403(b) plan that is within the jurisdiction of the Area Offices.

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

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

4.72.13.1.2.3
(03-01-2005)
Audit CAP

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

4.72.13.1.2.4
(03-01-2005)
Effect of Correction under EPCRS; Reliance

(1) Although excise, FICA taxes, and FUTA taxes (and corresponding withholding) are not waived under the agreement, the Service will not pursue the income tax liability of participants or income tax withholding obligations of the employer due to the failures corrected under VCP, Audit CAP, or SCP. However, correction of failures may result in income tax and withholding for income tax (e.g., a distribution of excess deferrals).

(2) Excise taxes required to be filed on Form 5330, Return of Initial Excise Taxes Related to Pension and Profit-Sharing Plans, (other than those arising under *IRC section 4974*) should not be resolved as part of the Compliance Statement under VCP or Audit CAP for 403(b) Plans.

(3) In general, excise tax issues should be resolved by securing a Form 5330 providing for 100% of the tax and interest outstanding (although recommendation to the Service Center to waive the failure to file and/or failure to pay penalty under *IRC section 6651* is at the discretion of the EP specialist).

4.72.13.1.3
(03-01-2005)
403(b) Filing Requirements

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

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

(2) In general, a 403(b) plan that provides only salary reduction contributions and under which the employer is minimally involved in selecting the funding vehicles is not an employee benefit plan under Title I. See DOL Reg. 2510.3-2(f).

4.72.13.1.4
(03-01-2005)
Examination Steps

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

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

Note: The plan may not have nor does the Code require it to have a basic plan document. However, faulty plan language may indicate operational defects. Furthermore, the annuity contract or custodial account must provide for direct rollovers under section 403(b)(10) and the limit on elective deferrals under section 401(a)(30). Only annuity contracts are required to be nontransferable under section 401(g).

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

(3) If the employer has a compliance statement through VCP:

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

4.72.13.2
(03-01-2005)
Eligibility

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

a. employer is eligible to maintain a 403(b) plan for participating employees,
b. participants in a 403(b) plan perform services for the employer as employees, and
c. self-employed and certain other ministers are described in *IRC section 414(e)(5)(A*).

4.72.13.2.1
(03-01-2005)
Eligible Employers

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

a. A State, a political subdivision of a State, or an agency or instrumentality of any one or more of these for employees who perform services for a public education organization described in *IRC section 170(b)(1)(A)(ii)*;
b. A non-profit organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 501(a),* or an organization treated as described in *IRC section 501(c)(3)*;
c. A grandfathered Indian tribal government; and
d. Beginning in years after December 31, 1996, a minister described in *IRC section 414(e)(5)(A).*

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

a. If an employer maintains an annuity plan and is not eligible, the plan is not a 403(b) plan. For resulting tax consequences, see *IRC sections 403(c)* and 72.
b. An ineligible employer may enter into a closing agreement with the Service pursuant to *Rev. Proc. 2003-44*.
c. Situations in which an employer's eligibility varies among taxable years are discussed in 4.72.13.5.

4.72.13.2.1.1
(03-01-2005)
Public Education Organizations

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

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

a. public schools
b. state colleges
c. universities

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

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

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

4.72.13.2.1.2
(03-01-2005)
Organizations Described in *IRC section 501(c)(3)*

(1) Another type of eligible employer is an organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 501(a)* (501(c)(3) organization). A 501(c)(3) organization is defined generally as one organized and operated exclusively for the following purposes:

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

(2) These organizations include:

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

(3) In order to be recognized as a 501(c)(3) organization, all organizations except church and related organizations, and other organizations excepted under section 508, must apply to the Service for a determination letter by filing Form 1023, Application for Recognition of Exemption Under *Section 501(c)(3) of the Internal Revenue Code*. See Publication 557, Tax-Exempt Status of Your Organization; and also *IRM 4.76.3*, Exempt Organizations Examination Guidelines.

4.72.13.2.1.3
(03-01-2005)
Grandfathered Indian Tribe

(1) A designated Indian Tribal Government is treated as a State for purposes of *IRC section 403(b)*, so an educational organization or a 501(c)(3) organization associated with a tribal government is always eligible to maintain a 403(b).

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

4.72.13.2.1.4
(03-01-2005)
***IRC section 414(e)(5)(A)* Minister**

(1) A self-employed minister may deduct, within the limits of *IRC section 404(a)(10)*, contributions to a retirement income account described in *IRC section 403(b)(9)*.

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

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

4.72.13.2.2
(03-01-2005)
Eligible Employees

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

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

4.72.13.2.3
(03-01-2005)
Contributions for Retired Participants

(1) Section 403(b) allows certain amounts to be excludable from gross income that are contributed to a 403(b) plan for up to five years after the year of termination of employment. Only non-elective contributions may be excluded and the contributions must fall within the section 415 limit.

Example 8: A school teacher (Teacher) retires from a public school and is entitled to receive $25,000 in accumulated sick leave and annual leave which, under a collective bargaining agreement, may be received in cash. Three days before this

amount is to be paid, Teacher requests that the payroll office pay this amount into her 403(b) plan over the next five years. In this example, the contributions would be made pursuant to a salary reduction agreement because the Teacher has the option to have the employer contribute the amount or receive the amount in cash. The Teacher may not utilize the five-year provision because a salary reduction agreement, which is an agreement between an employer and employee, cannot persist after retirement. The five-year provision only applies to non-elective contributions.

Example 9: The same facts as above, except that in the normal course of collective bargaining, a union has bargained away the right to receive the payment of accumulated sick and annual leave in cash and the amounts are required to be paid directly to the 403(b) plan by the employer. The amounts are non-elective contributions which can be contributed over a period of five years following retirement pursuant to the five-year provision assuming they satisfy the limit under section 415 and the definition of includible compensation. Only that portion of sick and annual leave attributable to the most recent one-year period of service may be included in includible compensation.

Example 10: As part of an employment contract, Public School District Z agrees to contribute to Superintendent A's 403(b) account $41,000 each year for five years following her retirement for a total of $205,000 in deferred compensation. Her last year's salary exceeds $41,000. This is a permissible use of the five-year provision because her includible compensation for her most recent one-year period of service is in excess of $40,000. This benefit does not violate nondiscrimination and coverage requirements which are not applicable to governmental 403(b) plans with respect to non-elective contributions. (Note that elective contributions under a 403(b) plan maintained by a public school or other governmental entity are subject to universal availability). See also Section 4.72.13.6 below.

4.72.13.2.4
(03-01-2005)
Examination Steps

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

   a. is a public educational organization,
   b. has *IRC section 501(c)(3)* status, or
   c. has a compliance statement with the Service covering the employer's ineligibility.

(2) Be sure to consider the employer's relationship to the participating employees. If the employer is not eligible, consider a closing agreement under Audit CAP for 403(b) Plans as provided in *Rev. Proc. 2003-44*.

(3) If the examination is conducted in connection with an Exempt Organizations audit, a loss of 501(c)(3) status will automatically cause the plan to fail the requirements of *IRC section 403(b)* for any plan year during which the employer was not eligible. Again, consider a closing agreement under *Rev. Proc. 2003-44*.

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

4.72.13.3
(03-01-2005)
Funding Vehicles

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

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

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

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

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

4.72.13.3.1
(03-01-2005)
Annuity Contracts

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

a. The annuity contract may be offered only by an insurance company.
b. The contract may be owned by the individual, or, in the case of a group annuity contract, by the employer.
c. The annuity may be either variable or guaranteed.
d. An annuity contract may contain a vesting schedule for non-salary reduction contributions, but the vesting schedule must comply with Title I, the Labor Title of ERISA, if applicable.

(2) Regulations extend the non-transferability requirement of *IRC section 401(g)* to 403(b) annuity contracts. Thus, a 403(b) annuity contract must provide that it is nontransferable. This means that the contract cannot be sold, assigned, or pledged as security for collateral.

a. However, loans may be made from an annuity contract and amounts held under the contract may be transferred or rolled over to another 403(b) plan under certain conditions.
b. Salary reduction contributions to an annuity contract and their earnings are subject to certain early distribution restrictions to ensure that they are used for retirement purposes. See *IRC sections 403(b)(7)* and 403(b)(11).
c. Excess contributions to an annuity contract are not subject to the excise tax under *IRC section 4973*. See 4.72.13.5 and 4.72.13.8.
Caution: For contracts purchased on or after 2/14/05, see section 1.403(b)-8(c)(2) of the Proposed 403(b) regulations, 2004-49 I.R.B. 925.

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

a. Life insurance is incidental if less than 50% of total employer contributions made on behalf of a participant are used to purchase an ordinary life insurance contract, or in the case of term or universal life insurance, no more than 25% of total contributions are used to purchase the life insurance contract.
b. As in qualified plans, the portion of each year's premium representing the cost of life insurance protection (referred to as P.S. 58 costs) is includible in gross income and counts toward the employee's basis in the annuity contract on distribution.
c. In addition, a contract on a participant's life must be converted to cash or an annuity or distributed to the participant at retirement. See *Rev. Rul. 60-84, 1960-1 C.B. 159; Rev. Rul. 66-143, 1966-1 C.B. 79; and Rev. Rul. 68-31, 1968-1 C.B. 151.*

(4) If a plan is structured so that contributions are placed in an employer's savings account to purchase annuity contracts for employees at retirement, the plan is not a 403(b) plan. See *Rev. Rul. 68-87, 1968-2 C.B. 187, and Rev. Rul. 68-488, 1968-2 C.B. 188.*

Example 11: Foundation, a 501(c)(3) organization, maintains an annuity plan intended to be a 403(b) plan (Plan). Foundation makes both salary reduction and non-salary reduction contributions to individual investment accounts (not mutual funds) for each of its employees. Foundation purchases annuity contracts for employees at their retirement. The arrangement is not a 403(b) plan.

Example 12: Employer is a public education organization maintaining a plan intended to be a 403(b) plan (Plan). All contributions under the Plan are invested in life insurance policies for its employees. Because life insurance must be incidental to the primary purpose of providing retirement benefits, the Plan is not a 403(b) plan.

4.72.13.3.2
(03-01-2005)
Custodial Accounts

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

a. the assets of a custodial account must be held by a bank or an approved non-bank trustee or custodian under *IRC section 401(f).*
b. the assets must be invested exclusively in regulated investment company stock (e.g., mutual funds) and consequently, a custodial account may not provide life insurance.
c. a custodial account may permit loans to participants.

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

(3) Unlike contributions to annuity contracts, excess contributions to a custodial account are subject to the excise tax under *IRC section 4973.* See 4.72.13.5.3.

4.72.13.3.3
(03-01-2005)
Retirement Income Accounts

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

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

(3) Retirement income accounts are generally subject to the rules and requirements for annuity contracts.

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

4.72.13.4
(03-01-2005)
Salary Reduction Contributions

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

(2) Salary reduction contributions under a 403(b) plan are also subject to specific requirements such as annual contribution limits, nondiscrimination rules, and withdrawal restrictions. These requirements are discussed in text 4.72.13.5, 4.72.13.6, and 4.72.13.7.

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

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

a. frequency that an employee is permitted to enter into or modify a salary reduction agreement,
b. compensation to which an agreement may apply, and
c. ability to revoke the agreement.

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

(6) An automatic reduction of an employee's salary by a certain amount may be treated as a salary reduction agreement if the employee has an effective opportunity to elect to receive the amounts in cash. See Rev. Rul. 2000-35.

(7) The salary reduction contributions must be in the nature of compensation.

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

4.72.13.4.1
(03-01-2005)
Examination Step

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

4.72.13.5
(03-01-2005)
Contribution Limits

(1) For years beginning on or after January 1, 2002, there are two separate limitations on the amount of contributions to a 403(b) plan which are excludable from gross income. These limitations are found in:

- *IRC section 402(g),* and
- *IRC section 415.*

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

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

(4) Section 415 places an overall limit on the amount of elective and non-elective contributions that may be made annually on an employee's behalf to a 403(b) plan during a single limitation year. Section 415 imposes a limit of the lesser of $ 41,000 or 100% of includible compensation on the maximum amount that may be contributed to a 403(b) plan for the year.

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

(6) The exclusion allowance, which limited contributions to a 403(b) plan, was repealed for years beginning after December 31, 2001. For exam years prior to that date, please refer to prior examination guidelines.

4.72.13.5.1
(03-01-2005)
***IRC section 402(g)* Limit on Elective Deferrals**

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

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

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

a. qualified CODA
b. salary reduction simplified employee pension plan
c. 403(b) plan
d. simple retirement account.

(4) Elective deferrals are subject to FICA.

(5) Elective deferrals under a 403(b) plan are employer contributions which are used to purchase an annuity contract (or made to a custodial account) under a salary reduction agreement.

(6) In addition to the 415 limit, there are two limits restricting the amount of elective deferrals that may be made on behalf of a participant:

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

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

Example 13: An employee participating in two salary reduction 403(b) plans with separate employers must count the elective deferrals made under both plans in applying the limit. If this employee also participated in a CODA under *IRC section 401(k)*, or a simple retirement account under *IRC section 408(p)*, these elective deferrals would also be counted. See *IRC section 402(g)(3)*.

(8) The contract requirement under *IRC section 403(b)(1)(E)* applies only to limit elective deferrals under annuity contracts purchased by a single employer. See 4.72.13.5.1.3.

(9) The coordination limit under IRC section 457(c)(2) was repealed for years beginning after December 31, 2001.

4.72.13.5.1.1
(03-01-2005)
One-Time Irrevocable Election

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

a. initial eligibility to participate in the salary reduction agreement, or
b. pre-tax contributions made as a condition of employment.
Caution: For FICA application, see T.D. 9159, 2004-49 I.R.B. 895

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

Example 14: X participates in a 403(b) plan (Plan). In order to receive employer contributions under the Plan, X is required to elect to defer 3% of salary in the form of Mandatory Contributions. X has the option of revoking this election at any time, although X never terminates his election. The Mandatory Contributions are elective deferrals because X's election is revocable. These contributions are therefore included in applying the *IRC section 402(g)* limit. They are also subject to FICA (if applicable).

Example 15: Assume the same facts as in *Example 14*, except that the Plan further provides that an election to terminate participation in the Plan is irrevocable. Thus, an employee who terminates his election will be permanently excluded from participating in the Plan. Even so, since the election to participate is revocable, the Mandatory Contributions are elective deferrals under *IRC section 402(g)*. The contributions are subject to FICA (if applicable).

Note: *Example 15* points out that if an employee may terminate his election to participate in a plan, the election is not considered to be irrevocable. Irrevocability relates to the election to participate rather than an election to terminate participation in a plan.

4.72.13.5.1.2
(03-01-2005)
Catch-Up Election

(1) Section 402(g)(7) provides a special election for certain long-term employees. Under the rule, they may catch up on the funding of their retirement benefit by increasing their elective deferrals over the $12,000 (for 2003) limit.

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

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

(3) With the exception of churches, years with different employers cannot be added together for purposes of satisfying the 15-year requirement.

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

a. $3,000,
b. $15,000 minus any elective deferrals made by the organization and previously excluded under the catch-up election, or
c. $5,000 times the employee's years of service minus the elective deferrals made to plans of the organization in prior taxable years.

(5) As can be seen from this election, there is a limit on increases under the election of $15,000, and the annual limit cannot exceed $15,000 for 2003. The catch-up applies to elective deferrals made by the qualified organization on behalf of the employee. The catch-up election is per employer and not per employee.

(6) For an individual who attains age 50 prior to the end of the year, there is an additional catch-up of $1,000 in 2002, $2,000 in 2003, and increasing $1,000 each year through 2006.

4.72.13.5.1.3
(03-01-2005)
Contract Limit

(1) As indicated in text 13.5.1.2, *IRC section 402(g)* limits all elective deferrals of a participant, even if the elective deferrals are made with respect to plans of separate employers. Section 403(b)(1)(E) imposes a contract requirement which limits the amount of elective deferrals under annuity contracts purchased by a single employer. A failure to satisfy this requirement results in the loss of 403(b) status of the annuity contracts.

4.72.13.5.1.3.1
(03-01-2005)
Contract Terms

(1) Under *IRC section 403(b)(1)(E)*, a contract purchased by an employer must comply with the requirements of *IRC section 401(a)(30)*.

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

(3) Section 403(b) contracts must reflect the 402(g) limit.

4.72.13.5.1.3.2
(03-01-2005)
Operational Requirement

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

   a. Under Reg. 1.402(g)-1(e), a contract may avoid the loss of 403(b) status by distributing the excess deferrals plus the earnings thereon by April 15 of the following taxable year, if the contract so permits.
   b. The distribution may be made notwithstanding any other provision of law.
   c. The portion of the distribution attributable to excess deferrals is taxable in the year of contribution, while the earnings are taxable in the year of receipt. The issuer must file a Form 1099 indicating the distribution.

(2) If a contract loses its status as a 403(b) because of paragraph (1) above, the affected annuity contract (or custodial account) loses its status under section 403(b) for the taxable year of the violation. Thus, all amounts contributed to the affected annuity contract or contracts for the year of the violation are includible in gross income.

   a. The excess deferrals are taxable again on distribution.
   b. The employer is responsible for applicable employment taxes and income tax withholding.

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

Example 16: Association, a 501(c)(3) organization, maintains a 403(b) plan (Plan) with a calendar plan year. In 2003, each of Association's highly compensated employees (HCEs) elects to make contributions of $40,000 on the mistaken assumption that the contributions are not elective deferrals limited by *IRC section 402(g).* The excess deferrals of $28,000 ($40,000 - $12,000) are not timely corrected. All contributions made to the affected annuity contracts are includible in the employees' gross income for taxable year 2003 and are subject to FICA. In addition, Association is responsible for employment taxes and withholding. The excess deferrals are taxable again on distribution.

Example 17: The same facts as Example 16, except that $ 15,000 of the $40,000 contributed to the Plan in 2003 consists of non-elective contributions. The $25,000 in elective deferrals are in excess of the *IRC section 402(g)* limit for the year, and thus all contributions made to the affected annuity contracts are includible in gross income for tax year 2003.

4.72.13.5.1.4
(03-01-2005)
Examination Steps

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

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

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

a. The operation of the plan -- have any participants revoked their elections?
b. Employment contracts -- is participation in the plan a condition of employment? If so, the contributions are not elective deferrals.
c. All plan documents, including SPDs, funding vehicles, and any memoranda or other communications to employees, if any.

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

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

(6) If the employer has another plan covering the same employees (including a 403(b) plan with elective deferrals), make sure that the combined amount of elective deferrals are within the 402(g) limit.

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

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

4.72.13.5.2
(03-01-2005)
Section 415 Limit

(1) Section 415 limits on contributions (hereinafter referred to as 415 limits or 415 contribution limits) that apply to qualified plans also generally apply to 403(b) plans. A 403(b) plan is treated as a defined contribution plan for purposes of the 415 contribution limits. Consequently, contributions to a 403(b) plan (including salary reduction contributions and after-tax employee contributions) may not exceed the lesser of 100% of includible compensation or $40,000 in the limitation year (although *IRC section 402(g)* further limits elective deferrals to $12,000, as indexed for 2003).

(2) The 415 limit applies to contributions made to a 403(b) plan with respect to the limitation year regardless of whether they are vested.

4.72.13.5.2.1
(03-01-2005)
Alternative Limitations

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

a. Such employees may elect to substitute the IRC section 415 limit with an annual limit of $10,000 (even if more than 100% of includible compensation) up to a total lifetime limit of $40,000.

(2) Even if the limitation under IRC section 415 is $41,000, IRC section 402(g) further limits elective deferrals to $13,000 for 2004 (or a maximum of $13,000 plus $3,000 if the full catch-up limit applies). The IRC section 402(g) limit must always be considered in examining a 403(b) plan with elective deferrals.

4.72.13.5.2.2
(03-01-2005)
Plan Aggregation

(1) Under *IRC section 415,* a participant generally is considered to exclusively control and maintain his own 403(b) plan. Consequently, contributions to a 403(b) plan are not combined or aggregated with contributions to a qualified plan except when a participant controls any employer. In this situation, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.

(2) Thus, where a participant controls any employer (this may be the employer contributing to the 403(b) plan or another employer) for a limitation year, the contributions to the 403(b) plan are combined with contributions to a qualified plan by the controlled employer or any affiliated employer under *IRC section 415.* See Reg. *IRC section 1.415-8(d)*.

(3) The following example illustrates that an employee who is covered by a pension plan of the employer may also participate in a 403(b) plan through the employer without having to aggregate the plans under *IRC section 415.* Thus, the employer could contribute non-salary reduction contributions of up to $40,000 to the 403(b) plan even though the employee has contributions under the qualified plan which are at the *IRC section 415* maximum.

Example 18: Employee A is employed by a hospital which is a 501(c)(3) organization. The hospital contributes to a 403(b) plan on behalf of A in the limitation year, and A is also a participant in the hospital's defined contribution plan. Employee A is not required to aggregate contributions under the qualified defined contribution plan with those made under the 403(b) plan for purposes of testing under IRC section 415.

Example 19: The facts are the same as in Example 18, except that A is also a physician maintaining a private practice in which he is more than a 50% owner. A is a participant in a defined contribution plan maintained by A's private practice. The defined contribution plan of A's private practice must be combined with A's 403(b) plan for purposes of applying the limit under *IRC section 415(c)* because A controls his private practice.

4.72.13.5.2.3
(03-01-2005)
Limitation Year

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

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

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

4.72.13.5.2.4
(03-01-2005)
Includible Compensation

(1) Includible compensation is generally all salary from the employer includible in gross income for the employee's most recent one-year period of service ending with or within the taxable year.

   a. Includible compensation also includes a participant's elective deferrals (all elective deferrals as described in section 402(g)(3)), and amounts not included in an employee's gross income by reason of *IRC section 125 or 457(b).*

(2) Includible compensation does not include:

   a. Contributions (vested or not vested) made by the employer to a qualified plan, including contributions picked up by the employer under *IRC section 414(h)(2),* because they are not currently includible in compensation. See *Rev. Rul. 79-221, 1979-2 C.B. 188.*
   b. Except for elective deferrals, any contributions to a 403(b) plan of the employer even if the contributions are includible in gross income.

c. Compensation earned while the employer was not eligible to maintain the 403(b) plan.
d. Compensation earned prior to the employee's most recent one-year period of service.
e. Includible compensation does not include any amount contributed by the employer for a 403(b) annuity contract or any amount received by a former employee after the fifth taxable year following the taxable year in which such employee was terminated.
f. For 2003, the maximum amount of compensation that may be taken into account is $200,000.

4.72.13.5.2.5
(03-01-2005)
Effect of Contributions in Excess of *IRC Section 415* Limit

(1) Contributions to a 403(b) plan in excess of the *IRC section 415* limit are includible in the employee's gross income for the tax year ending with or within the limitation year.

Example 20: Foundation is a 501(c)(3) organization which maintains a 403(b) plan (Plan) for its employees. The gross annual compensation of Employee A equals $60,000. Contributions to the Plan on behalf of Employee A equal $42,500 (all are non-salary reduction) in the limitation year ending December 31, 2003, $2,500 above the allowable 415 limit. The $2,500 excess is includible in A's gross income for the 2003 taxable year.

4.72.13.5.2.6
(03-01-2005)
Correction

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

a. the allocation of forfeitures,
b. a reasonable error in estimating a participant's compensation,
c. a reasonable error in determining total elective deferrals, or
d. in certain other limited facts and circumstances as determined by the Commissioner. See *Rev. Proc. 92-93, 1992-2 C.B. 505.*

(2) In the absence of such correction, excess 415 amounts and earnings thereon are currently includible in the participant's gross income.

4.72.13.5.2.7
(03-01-2005)
Examination Steps

(1) Check the annual contributions to the 403(b) plan. If the amount deferred for any employee exceeds $40,000, there may be excess 415 amounts.

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

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

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

Example 21: Private School, a 501(c)(3) organization, maintains both a 403(b) plan (Plan A) and a matching plan under *IRC sections 401(a)* and 401(m) (Plan B). The contributions provided under Plan B are matched to elective deferrals under Plan A. In 2001, Private School contributes $3,000 of elective deferrals and $3,000 of matching contributions to Plans A and B on behalf of Employee X. X must exclude the matching contributions in calculating includible compensation for purposes of computing X's 2003 415 limitation.

4.72.13.5.3
(03-01-2005)
Excise Tax

(1) Under *IRC section 4973,* a 6% cumulative excise tax is imposed on the employee for excess contributions made to a 403(b)(7) custodial account.

(2) Excess contributions are the excess of the amount contributed over the *IRC section 415* limit.

(3) To the extent contributions are in excess of the 415 limit, the contributions are taxable.

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

(5) Excess contributions are determined at the end of the taxable year.

(6) The excise tax applies only to the excess contributions and not to earnings on the contributions. As illustrated in the following example, the excise tax does not apply to excess contributions (contributions in excess of the 415 limit) invested in annuity contracts. It does not apply to excess deferrals. Contributions are tested on a yearly basis with respect to the applicable 415 limit for the year.

Example 22: Foundation maintains a 403(b) plan (Plan) on behalf of its employees. The funding vehicles for the Plan include both annuity contracts and custodial accounts. In the limitation year ending December 31, 2003, 50 employees receive contributions in excess of the 415 limit. All of the excess 415 amounts are includible in employees' gross income in taxable year 2003. In addition, the portion of the excess 415 amounts invested in the custodial accounts are subject to the excise tax under *IRC section 4973*. Foundation may contribute less in 2004 with respect to affected employees to prevent excess contributions under section 415 and application of the excise tax.

4.72.13.5.3.1
(03-01-2005)
Examination Steps

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

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

4.72.13.6
(03-01-2005)
Nondiscrimination and Coverage

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

a. These rules generally must be satisfied for plan years beginning after December 31, 1988.
b. These rules do not apply to churches, including qualified church-controlled organizations, as defined by *IRC section 3121(w)(3).*

(2) Nondiscrimination and coverage requirements (except *IRC section 401(a)(17))* with respect to non-salary reduction contributions do not apply to governmental 403(b) plans.

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

(3) Currently there are no nondiscrimination regulations under *IRC section 403(b)(12)*. Pending the issuance of regulations or other guidance, Notice 89-23, *1989-1 C.B. 654* (extended by Notice 96-64, *1938-2 C.B. 229*), provides guidance for complying with the nondiscrimination rules.

a. Notice 89-23 deems a 403(b) plan to satisfy nondiscrimination if the employer operates the plan in accordance with a good faith, reasonable interpretation of *IRC section 403(b)(12)*. One means of satisfying this test is through the safe harbors set forth in Notice 89-23.
b. Under the notice, salary reduction and non-salary reduction contributions are tested separately for nondiscrimination. Only non-salary reduction contributions (both matching and non-elective) are subject to the coverage requirements of *IRC section 410(b)*. See 4.72.13.6.2.

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

4.72.13.6.1
(03-01-2005)
Salary Reduction Contributions

(1) Salary reduction contributions are tested separately from non-salary reduction contributions for nondiscrimination. See *IRC section 403(2)(12)(A)(ii)*.

a. The nondiscrimination requirement for salary reduction contributions is satisfied only if the plan in operation allows each employee to elect to defer more than $200 annually. Unlike a qualified CODA, nondiscrimination with respect to salary reduction contributions is not satisfied through compliance with the ADP test.
b. The test for salary reduction contributions focuses on eligibility and generally requires universal eligibility. However, there is no requirement that the opportunity to make salary reduction contributions be available; but once that opportunity is available to any employee, it must be available to all nonexcludable employees to satisfy nondiscrimination.
c. Until future guidance is issued, both public education institutions and 501(c)(3) organizations MUST currently operate their 403(b) plans in accordance with a good faith/reasonable interpretation of the nondiscrimination requirement for salary reduction contributions. No plan provisions are currently required, but faulty plan language may indicate an operational violation.
d. Additional catch-up contributions under IRC section 414(v) must be universally available to employees if these are made available to any employee.

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

a. nonresident aliens with no U.S. source income,
b. employees who normally work less than 20 hours per week,
c. collectively-bargained employees,
d. students performing certain services,

e. employees whose maximum salary reduction contributions under the plan would be no greater than $200,
f. participants in an eligible 457 plan, a qualified CODA, or other salary reduction 403(b) plan, and
g. certain ministers described in *IRC section 414(e)(5)(C)*. Note: Unlike a qualified plan, a 403(b) plan is not permitted to have any minimum age and service exclusion for salary reduction contributions.

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

(4) Under Notice 89-23, employer means the common law employer (and not the controlled group) for purposes of testing salary reduction contributions for nondiscrimination. A good faith, reasonable interpretation as to the identity of the employer is sufficient for this purpose.

a. Salary reduction contributions made pursuant to a one-time irrevocable election at initial eligibility to participate in the salary reduction agreement, or pursuant to certain other one-time irrevocable elections specified in the regulations, and pre-tax contributions made as a condition of employment are treated and tested as non-salary reduction contributions. See text 4.72.13.5 for a discussion of a similar definition for elective deferrals under *IRC section 402(g).*

(5) Examples 23-26 illustrate that salary reduction contributions are tested separately from other contributions for nondiscrimination and that these contributions must be offered universally to non-excludable employees. The effect of violating nondiscrimination is the loss of 403(b) status. Contributions to the Plans are therefore subject to income tax, employment tax and withholding.

Example 23: Employer is a large public university located in City Y. Employer maintains an annuity plan (Plan) intended to be a 403(b) plan. Both non-elective, nonmatching contributions and salary reduction contributions are provided under the Plan. Under the Plan, only senior administrative staff and faculty are eligible to elect to defer a portion of their salary pursuant to salary reduction agreements with Employer. Employer also maintains a defined benefit plan for remaining employees. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory. The Plan does not satisfy the requirements of *IRC section 403(b)*.

Example 24: Same as Example 23, except that all full-time employees are eligible to participate in the Plan. There are 40 part-time clerical employees who are not students and who normally work 29 hours per week (or 1,508 hours per year). Since the part-time employees in this example are not excludable, the salary reduction contributions are discriminatory. The Plan is not a 403(b) plan.

Example 25: Employer is a small private school which maintains an annuity plan intended to be a 403(b) plan. All eligible employees may elect to defer at least 4% of compensation. An eligible employee, A, has compensation of $25,000 for 2000 and elects prior to 2000 to defer 1.5% of compensation. The plan administrator declines to process the election and informs A that the minimum deferral is 4% of compensation. The salary reduction contributions are discriminatory, and the Plan fails to satisfy 403(b).

Example 26: Employer is a private hospital maintaining an annuity plan (Plan) intended to be a 403(b) plan. The Plan provides only a salary reduction arrangement. Under the Plan, all medical doctors and senior administrative staff are eligible to participate in the Plan immediately upon hire. Remaining employees, including nurses and other support staff, are eligible only after two years of service and attainment of age 21. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory, and the Plan loses its status as a 403(b).

4.72.13.6.2
(03-01-2005)
Non-Salary Reduction Contributions

(1) Non-salary reduction contributions are:

a. all contributions that are not salary reduction contributions
b. basically all non-elective and matching contributions
c. tested separately from salary reduction contributions for nondiscrimination.

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

a. *IRC section 401(a)(4)* (nondiscrimination)
b. *IRC section 401(a)(5)* (permitted disparity)
c. *IRC section 401(a)(17)* (the $200,000 ceiling on compensation, as indexed for 2003)
d. *IRC section 401(a)(26)* (minimum participation)
e. *IRC section 401(m)* (matching and after-tax employee contributions)
f. *IRC section 410(b)* (minimum coverage) for non-salary reduction contributions

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

(4) For 501(c)(3) organizations, under Notice 89-23, nondiscrimination requirements for non-salary reduction contributions are deemed satisfied if the employer operates the plan in accordance with a good faith reasonable interpretation of the above Code sections. The safe harbors in the notice are one means of satisfying the good faith/reasonable interpretation test.

(5) Excludable employees are those employees who have not satisfied any permissible age and service requirements of the plan, in addition to those listed above in 4.72.13.6.1 (2).

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

- (b) (controlled groups)
- (c) (groups under common control)
- (m) (affiliated service groups)

- (o) (other organizations or arrangements described by regulations). Note: Until further guidance is issued, a good faith, reasonable interpretation applies in defining the employer for this purpose. See Notice 89-23 for more detail.

4.72.13.6.3
(03-01-2005)
Highly Compensated Employee

(1) For years beginning after December 31, 2003, the definition of an HCE means any employee who:

a. was a 5% owner at any time during the year or the preceding year, or
b. for the preceding year has compensation from the employer in excess of $90,000 (as indexed for COLAs), and if the employer so elects for the preceding year, was in the top paid group of employees for such preceding year.

4.72.13.6.4
(03-01-2005)
Examination Steps

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

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

a. who can make salary reduction contributions and when they can be made.
b. whether salary reduction contributions are in fact available to all nonexcludable employees. Note: Because the definition of salary reduction contribution and elective deferral are similar, refer to 4.72.13.5.1.4 (Examination Steps) concerning whether contributions are elective or nonelective. Nondiscrimination requirements may be violated if the employer fails to properly characterize the contributions.

(3) Ask the employer which employees were excluded from participation and the basis on which they were excluded.

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

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

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

4.72.13.7
(03-01-2005)
Minimum Distribution Requirements

(1) *IRC section 403(b)(10)* imposes minimum distribution requirements on 403(b) annuity contracts. These requirements relate to the latest date at which distributions of a minimum amount must commence.

(2) In applying the minimum distribution rules, 403(b) plans generally are treated as IRAs under *IRC section 408.*

a. The rules applicable to individual retirement arrangements (IRAs) are generally the same as those applicable to qualified plans under *IRC section 401(a)(9).*
b. The minimum distribution requirements under *IRC section 401(a)(9)* relate to the form and timing of both before-and after-death distributions.

c. Final regulations were issued in April, 2002, generally effective January 1, 2003. Governmental plans may be subject to a later effective date. See Rev. Proc. 2003-10.

4.72.13.7.1
(03-01-2005)
Required Beginning Date

(1) The required beginning date (the RBD) or the date at which distributions must commence from a participant's 403(b) annuity contract is April 1 of the calendar year immediately following the calendar year in which the participant attains age 70 1/2 or retires, whichever occurs last.

Example 28: Participant has a 403(b) annuity contract with a 501(c)(3) organization and attains age 70 1/2 in 2002, but has not retired from employment by the end of 2002. This participant's RBD is April 1 of the calendar year following the year in which the participant retires.

4.72.13.7.2
(03-01-2005)
More Than One 403(b) Annuity Contract

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

4.72.13.7.3
(03-01-2005)
Bifurcated Account

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

a. Prior law (generally requiring distributions by the end of the calendar year in which the participant attains age 75) would apply to pre-1987 accruals.
b. If records are not kept, the entire account balance is subject to *IRC section 401(a)(9)*.
c. The minimum distribution incidental benefit (MDIB) requirement applies to the entire account balance, although prior law applies to the pre-1987 account balance in this regard. See Treas. Reg. 1.403(b)-2, Q&A-3.
d. If no actual amount is required to be distributed by April 1, 1988, because of these rules, the participant may treat December 31, 1988, as the RBD for all purposes under *IRC section 403(b)(10).* See Notice 88-39, *1988-1 C.B. 525*.

Example 28: Employer is a 501(c)(3) organization maintaining a 403(b) plan (Plan) on behalf of its employees. The Plan was established in 1972. The funding vehicles for the Plan are annuity contracts. The issuer of the annuity contracts kept records of the pre-1987 account balance for a participant who attains age 70 1/2 in 2000 and has not retired. The RBD for the pre-1987 account balance must be no later than the end of the calendar year in which the participant attains age 75 or, if later, April 1 of the calendar year immediately following the calendar year in which the participant retires. The RBD for the post-1986 account balance must be no later than April 1 immediately following the calendar year in which the participant retires.

4.72.13.7.4
(03-01-2005)
Excise Taxes

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

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

4.72.13.7.5
(03-01-2005)
Examination Steps

(1) Check all documents concerning the RBD.

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

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

4.72.13.8
(03-01-2005)
Early Distribution Restrictions

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

4.72.13.8.1
(03-01-2005)
Annuity Contracts

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

a. attainment or age 59 1/2
b. death
c. disability
d. severance of employment or
e. hardship of the employee (not including earnings, except as provided in the following sentence). Note: Amounts held in a 403(b)(1) annuity contract as of the close of the last year beginning before January 1, 1989, and amounts contributed as non-salary reduction contributions are not subject to distribution restrictions.

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

Example 29: Employee A began participating in a 403(b) plan (Plan) in 1989. The Plan is funded through both salary reduction and non-salary reduction contributions, which are invested in annuity contracts. A is 30 years old, has not separated from service and is not disabled. In 2002, A makes a $ 5,000 withdrawal that is not a hardship withdrawal. If any portion of the withdrawal is attributable to salary reduction contributions and the earnings thereon, the early distribution restrictions of *IRC section 403(b)(11)* would be violated.

Example 30: The same facts as to **Example 29,** except that the Plan provides only for non-salary reduction contributions. A's withdrawal does not violate *IRC section 403(b)(11)* (although A must pay an early distribution tax under *IRC section 72(t)).* See 4.72.13.8.5.

4.72.13.8.2
(03-01-2005)
Custodial Accounts

(1) Under *IRC section 403(b)(7)*, a distribution from a custodial account may not be paid or made available to a distributee before the employee attains age 59 1/2 , severs employment, dies or becomes disabled.

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

Example 31: Employee A is a participant in a 403(b) plan (Plan). Contributions under the Plan are strictly non-salary reduction. In 2000, A withdraws $10,000 from the Plan. A has not severed employment or become disabled. A is 40 years old. The funds in A's 403(b) account are invested in a custodial account. Since the contributions are invested in a custodial account, A's withdrawal violates *IRC section 403(b)(7).*

4.72.13.8.3
(03-01-2005)
Retirement Income Accounts

(1) A retirement income account is subject to the distribution restrictions that apply under *IRC section 403(b)(11).*

4.72.13.8.4
(03-01-2005)
Grandfathered Annuity Contracts

(1) Unlike other 403(b) annuity contracts, a distribution event is not required for a distribution from a grandfathered annuity contract purchased by an Indian tribal government to the extent it is rolled over under *IRC section 403(b)(10)* to an appropriate funding vehicle.

4.72.13.8.5
(03-01-2005)
Early Distribution Tax under *IRC section 72(t)*

(1) *IRC section 72(t)* restricts premature distributions from a 403(b) plan by imposing a 10% additional income tax with respect to distributions that are made prior to the events described in *IRC section 72(t)*. These events differ from those under *IRC sections 403(b)(7)* and (b)(11).

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

a. made after the attainment of age 59 1/2, separation from service after age 55, death, disability, or
b. which are part of a series of substantially equal payments made over the life or life expectancy of the employee or the joint lives or life expectancies of the employee and the employee's designated beneficiary.

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

- For example, the tax applies to early distributions of non-salary reduction contributions made to an annuity contract even though *IRC section 403(b)(11)* would not restrict such distributions. Note: In Examples 29, 30 and 31, A is also subject to the additional tax under *IRC section 72(t).*

4.72.13.8.6
(03-01-2005)
Examination Steps

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

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

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

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

4.72.13.9
(03-01-2005)
Transfers and Rollovers

(1) Within certain limits, funds may be moved by transfer or rollover from one 403(b) plan or contract without being includible in gross income in the taxable year of the transfer or rollover.

4.72.13.9.1
(03-01-2005)
Transfers

(1) Transfers of funds between 403(b) plans or contracts are not considered actual or deemed distributions and consequently they are not currently taxable if the transferred funds continue to be subject to the same or more stringent distribution restrictions. See Rev. Rul. 90-24. Note: As discussed in 4.72.13.8, the statutorily imposed restrictions differ between 403(b)(1) annuity contracts and 403(b)(7) custodial accounts, so transfers between these types of arrangements may be difficult. There is no Code requirement that a transfer from a 403(b) plan or contract be permitted, or that a 403(b) plan or contract have language to effect or accept a transfer (unlike direct rollover distributions, see text 4.72.13.9.2).

(2) Transfers may also be made from a 403(b) plan to a governmental defined benefit plan for the purchase of permissive service credits under IRC section 415(n)(3). See IRC section 403(b)(13).

(3) Note that many state plans have not been amended to permit such a transfer, nor are they required to do so, and the funds transferred must be used specifically to purchase permissive service credits that fall within the definition of section 415(n)(3).

Example 32: A 403(b)(1) annuity contract is purchased entirely with non-salary reduction contributions. The funds under the annuity may be transferred tax free to a 403(b)(1) annuity contract or 403(b)(7) custodial account.

Example 33: A 403(b)(1) annuity contract is purchased with salary reduction contributions. Funds may be transferred tax free to a 403(b)(7) custodial account, or a 403(b)(1) annuity contract if they continue to be subject to identical or more stringent distribution restrictions.

Example 34: Employer makes both salary reduction and non-salary reduction contributions to a custodial account. Funds from the 403(b)(7) custodial account may be transferred tax free to another 403(b)(7) custodial account, or to a 403(b)(1) annuity contract if the transferred funds continue to be subject to the same or more stringent distribution restrictions.

The transfer may be made regardless of whether a complete or partial interest is transferred, the transfer is directed by the individual, or the individual is a current or former employee, or a beneficiary of a former employee. These transfers may be made without violating the non-transferability requirement under *IRC section 401(g).* See *Rev. Rul. 90-24, 1990-1 C.B. 97*.

Example 35: Employee A requests that the assets of her 403(b) custodial account be transferred to a qualified defined contribution plan. Employee A cannot have the assets transferred since the transfer does not satisfy section 403(b)(13). Employee A can only effect a transfer of 403(b) assets to a governmental defined benefit plan for the purchase of permissive service credits pursuant to 403(b)(13), if the plan so provides, or a transfer of assets from one 403(b) plan to another as provided by Rev. Rul. 90-24.

Example 36: Employer would like to convert its 403(b) plan into a 401(k) plan by transferring all of the assets in the 403(b). There is no Code provision that would allow such a transfer. The employer also cannot accomplish a transfer through a termination of the 403(b) plan since plan termination is not a distribution event.

4.72.13.9.2
(03-01-2005)
Rollovers

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

   a. The requirements for a proper rollover are that all or a portion of the balance to the credit of the distributee be paid to the employee in an eligible rollover distribution; the employee rolls any portion of the property he or she receives in the distribution to an IRA, another 403(b) investment, a qualified plan or a 457(b) governmental plan; and if property other than money is distributed, the property transferred is the same as the property distributed; then the distribution (to the extent transferred) shall not be includible in gross income for the taxable year in which paid.
   b. A proper rollover must be completed within 60 days of the employee's receipt of the distribution. The 60-day period may be waived by the Service in cases of hardship. See Rev. Proc. 2003-16.
   c. Distributions not properly rolled over are currently includible in the employee's gross income and may be subject to additional tax under *IRC section 72(t)*. Unlike transfers, there must be a distribution event under the plan or contract to have an eligible rollover distribution.

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

   a. Unless made in the form of a direct rollover, all eligible rollover distributions are subject to 20% mandatory income tax withholding, even if they are subsequently properly rolled over (and thus excludable from gross income). The payor (i.e., insurer or custodian) is responsible for the withholding.
   b. A direct rollover is both exempt from withholding and excludable from gross income.
   c. A direct rollover is an eligible rollover distribution from a 403(b) plan or contract that is paid directly from the 403(b) plan or contract to an IRA, another 403(b) plan or contract, a plan qualified under section 401(a), or a 457(b) governmental plan.

Example 37: Employee, age 59 1/2, received a $150,000 eligible rollover distribution from a 403(b) plan on May 5, 2003. Twenty percent, or $30,000, was withheld

by Payor/Insurer. On June 20, 2003, Employee rolled over $120,000 (the amount he actually received from Payor/Insurer) to an IRA. The $30,000 withheld by Payor/Insurer and not rolled over is subject to federal income tax for 2003. Employee could have avoided income tax by rolling over an additional $30,000 from other funds.

Example 38: The same facts as Example 37, except that Employee elected a direct rollover of the $150,000 eligible rollover distribution. The $150,000 is not subject to withholding and is excludable from Employee's gross income.

(3) Under *IRC sections 403(b)(10)* and 401(a)(31), a 403(b) contract must permit an employee to elect a direct rollover of an eligible rollover distribution to a specified IRA or a 403(b) plan or contract. The employee must also have a meaningful right to elect a direct rollover. This means that within a reasonable period of time prior to making the eligible rollover distribution, the payor must provide an explanation to the employee of his right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover.

(4) 403(b) plans must be operated in compliance with the above rules. The underlying document must reflect the direct rollover requirements.

4.72.13.9.2.1
(03-01-2005)
Special Rule for Rollovers

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

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

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

4.72.13.9.3
(03-01-2005)
Examination Steps

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

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

4.72.13.10
(03-01-2005)
Tax Consequences of *IRC Section 403(b)* Failures

(1) This section lists typical *IRC section 403(b)* failures (403(b) failures) or defects and indicates the scope of resulting tax consequences.

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

a. plan failures,
b. annuity contract failures, and
c. transactional failures. Note: Because of overlap, however, these categories should be used as a guide only and any failure discovered on an examination should be analyzed based on the particular facts related to the failure.

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

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

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

(6) These failures may also result in additional income tax withholding, FICA taxes, FUTA taxes (with respect to an ineligible employer), FICA and FUTA withholding, and excise taxes. However, if the failures are corrected pursuant to one of the Service's correction programs (see 4.72.13.1.2, which provides an overview of EPCRS), the Service will not pursue the collection of income tax or withholding for income tax resulting from the failure. Corrections of failures may result in their own tax consequences.

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

4.72.13.10.1
(03-01-2005)
Plan Failures

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

a. The plan for this purpose is the aggregate annuity contracts (including custodial accounts and retirement income accounts) established by the employer on behalf of its employees, unless the plans are separate or the plans are properly disaggregated.
b. Except with respect to text 4.72.13.10.1.1, employer is defined as the common law employer and any related employer under IRC section 414(b), (c), (m) or (o).

(2) For plan failures, all contributions made to the plan beginning in the taxable year of the failure are includible in the participants' gross income (except contributions subject to a substantial risk of forfeiture). Contributions made under a defective 403(b) plan may not be rolled over to an eligible retirement plan.

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

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

(4) Annuity contracts not purchased until participants reach retirement age or status. See text 4.72.13.3.1. In this case, the plan is intended to be funded through annuity contracts (and not custodial accounts) but the employer fails to

purchase the annuity contracts (until retirement age). In the absence of appropriate funding vehicles, the plan from its inception is not a 403(b) plan.

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

(6) Failure to satisfy the minimum participation rules.

(7) Inadequate coverage.

4.72.13.10.2
(03-01-2005)
Annuity Contract Failures

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

a. These failures cause a participant's annuity contract to fail to satisfy the requirements of *IRC section 403(b)*, and consequently, all contributions made under the annuity contract beginning in the taxable year of the failure will be includible in the participant's gross income (except contributions that are subject to a substantial risk of forfeiture).
b. The earnings on premiums paid for the purchase of a 403(b)(1) annuity contract (and not custodial accounts) are not includible in gross income.

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

a. Annuity contract not purchased from an insurance company or not a 403(b) annuity contract (for example, the purchase of a life insurance contract).
b. Custodial account not maintained by bank or an approved non-bank trustee.
c. Failure of custodial account to invest exclusively in regulated investment company stock.
d. Violation of incidental death benefit requirements.
e. Failure of annuity contract (and not a custodial account) to satisfy the nontransferability requirement of *IRC section 401(g)* (in either form or operation).
f. Impermissible distribution under *IRC section 403(b)(7)* or (b)(11). This failure includes an improper transfer (see *Rev. Rul. 90-24*), a distribution disguised as a loan, and the executing on a security in the event of default on a loan. The *IRC section 72(t)* tax may also apply.
g. Failure to provide a direct rollover (in form or operation).
h. Pattern of violating the minimum distribution rules.
i. Uncorrected excess deferrals. The exclusion allowance does not apply with respect to an annuity contract with excess deferrals that are not timely corrected. The excess deferrals are includible in gross income in both the year contributed and the year distributed. See *IRC section 402(g)(6)* and text 4.72.13.5.
j. Failure of annuity contract to preclude excess deferrals. For plan years beginning on or after January 1, 1998, the exclusion allowance does not apply with respect to contributions made to purchase the contract.

4.72.13.10.3
(03-01-2005)
Transactional Failures

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

a. Excess 415 amounts. Excess 415 amounts result in current income inclusion of the excess. The annuity contract or custodial account is bifurcated into a non-qualified annuity (comprised of the excess and earnings thereon) and qualifying 403(b) annuity. If excess 415 amounts are made to a custodial account, the *IRC section 4973* excise tax also applies. See text 4.72.13.5.2.
b. Certain loans. The amount of a loan that does not satisfy the requirements of *IRC section 72(p)* is a deemed distribution that is includible in gross income. (If the participant's account balance is reduced to satisfy the loan balance, there is an actual distribution which could violate *IRC sections 403(b)(11)* and (b)(7) and the failure becomes an annuity contract failure.)
c. Isolated instance of failure to satisfy minimum distribution requirements. The participant may be subject to the *IRC section 4974* excise tax if the tax is not waived by the Service. The required minimums are includible in gross income on distribution.
d. Salary reduction agreement not legally binding. Amounts contributed under the inadequate agreement are includible in gross income. In the absence of non-salary reduction contributions, the entire annuity contract is adversely affected. This failure may also overlap with a failure to provide salary reduction contributions universally to all non-excludable employees. See text 4.72.13.4.
e. Salary reduction agreement applies to amounts currently available to the employees at the effective date of the agreement.
f. Participation of non-employees.
g. Timely corrected excess deferrals.

4.72.13.11
(03-01-2005)
Glossary

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

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

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

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

(5) Elective deferrals: Defined in *IRC section 402(g)(3),* elective deferrals are elective contributions by a participant made to a qualified CODA, a SEP, a 403(b) plan, a simple individual retirement account, except they do not include contributions made pursuant to one-time irrevocable elections at initial eligibility to participate in the plan nor contributions made as a condition of employment. They are subject to the *IRC section 402(g)* limit of $13,000 for 2004.

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

(7) Excess contributions: A term used for purposes of the excise tax under *IRC section 4973,* they are contributions to a custodial account in excess of the *IRC section 415* limit.

(8) Excess deferrals: Elective deferrals that are in excess of the *IRC section 402(g)* limit.

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

(10) Includible compensation: Generally all salary, bonuses and other wages from the employer includible in gross income for the employee's most recent one-year period of service ending with or within the taxable year and excluding amounts contributed on the employee's behalf to a 403(b) or qualified plan. Includible compensation includes elective deferrals (and amounts which are not includible in gross income by reason of *IRC section 125* or 457(b)). Includible compensation is used for testing contributions to a 403(b) plan under the section 415 limit.

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

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

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

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

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

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

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

(18) Retirement income account: Generally, a defined contribution program specifically for a church or a related organization maintaining a 403(b) plan. In rare instances, a retirement income account may be a defined benefit plan.

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

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

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

(22) Years of service: Used in computing eligibility for the catch up election under section 402(g), it includes all years of service with the employer ending with or within the taxable year.