Section 403(b) Plan Design and Operation

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This practice note discusses the rules that apply when eligible tax-exempt organizations (or their employees) establish tax-sheltered annuities, custodial accounts, or retirement income accounts, as described in Section § 403(b) of the Internal Revenue Code (403(b) plans). While all employers are eligible to set up a defined benefit plan, and most tax-exempt nongovernmental employers are eligible to set up 401(k) plans, 403(b) plans are another option for certain tax-exempt and governmental organizations. These organizations may establish a 403(b) plan (sometimes called a tax-sheltered annuity plan or a TSA), which can fulfill most of the functions of a qualified plan, including allowing for pre-tax employee elective contributions, while offering various advantages to employers over a traditional qualified plan design.

This practice note addresses the following topics:

- 403(b) Plan Overview
- Eligible Employers and Employees
- ERISA Coverage of 403(b) Plans
- Qualification Requirements
- 403(b) Plan Contributions
- 403(b) Plan Distributions
- Implementation and Operation
- Correcting 403(b) Plan Errors
- Terminating 403(b) Plans
- EP Subcommittee Report: 403(b) Plan Issues and Recommendations
- Advantages and Disadvantages of 403(b) Plans

For more information on 403(b) plans, see Employee Compensation and Benefits Tax Guide ¶ 502.14 and the IRS website resource for 403(b) plans.

403(b) Plan Overview

A 403(b) plan is a type of retirement plan providing for deferred taxation on certain contributions and earnings made by specific kinds of tax-exempt organizations (primarily, public schools and 501(c)(3) tax-exempt organizations) for their employees and by certain ministers. I.R.C. § 403(b)(1). For the participant, a 403(b) plan appears much like a 401(k) plan in that it provides for an individual account for each participant. However, 403(b) plan investment options are more limited. 403(b) plans are subject to some, but not all of the requirements that apply to 401(k) and other retirement plans qualified under I.R.C. § 401(a). A 403(b) plan can allow employees, the employer, or both to contribute to the plan. Also, like a 401(k) plan, a 403(b) plan can include a qualified Roth contribution program.

Although 403(b) plans have been around in some form for over 50 years, the Treasury Department only issued final regulations under I.R.C. § 403(b) in 2007, which generally became effective in 2009. 72 Fed. Reg. 41,127 (July 26, 2007).

Eligible Employers and Employees

Only certain types of employees are eligible to participate in a 403(b) plan, essentially restricting 403(b) plan sponsors to certain tax-exempt organizations, schools (including colleges and universities) sponsored by state and local governments, and ministers or their employers or deemed employers. If a plan permits ineligible employees to participate, the plan may lose its tax-favored status (unless a correction is made under the IRS Employee Plans Correction Resolution System (EPCRS); see Correcting 403(b) Plan Errors later in this practice note).

The following types of employees are eligible to participate in a 403(b) plan:

- **501(c)(3) employees.** Employees of tax-exempt organizations established under I.R.C. § 501(c)(3) and cooperative hospital service organizations (501(c)(3) organizations), as described further below.
- **School employees.** Individuals who are (1) involved in the daily operations of a public school, college, or university that is sponsored by a state, local, or Indian tribal governmental body (public school systems), as described further below under "Public School Systems" or (2) civilian faculty and staff of the Uniformed Services University of the Health Sciences. See below for further discussion.
- **Ministers.** Ministers described in I.R.C. § 414(e)(5), provided they are:
    - Employed by a 501(c)(3) organization
    - Self-employed –or–
    - Not employed by a 501(c)(3) organization, but functioning as a minister in their daily responsibilities with their employer, such as a chaplain for a state-run prison

I.R.C. § 403(b)(1)(A); 26 C.F.R. § 1.403(b)-2(b); I.R.S. Maintaining Eligibility to Sponsor a 403(b) Plan.

501(c)(3) Organizations

All 501(c)(3) organizations must be organized and operated exclusively for a purpose that is:

- Charitable
- Religious
- Educational
- Scientific
- Literary
- For public safety testing
- For fostering national or international amateur sports competition –and/or–
- For preventing cruelty to children or animals

I.R.C. § 501(c)(3).

Other 501(c)(3) organization requirements are that none of its earnings may inure to any private shareholder or individual, and the entity may not attempt to influence legislation as a substantial part of its activities nor participate in any campaign activity for or against political candidates. In addition, assets of the organization must be permanently dedicated to an exempt purpose and, upon dissolution, the assets must be distributed for a charitable purpose. 26 C.F.R. § 1.501(c)(3).

Most 501(c)(3) organizations (or their parent organizations) are required to have an IRS determination as to their status. There is an exception for filing for church and related organizations (and other I.R.C. § 508 excepted organizations) and entities organized before October 9, 1969. An online search tool providing a list of organizations with determination letters can be found on the IRS website at EO Select Check. Information regarding the application process is available in I.R.S. Publication 557, Tax Exempt Status for Your Organization.

A cooperative hospital service organization described in I.R.C. § 501(e) is treated as if it were a 501(c)(3) organization if it is organized and operated solely to perform on a centralized basis certain services for two or more tax-exempt or governmental hospitals. Rev. Rul. 72–329, 1972–2 C.B. 226.

Public School Systems

A public school system eligible to adopt a 403(b) plan is a state-sponsored educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. Included in this category are employees of public schools and state colleges or universities. 26 C.F.R. § 1.403(b)-2(b)(14).

The employer must be a state, a political subdivision of a state, or an agency or instrumentality of one of these. I.R.C. 403(b)(1)(A)(ii). Implementing regulations interpret "state" to include the District of Columbia and Indian tribal governments as provided under I.R.C. § 7871(a)(6)(B). 26 C.F.R. § 1.403(b)-2(b)(20).

Both faculty and nonacademic staff (e.g., custodial staff) performing services for the educational organization may be covered by the 403(b) plan, but elected or appointed officials (holding positions in which persons that are not education professionals may serve) are not eligible. Members of the school board and university regents or trustees are not eligible. 26 C.F.R. § 1.403(b)-2(b)(10). Additional guidance on this issue may be found in the I.R.S. 403(b) Plan Fix-It Guide.

Employers Not Permitted to Adopt 403(b) Plans

Adoption of a purported 403(b) plan by an organization not qualified to adopt one is a common violation of the I.R.C. § 403(b) rules. Correction under the IRS EPCRS program (discussed below) can preserve the tax-deferred status of contributions made prior to the discovery of ineligibility.

When analyzing employer eligibility, several special situations should be considered:

- **Non-501(c)(3) organizations, even if tax exempt.** Only a 501(c)(3) organization can adopt a 403(b) plan. Organizations that are tax exempt under another subparagraph of I.R.C. § 501(c) are not eligible employers. Examples of ineligible employers are trade associations exempt under I.R.C. § 501(c)(6) and unions exempt under I.R.C. § 501(c)(5).
- **Governmental organizations other than public school systems.** A governmental organization can adopt a 403(b) plan only if it is a public school system, as described above, with the following exceptions:
    - A governmental organization that is also a 501(c)(3) organization can maintain a 403(b) plan. An organization affiliated with government may qualify for I.R.C. § 501(c)(3) exemption if it is separately incorporated or formed to accomplish one or more exempt purposes. For example, a public hospital may receive 501(c)(3) status. However, an organization may not obtain 501(c)(3) status if it has governmental regulatory or enforcement powers that would be beyond those permitted by an organization described in I.R.C. § 501(c)(3).
    - A governmental organization can have mixed functions. For example, a prison would not normally be a public school, and therefore could not maintain a 403(b) plan for its employees. However, employees of the education section of a prison (designed to provide educational opportunities to prisoners) could participate in a 403(b) plan. I.R.S. Gen. Couns. Mem. 38666, 1981 GCM LEXIS 92 (Mar. 27, 1981).
- **Nonqualifying affiliates of a 403(b) plan authorized entity.** An affiliate of an organization authorized to maintain a 403(b) plan cannot participate in the plan unless the affiliate also would be an eligible employer. For example, it is common for a private university described in I.R.C. § 501(c)(3) to own a taxable technology start-up to engage in commercialization of university-based research. Even though the technology company is wholly owned by the university, and its earnings are paid as dividends to the university, employees of the technology company cannot participate in a 403(b) plan. To the extent that some employees may divide their time between the university and its taxable affiliate, only their compensation from the university can be counted for purposes of the 403(b) plan.

ERISA Coverage of 403(b) Plans

Most private employer-sponsored 403(b) plans are subject to the Employee Retirement Income Security Act (ERISA), which has several requirements that parallel rules for qualified defined contribution and qualified defined benefit plans under the Internal Revenue Code, but don't otherwise directly apply to 403(b) plans, including:

- Vesting rules under ERISA § 203(a)(2)(B) (29 U.S.C. § 1053(a)(2)(B)) and I.R.C. § 411(a)(2)(B)
- Asset transfer rules under ERISA § 208 (29 U.S.C. § 1058) and I.R.C. § 414(l)
- Qualified joint and survivor annuity rules under ERISA § 205 (29 U.S.C. § 1055) and I.R.C. § 401(a)(11)
- Anti-cutback rules as applied to transfers under ERISA § 204(g) (29 U.S.C. § 1054(g)) and I.R.C. § 411(d)(6)

So, 403(b) plans that are subject to ERISA must also comply with these rules as well as ERISA's reporting and disclosure requirements, and—perhaps more significantly—such 403(b) plan sponsors are subject to ERISA's fiduciary and prohibited transaction rules, unless an exemption applies.

For further information on ERISA reporting requirements, see Dep't of Labor Field Assistance Bulletin 2009-02 (July 20, 2009) and Field Assistance Bulletin 2010-01 (Feb. 17, 2010) (hereinafter, FAB 2010-01).

ERISA fiduciary status may be a particular area of concern in light of recent litigation targeting several university 403(b) plans asserting breaches of fiduciary duty. E.g., Vellali, et al. v. Yale University, et al. 3:16-cv-01345 (D. Conn.), Sacerdote, et al. v. New York University 1:16-cv-06248 (S.D.N.Y.); Sweda, et al. v. The University of Pennsylvania, et al. 2:16-cv-04329 (E.D. Pa.); Clark, et al. v. Duke University, et al. 1:16-cv-1044 (M.D.N.C.); Munro, et al. v. University of Southern California, et al. 2:16-cv-06191 (C.D. Cal.).

Sponsor-Based Exemptions from ERISA Coverage

The ERISA rules do not apply to governmental plans or nonelecting church plans, which are generally exempt from ERISA. (Church plans may elect to be covered by ERISA.) ERISA § 4(b)(1), (2) (29 U.S.C. § 1003(b)(1), (2).

Non-ERISA 403(b) Plans

An exemption from ERISA Title I (governing reporting and disclosure, participation and vesting, funding, and fiduciary requirements) is available even for 403(b) plan sponsors that are subject to ERISA if the arrangement meets certain requirements that minimize employer involvement (non-ERISA 403(b) plans). A non-ERISA 403(b) plan is a program with limited employer involvement that provides for the purchase of annuity contracts or custodial accounts invested solely in mutual funds that is not recognized as an ERISA § 3(2)(A) employee pension benefit plan because it is not treated as "established or maintained by an employer." 29 C.F.R. § 2510.3-2(f); see Dep't of Labor Field Assistance Bulletin 2007-02 (July 24, 2007) (hereinafter, FAB 2007-02); FAB 2010-01.

Department of Labor (DOL) regulations provide safe harbor rules for non-ERISA 403(b) plans. To qualify for the safe harbor, the 403(b) plan must satisfy the following requirements:

- **Voluntary participation.** Participation in the plan must be completely voluntary for employees.
- **Employee enforceability.** All rights under the arrangement are enforceable solely by the employee, a beneficiary of the employee, or an authorized representative of the employee or beneficiary.
- **Restricted employer involvement.** The sole involvement of the employer must be limited to the following activities:
    - Permitting annuity contractors (including any agent or broker who offers annuity contracts or who makes available custodial accounts) to publicize their products to employees
    - Requesting information concerning proposed funding instruments or annuity contractors
    - Summarizing information on funding instruments or annuity contractors for employee review and analysis
    - Collecting contributions as required by salary reduction agreements or by agreements to forego salary increases, remitting such contributions to annuity contractors, and maintaining records of such amounts (i.e., no employer contributions are permitted)
    - Holding in the employer's name one or more group annuity contracts (including the right to act as an employee representative for contract amendments)
    - Limiting the funding instruments made available to employees, or the annuity contractors who may approach employees, in a manner designed to afford employees a reasonable choice in light of all relevant circumstances (described further below)

- **No employer compensation.** The employer receives no direct or indirect consideration or compensation, in cash or otherwise, except reasonable compensation to cover expenses properly and actually incurred in the performance of its duties pursuant to the salary reduction agreements or agreements to forego salary increases.

29 C.F.R. § 2510.3-2(f).

The circumstances that may be considered by an employer desiring to limit the non-ERISA 403(b) plan funding media or products or annuity contractors include (but are not limited to):

- The number of employees affected
- The number of contractors who have indicated interest in approaching employees
- The variety of available products
- The terms of the available arrangements
- The administrative burdens and costs to the employer
- The possible interference with employee performance resulting from direct solicitation by contractors

Id.

Note that the non-ERISA 403(b) plan safe harbor covers only arrangements that are limited to employee elective deferrals. There can be no employer contributions of any kind. 29 C.F.R. § 2510.3-2(f)(3)(iv). The DOL has provided guidance on other issues concerning the safe harbor, as discussed in the following sections.

Employer Administrative Reviews Permitted for Non-ERISA 403(b) Plans

Certain employer activities designed to ensure that a 403(b) plan continues to be tax compliant under I.R.C. § 403(b) are permissible activities that will not take a non-ERISA 403(b) plan out of the safe harbor. This is because employers have an interest separate from acting as their employees' authorized representatives in ensuring that the 403(b) plan's annuity contracts and custodial accounts are tax compliant. Specifically, for example, the employer can be liable to the IRS for potentially substantial penalty taxes, correction fees, and employment taxes on employee salary deferrals for noncompliance, even if the violation was caused by an employee or annuity contractor. Thus, an employer's compliance monitoring activities are consistent with the safe harbor (including in correcting errors). FAB 2007-02; FAB 2010-01; Dep't of Labor Information Letter (Feb. 27, 1996).

However, to clearly indicate the employer's limited involvement in the plan, where the written plan document allocates responsibility for performing administrative functions to persons other than the employer, the relevant document(s) should identify the parties that are responsible for administrative functions, including those related to tax compliance. The documents should delineate the employer's limited role in the activity and allocate discretionary determinations to the annuity provider or participant or other third party selected by the provider or participant. FAB 2007-02; FAB 2010-01.

Impermissible Employer Discretion in Non-ERISA 403(b) Plans

If the employer exercises discretion in administering the plan, it may be deemed to have taken over control as the plan sponsor, resulting in the loss of ERISA Title I exemption (unless it is a governmental or nonelecting church plan, exempt from Title I requirements). Such prohibited exercises of discretion include determinations authorizing, directly or indirectly through a third-party administrator:

- Administering distributions, including hardship distributions, domestic relations orders, and processing participant loans
- Satisfying applicable qualified joint and survivor annuity requirements –or–
- Plan-to-plan transfers or contract exchanges

FAB 2007-02; FAB 2010-01; Dep't of Labor Adv. Op. 94-30A (Aug. 19, 1994).

Thus, maintaining a non-ERISA 403(b) plan's exemption from ERISA is practical only if the annuity and/or custodial account providers are willing to take on the bulk of administrative duties under the plan, and the employer is willing to concede control of most plan functions to them. As discussed below, this can lead to compliance issues because each vendor is typically unaware of what other vendors are doing.

Qualification Requirements

The following sections outline the qualification rules for all 403(b) plans to be eligible for tax-favored status under 26 C.F.R. § 1.403(b)-3:

- Funding restrictions
- Written document requirement
- Nondiscrimination rules
- Contribution and benefit rules and limitations
- Rollover distribution requirements
- Required minimum distribution rules
- Nontransferability rule

These rules are separate from any requirements under ERISA, which would also apply to 403(b) plans that are subject to ERISA (see the discussion in the previous section, ERISA Coverage of 403(b) Plans, regarding non-ERISA 403(b) plans). See 403(b) Plan Distributions for further discussion on distribution requirements.

Funding Restrictions

There are only three categories of funding arrangements that can be used for a 403(b) plan:

- **Annuity contracts** (26 C.F.R. §§ 1.403(b)-2(b)(2), -8(c)). Generally, 403(b) plan annuity contracts must be issued by a state-regulated insurance company and offer an annuity form of benefit.
- **Custodial accounts** (I.R.C. § 403(b)(7) and 26 C.F.R. § 1.403(b)-8(d)). These are separate accounts that must be held by a financial institution described in I.R.C. § 401(f)(2) and:
    - Be invested solely in mutual funds
    - Comply with the 403(b) plan distribution limitations (described under 403(b) Plan Distributions below)
    - Be operated for the exclusive purpose of providing benefits for participants or their beneficiaries –and–
    - Meet the rules in 26 C.F.R. § 1.403(b)-8(d)(2) regarding distribution limitations
- **Church retirement income accounts** (I.R.C. § 403(b)(9) and 26 C.F.R. § 1.403(b)-9). Church sponsors of 403(b) plans may use retirement income accounts to fund plan benefits, which allow for increased investment flexibility. They must:
    - Be maintained under a separate accounting
    - Limit benefits only to gains or losses on invested assets –and–
    - Be operated for the exclusive purpose of providing benefits for participants or their beneficiaries

26 C.F.R. § 1.403(b)-8.

Unlike a qualified plan, a 403(b) plan (other than certain grandfathered self-insured state and local government 403(b) plans or a church retirement income account) cannot be funded through a trust that holds stocks, bonds, or other investments. See 26 C.F.R. §§ 1.403(b)-8(c)(3), -9.

The 403(b) plan must specify which specific contracts will be available under the plan. The issuers of such contracts are known as approved vendors.

Written Document Requirement

A 403(b) plan must be documented in a written defined contribution plan that satisfies certain regulatory requirements and be operated in compliance with the plan. Specifically, the written plan document must set forth all the material terms and conditions regarding the following:

- Eligibility
- Contributions and benefits
- Contribution limitations
- Contracts available under the plan (approved vendors) –and–
- Time and form of benefit distributions (including rules for rollover and required minimum distributions)

26 C.F.R. § 1.403(b)-3(b)(3)(i).

The plan also may set forth certain optional features that are consistent with but not required under I.R.C. § 403(b). These include:

- Hardship withdrawals
- Plan loans
- Plan-to-plan transfers (or from annuity contract to annuity contract) –and–
- Acceptance of rollovers to the plan

Id.

As provided in the final regulations, the existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan. Without such a central document for a comprehensive summary of responsibilities, there is a risk that many of the important responsibilities required under the statute and final regulations may not be allocated to any party. Failure to adopt a written plan document, or to follow its terms, is a common plan defect that is correctable under the IRS EPCRS program. See Correcting 403(b) Plan Errors.

Multiple Documents

The written plan document can consist of more than one document. That is, plans are permitted to incorporate other documents, such as annuity contracts and custodial agreements. 26 C.F.R. § 1.403(b)-3(b)(3)(ii).

Considerations for Non-ERISA 403(b) Plan

Consider advising a tax-exempt employer that wishes to maintain non-ERISA 403(b) plan status to exclude from its written plan document any provisions concerning hardship withdrawal distributions, loans, plan-to-plan transfers, and acceptance of rollovers. Employer involvement in those activities can jeopardize the non-ERISA 403(b) plan status. These provisions may appear instead in the annuity contract, custodial account agreement, or other ancillary document prepared by the third party administering the relevant aspect of the arrangement. Under the safe harbor rules, the employer could presumably limit the funding media or products available to employees, or the annuity contractors who may approach employees, to ones that agreed to include and administer such provisions. 29 C.F.R. § 2510.3-2(f)(3)(vii); FAB 2007-02.

Model Language

The IRS has provided model language for 403(b) plans designed to satisfy requirements under I.R.C. § 403(b) for public school sponsors, which can be modified for other types of eligible employers. Rev. Proc. 2007-71, 2007-2 C.B. 1184 (see March 2015 revised version available on the IRS website). See also the section entitled “Pre-approved 403(b) Plans,” under Implementation and Operation below.

Nondiscrimination Rules

The section 403(b) nondiscrimination rules are designed to ensure that coverage under a 403(b) plan does not discriminate in favor of highly compensated employees. Church-sponsored 403(b) plans are exempt from these rules. I.R.C. § 403(b)(1)(D). Their application to other plans depends on whether the plan is maintained by a government or a private employer:

- **Governmental and private employer plans** are subject to the universal availability rule for elective deferrals.
- **Private employer plans** are also subject to similar nondiscrimination rules as defined contribution and defined benefit plans qualified under I.R.C. § 401(a).

Universal Availability for Elective Deferrals

Plans of governments and private employers (but not churches) that permit elective deferrals under their 403(b) plans must make them available to all employees, subject to the exceptions for excludable employees noted below. This is the case even if the employee has not met the plan's age and service requirements for employer contributions. I.R.C. § 410(b)(12)(A)(ii); 26 C.F.R. § 1.403(b)-5.

Aggregation rules are as follows:

- Individual 501(c)(3) organizations are treated separately, even if related to other 501(c)(3) entities.
- A single-member limited liability company (LLC) that is a disregarded entity of a 501(c)(3) organization sponsoring the plan is treated as a branch of the sponsor, so the LLC's employees are treated as employees of the sponsor.
- Government employers are aggregated if they are part of a common payroll.
- If an employer has historically treated geographically distinct units as separate for employee benefit purposes, then such units can be treated separately for universal availability but only if the unit is run independently on a day-to-day basis. An exception to this exception applies to units within the same Standard Metropolitan Statistical Area.

26 C.F.R. § 1.403(b)-5(b)(3); I.R.S. Chief Couns. Mem. 201634021, 2016 IRS CCA LEXIS 81 (Aug. 19, 2016).

Excludable Employees

Certain employee groups may be excluded (on a universally basis) from participation in a 403(b) plan without violating the universal availability rule:

- Any employee not willing to contribute more than $200 per year
- Employees who work less than 20 hours per week or any lower number stated in the plan document (I.R.C. § 403(b)(12)(A)(ii)), but only if:
    - The employer expects the employee to work fewer than 1,000 hours for the 12 months beginning on the date of hire, and
    - The employee does work fewer than 1,000 hours in each subsequent plan year (or, if the plan so provides, each subsequent 12-month period) thereafter
- Employees eligible to make salary deferral contributions to another 403(b), government 457(b), or 401(k) plan of the employer
- College work-study students described in I.R.C. § 3121(b)(10) –and–
- Nonresident aliens with no U.S. source income

I.R.C. § 403(b)(12)(A); 26 C.F.R. §§ 1.403(b)-5(b)(3)(i), -5(b)(4)(ii).

Universal availability rule compliance is an issue for many 403(b) plans. For example, a school often hires substitute teachers whose work schedule is unpredictable. The employer may initially not permit elective deferrals based on an expectation they will work less than 20 hours per week and will not exceed 1,000 hours for they year (a permissible exception, as noted above). However, if this is done, the employer needs to carefully track actual hours to ensure that a substitute that ceases to qualify for an exempt category is given the opportunity to participate. As an alternative, many employers simply permit all employees, regardless of hours worked, to make elective deferrals.

Notice Requirement

There is a notice component to the universal availability rule. Employers must provide all eligible employees with an annual notice concerning the opportunity to make salary deferrals to a 403(b) plan offering elective deferrals. The notice must also advise employees how they can make or change the amount designated for salary deferral purposes. I.R.C. § 403(b)(12)(A); 26 C.F.R. § 1.403(b)-5(b)(2).

No Contingent Benefits

Finally, the universal availability rule prohibits 403(b) plans from making an employee's right to receive any employee benefit contingent on his or her decision to make an employee elective deferral contribution to the 403(b) plan (other than matching

contributions, plan loan benefits relating to a deferral amount, or alternative benefits, credits, or cash under a cafeteria plan available in lieu of the 403(b) plan contribution).

Universal Availability Rule Compliance Review

Following are steps for universal availability compliance and monitoring:

- Review the 403(b) plan document and administrator's practices and procedures concerning universal availability.
- Review eligibility rules generally for 403(b) plan compliance. Remember that employers cannot exclude employees based on job classifications, such as visiting professors or adjuncts, student workers or interns, substitute teachers, seasonal or temporary employees, administrative workers, bus drivers, custodial staff, cafeteria workers. Only individuals falling in a permissible excludable class under the terms of the plan can (and must) be excluded.
- If part-time employees are excluded, establish procedures for determining excludable status and implement periodic testing to ensure the 20-hour-per-week and 1,000-hour-per-year rules continue to be satisfied for all excluded individuals.
- Ensure the annual notice provides an accurate description of the 403(b) plan eligibility requirements and is distributed each year.

For a thorough discussion of issues relating to universal availability compliance, see the 2015 report by the Employee Plans Subcommittee of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT), available at ACT, 2015 Report of Recommendations, pp. 28-38.

Other Nondiscrimination Rules

The plans of private employers, but not governments or churches, are subject to the same as the rules that apply to qualified plans under I.R.C. §§ 401(a)(4) (nondiscrimination in contributions and benefits), 401(a)(17) (compensation limit), 401(m) (matching and after-tax contributions), and 410(b) (minimum coverage). 26 C.F.R. §§ 1.414(c)-5(a)(1).

Unlike the universal availability rule, these nondiscrimination requirements apply on a related-entity basis under the employer aggregation rules of I.R.C. §§ 414(b), (c), (m), and (o), rather than just to the employer maintaining the plan. On their face, I.R.C. §§ 414(b) and (c), which define "controlled group," apply only to controlled groups of corporations and two or more trades or businesses under common control. However, regulations take the position that these rules apply to tax-exempt organizations as well (other than churches) and provide rules for determining controlled group status in the case of tax-exempt organizations. 26 C.F.R. §§ 1.414(c)-5(a)(4), -5(b)(3).

Contribution and Benefit Rules and Limitations

Benefits under a 403(b) plan are based on contributions made and earnings thereon. The written plan document must specify the types of contributions allowed. 403(b) plan contributions are also subject to limitations, like other qualified plans. In the case of a private employer, such contributions must satisfy certain nondiscrimination requirements, as discussed in the previous section. As with employer contributions under a qualified plan, employer contributions, including those made by the employee under a salary reduction agreement, and earnings are not included in the employee's income until distributed (except for after-tax and Roth contributions). I.R.C. § 403(b)(1).

A 403(b) plan can permit any or all of the following types of contributions, but the plan must specify which types are permitted:

- Elective deferrals
- Employer contributions (including matching, discretionary, and/or mandatory contributions)
- Roth contributions
- After-tax contributions
- Rollover contributions

Each of these are described in the 403(b) Plan Contributions section below. A 403(b) plan may also provide for automatic enrollment. I.R.C. § 414(w).

Contribution Limits

Similar to contributions under 401(k) plans, contributions to 403(b) plans are subject to:

- Maximum annual limits under I.R.C. § 402(g) on elective deferrals and Roth contributions
- Maximum annual additions under I.R.C. § 415 on all types of contributions (other than rollovers)

Annual Limit on Elective Deferrals and Catch-Up Contributions

Elective deferral limit. The normal annual limit on elective deferrals plus contributions under an eligible Roth contribution program to a 403(b) plan is determined under the I.R.C. § 402(g) threshold, as adjusted for inflation ($18,000 in 2017), the same limit that applies to elective contributions under a 401(k) plan. I.R.C. §§ 402(g)(1)(A), 402A(c)(2); 26 C.F.R. § 1.403(b)-3(c). See the paragraph captioned "One-time election to exceed 402(g) limit" in the above discussion of elective deferrals for a special rule allowing a new 403(b) plan participant to exceed the annual limit. I.R.C. §§ 402(g)(3), 403(b)(12).

Timing rules for the return of any excess deferral resulting from a failure to comply with the elective deferral limit are found in 26 C.F.R. §§ 1.403(b)-4(f)(4).

Catch-up contribution rules. There are two catch-up contribution opportunities for eligible employees to increase the elective deferral limit for a year:

- Age 50 catch-up –and–
- 15-years-of-service catch-up

Age 50 catch-up contribution. If permitted by the 403(b) plan, employees who are age 50 or over at the end of the calendar year can also make catch-up contributions up to the statutory catch-up limit under I.R.C. § 414(v), as adjusted for inflation ($6,000 in 2017). The amount cannot exceed the employee's compensation for the year. I.R.C. § 414(v); 26 C.F.R. § 1.403(b)-4(c)(2).

If an employee covered by a 403(b) plan is also covered by a 401(k) plan (or a simplified employee pension or SIMPLE retirement account), the plans are combined in applying the annual limit on elective deferrals and the age-50 catch-up limit. 26 C.F.R. § 1.402(g)-1(b).

15-years-of-service catch-up contribution. A special rule for 403(b) plans under I.R.C. § 402(g)(7) allows plans to provide for a separate catch-up right for employees having at least 15 years of service with a:

- Public school system
- Hospital
- Home health service agency
- Health and welfare service agency
- Church –or–
- Convention or association of churches (or associated organization)

26 C.F.R. § 1.403(b)-4(c)(3)(ii).

If permitted under the plan, this catch-up rule increases the annual limit otherwise applicable by the **least** of:

- $3,000
- $15,000, reduced by the amount of additional elective deferrals made in prior years under this rule
- $5,000 times the number of the employee's years of service for the organization, minus the total elective deferrals made for earlier years –or–
- The participant's compensation for the year (as defined in 26 C.F.R. § 1.403(b)-2)

26 C.F.R. § 1.403(b)-4(c)(3)(ii).

Special rules for determining years of service for this purpose are given in 26 C.F.R. § 1.403(b)-4(e). Several examples applying the

catch-up rules are given in 26 C.F.R. § 1.403(b)-4(c). See also I.R.S. Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans), §4.

When both catch-up opportunities are available (because a qualifying individual is age 50 or older by year-end), the employee may utilize both, but regulations require the additional amounts to be applied first to the 15-years-of-service catch-up and then to the age 50 catch-up. 26 C.F.R. § 1.403(b)-4(c)(4).

Due to its complexity and the subsequent introduction of the age-50 catch-up rules, many employers have eliminated the 15-years-of-service catch-up from their 403(b) plans. The IRS 403(b) Fix It Guide identifies allowing this catch-up to an employee who does not have the required 15 years of full-time service with the same employer as a common plan defect.

Limit on Annual Additions under I.R.C. § 415

The annual additions limit that applies to qualified defined contribution plans also applies to the aggregate of all contributions to a 403(b) plan, other than rollover contributions and age-50 catch-up contributions. I.R.C. § 403(b)(1); 26 C.F.R. § 1.403(b)-4(b).

The limit is the lesser of:

- The statutory limit, adjusted for inflation under I.R.C. § 415(d) ($54,000 for 2017 limitation years) –or–
- 100% of includible compensation (as defined in 26 C.F.R. § 1.403(b)-2)

I.R.C. § 415(c)(1); 26 C.F.R. § 1.403(b)-4(b)(2); see also 26 C.F.R. §§ 1.415(b)-1(b)(2), (c) for special application rules relating to 403(b) plans.

It is important to establish a separate account to hold excess contributions to prevent commingling with 403(b) plan-eligible contributions. Failure to do so could taint the tax-qualified status of the entire 403(b) plan. 72 Fed. Reg. 41,136; 26 C.F.R. §§ 1.403(b)-3(b)(2), -4(f).

Special rule for former employee contributions. Where contributions continue for a former employee, the former employee's compensation for this purpose is based on the amount earned during the most recent year of service for up to the next five taxable years. 26 C.F.R. 1.403(b)-4(d). Thus, it is possible for nonelective employer contributions to a 403(b) plan to continue for up to five years in the case of a retired or terminated participant. See 26 C.F.R. §§ 1.403(b)-3(b)(4), -4(d).

Special rule for Church employees. In lieu of the Section 415 limit, a church employee can choose to use $10,000 a year as the limit on annual additions. This is only useful if the employee's includible compensation is less than $10,000 and if the total contributions will exceed 100% of the employee's includible compensation. Moreover, total contributions over the employee's lifetime under this choice cannot be more than $40,000. See 26 C.F.R. § 1.403(b)-9(b).

Aggregation of contributions under separate plans. Normally, an employee who participates in a 403(b) plan and a qualified defined contribution plan, simplified employee pension, defined benefit plan that provides for employee after-tax contributions, or individual medical benefit account that is part of a pension or annuity plan need not combine contributions made to the 403(b) plan with contributions to the other types of plans for purposes of the Section 415 limit. However, the plans must be combined if the other plan is maintained by a corporation, partnership, or sole proprietorship over which the employee has more than 50% control. I.R.C. § 415(k)(4).

For example, if a tax-exempt organization maintains both a qualified plan and a 403(b) plan, up to the lesser of $53,000 (in 2016) or 100% of compensation could be contributed to each plan. However, if a doctor employed by a tax-exempt hospital also has a qualified plan for his or her own private medical practice, the 403(b) plan of the hospital would have to be combined with the qualified plan of the private medical practice in applying the limit.

Incidental Benefit Rule

Requirements imposed on qualified plans under 26 C.F.R. § 1.401-1(b)(1)(ii) regarding the extent to which incidental life or accident or health insurance benefits may be provided as plan benefits also apply to 403(b) plans. 26 C.F.R. §§ 1.403(b)-3(a)(8), -6(g).

Nonforfeitability/Vesting

In theory, contributions under a 403(b) plan must be nonforfeitable. 26 C.F.R. § 1.403(b)-3(a)(2). As a practical matter, though, there is a workaround build into the regulations whereby forfeitable contributions are treated as not having been made to the 403(b) plan, but rather to a separate I.R.C. § 403(c) annuity (or a tax-exempt employee trust where a custodial account is used), when they are made. (Forfeitable contributions are required to be kept in a separate bookkeeping account than nonforfeitable contributions.) Then, as amounts become vested, and assuming all of the 403(b) plan conditions (other than nonforfeitability) are met for those

contributions, those amounts are retroactively treated as having been made to the 403(b) plan for purposes of the maximum limits on contributions when they become nonforfeitable. 26 C.F.R. § 1.403(b)-3(d)(2).

In this way, many 403(b) plans subject employer matches, employer discretionary contributions, and/or employer mandatory contributions to a vesting schedule (vesting for employee elective deferrals would be permissible in non-ERISA 403(b) plans, but is highly unusual).

For example, a plan might provide that an employee would be 20% vested after two years, 40% after three years, 60% after four years, 80% after five years, and 100% (nonforfeitable) after six years. If an employee left after two years with an employer contribution account balance of $5,000, the employee would receive only $2,000. The remaining $3,000 in the account would, depending on the plan terms, be used for plan administrative expenses, divided among the accounts of other employees, or used to reduce future employer contributions.

To avoid participants becoming immediately subject to taxation upon a termination of the plan, however, a 403(b) plan that allows for any type of forfeitable contribution should provide for automatic full vesting upon plan termination (as would be mandatory for a traditional qualified plan).

Vesting Requirements for Plans Subject to ERISA

For 403(b) plans that are subject to ERISA, any vesting schedule must be at least as favorable as is required under ERISA. Thus, such 403(b) plans can subject employer contributions to three-year cliff vesting or six-year graded vesting, as described in the example given above (or more liberal vesting schedules). ERISA § 203(a)(2)(B) (29 U.S.C. § 1053(a)(2)(B)) (parallel provisions under I.R.C. § 411(a)(2)(B)).

Rollover Distribution Requirements

If a participant or beneficiary in a 403(b) plan is entitled to a distribution from the plan, the plan must give the participant or beneficiary the option to have the amount directly transferred to another plan rather than being paid to the participant or beneficiary. The qualified plan rollover rules under I.R.C. §§ 401(a)(31) and 402(c) and (f) apply (other than inherited IRA rules). Thus, 403(b) plan rollovers may be made to qualified plans, other 403(b) plans, and eligible governmental 457(b) plans (including to designated Roth accounts) as well as to I.R.C. § 403(a) annuity plans and traditional and Roth IRAs. I.R.C. § 403(b)(8), (10); 26 C.F.R. §§1.403(b)-3(a)(7), -7(b).

The qualified plan automatic cashout rules also apply, so if a plan calls for certain small benefits in excess of $1,000 to be paid to a participant without the participant's election, the amount must be automatically directly transferred to an IRA unless the participant elects to the contrary. See I.R.C. § 401(a)(31).

Note that although rollovers out of the plan are required, accepting rollovers into a 403(b) plan is not.

Required Minimum Distributions

A 403(b) plan is treated as an individual retirement plan for purposes of satisfying the required minimum distribution (RMD) rule sunder I.R.C. § 401(a)(9). 26 C.F.R. §§ 1.403(b)-3(a)(6), -6. Special rules of application for 403(b) plans, including treatment of grandfathered benefits accruing before 1987, are found in 26 C.F.R. § 1.403(b)-6(e). Generally, 403(b) plan annuity contracts are treated like individual retirement accounts for purposes of the RMD rules. For further information on RMDs, see Employee Benefits law § 3A.02[m].

Nontransferability

Except in the case of a contract issued before January 1, 1963, 403(b) plan contracts must be nontransferable. Thus, an employee could not sell the contract to a third party. I.R.C. § 401(g); 26 C.F.R. § 1.403(b)-3(d)(2). Nor can a creditor of the employee seize the contract as payment for a debt, even in a bankruptcy situation. 11 U.S.C. § 541(b)(7). Special rules relating to the exchange of annuity contracts within a 403(b) plan and plan-to-plan transfers are considered in the discussion on distributions further below.

403(b) Plan Contributions

This section describes the different types of contributions permitted under a 403(b) plan.

Elective Deferral Contributions

Similar to 401(k) plan deferrals, these contributions to a 403(b) plan are made under a salary deferral agreement on a pre-tax basis and reduce the income shown on the employee's Form W 2. I.R.C. §§ 402(e)(3), 403(b)(1)(E), 402(g)(3)(C). For example, if an employee whose salary is $50,000 gross contributes $5,000 to the 403(b) plan as an elective deferral, the wages reported on the Form W 2, Box 1, will be $45,000 rather than $50,000.

403(b) plan elective deferrals are subject to the following rules:

- **Annual limit.** 403(b) plan elective deferrals are subject to the same annual limit as for 401(k) plans, determined on an aggregate basis for the individual, including the additional amounts for catch-up contributions, discussed further below. I.R.C. § 402(g).
- **One-time election to exceed 402(g) limit.** A special rule allows plans to let an employee make a one-time irrevocable election at the time of initial eligibility in a 403(b) plan to contribute without regard to the elective deferral limitation. I.R.C. §§ 402(g)(3), 403(b)(12); I.R.S. Rev. Rul. 2000-35, 2000-2 C.B. 138.
- **Social Security/Medicare taxes apply.** Like elective deferrals to a 401(k) plan, elective deferrals to a 403(b) plan are subject to applicable Social Security and Medicare taxes. I.R.C. § 3121(a)(5)(D).
- **Additional tax relief for retired public safety officers.** While elective deferrals and earnings thereon from a 403(b) plan are generally all taxable when distributed. However, eligible retired public safety officers may use a distribution of up to $3,000 made directly from a 403(b) plan to pay premiums on accident, health, or long-term care insurance, without including the amount in taxable income. The premiums can be for the employee or the employee's spouse or dependents. I.R.C. § 402(l)(3)(B).

Employer Contributions

A 403(b) plan may provide for employer matching, discretionary, or mandatory contributions. I.R.C. § 403(b)(1), (7). However, a 403(b) plan that provides for employer contributions cannot be a non-ERISA 403(b) plan. 29 C.F.R. § 2510.3-2(f)(3)(iv). Several types of employer contributions are possible:

- **Employer matching contributions.** For matching contributions, the plan states the formula for matching contributions made by the employer based on the amount of the employee's elective deferrals. For example, the employer may contribute an amount equal to 50% of elective deferrals (or, in some cases, elective deferrals and after-tax contributions). Typically, the match will be subject to a cap (e.g., that only contributions equal to the first 6% of an employee's compensation will be matched).
- **Employer discretionary matching contributions.** With a discretionary match, the employer decides how much to contribute toward the match. However, the plan terms must specify how the match is to be divided among employees. For example, it could specify that the match would not apply to contributions that exceeded the first 6% of an employee's compensation, but that the percentage match would depend on the amount the employer chose to contribute for that year.
- **Employer discretionary contribution.** With a discretionary contribution, the plan could specify that the employer may decide each year how much to contribute to the 403(b) plan, but the plan terms must set forth how the amount is to be allocated among employees (e.g., in proportion to compensation).
- **Employer mandatory contributions.** With a mandatory contribution, the plan document states the amount to be contributed by the employer. For example, an employer may contribute to the 403(b) plan 5% of employee compensation each year.
- **Special rule for former employees.** Subject to the limits in 26 C.F.R. § 1.403(b)-4(d), an employer may continue to make contributions on behalf of a former employee for up to five years after the year employment ends.

After-tax Employee Contributions

After-tax employee contributions do not give the employees an immediate tax benefit. However, earnings on the contributions are tax deferred until distributed from the plan, which could positively affect investment returns. I.R.S. 403(b) Plan Basics.

Roth Contributions

A 403(b) plan is recognized as an applicable retirement plan that may include a qualified Roth contribution program. I.R.C. § 402A(b),

(e)(1)(B). Thus, 403(b) plans may allow employees to make elective Roth contributions. These contributions must be maintained separately from pre-tax and after-tax elective contributions and, like after-tax contributions, are treated as an elective deferral, but are not excludable from the employee's gross income. However, for qualified distributions made from a Roth account, the earnings on the contributions are tax free, not merely tax deferred as for pre-tax or after-tax contributions. I.R.C. § 402A(d)(1); 26 C.F.R. § 1.403(b)-3(c) (incorporating rules under 26 C.F.R. § 1.401(k)-1(f)(1), (2)).

To be a qualified Roth distribution, the distribution from the 403(b) plan must be made, and must be:

- Made at least five years after the employee first contributes to the Roth account –and–
- Meet one of the following criteria:
    - Occur on or after the date the employee becomes age 59½
    - Be made to a beneficiary, or to the employee's estate, after the death of the employee
    - Be attributable to the employee's being disabled (as defined under I.R.C. § 72(m)(7)) –or–
    - Be used to pay for qualified first-time homebuyer expenses (as defined under I.R.C. § 72(2)(F))

I.R.C. § 402A(d)(2).

Rollover Contributions

A 403(b) plan can (but is not required to) permit rollovers from:

- A qualified plan
- Another 403(b) plan
- A governmental 457(b) plan –or–
- An IRA from which an employee is receiving a distribution

I.R.C. § 402(c)(1), (8).

Such rollovers continue the tax deferral on the amounts from the other plan. Id.

403(b) Plan Distributions

This section describes 403(b) plan distribution rules, describing when benefit distributions are generally permitted and special distributions rules for plan terminations, domestic relations orders, and plan loans. Certain permitted exchanges and transfers that are not treated as distributions are also discussed.

General Distribution Restrictions

A 403(b) plan's distribution provisions must limit distributions to take into account limitations under I.R.C. § 403(b)(10) similar to defined contribution qualified plans. Certain distributions that are permitted will give rise to penalties on the plan participant. A plan may, but is not required to, limit distributions to avoid penalties on the participant.

Generally, a 403(b) plan can permit a distribution to be made only once the employee:

- Reaches age 59½
- Has a severance from employment
- Dies
- Becomes disabled (within the meaning of I.R.C. § 72(m)(7)
- Encounters financial hardship, but only for elective deferral contributions (excluding income), as described below –or–
- Is eligible for a qualified reservist distribution

26 C.F.R. §§ 1.403(b)-6(b) to (d).

However, the restrictions above do not apply to after-tax contributions. Id. Rollover contributions are also exempt. 26 C.F.R. § 1.403(b)-6(i). Thus, for example, a plan can permit in-service withdrawals of such amounts, even if the employee has not attained age 59½.

Hardship distribution rules. To be a hardship distribution, the same rules apply as under the qualified plan distribution rules. They are only permissible for an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse or dependent. IRS regulations provide certain safe harbors under which a distribution will be assumed to meet these tests. 26 C.F.R. § 1.403(b)-6(d)(2); see 26 C.F.R. § 1.401(k)-1(d)(3). For additional compliance information, see Checklist—Complying with I.R.C. Hardship and Unforeseeable Emergency Distribution Requirements.

Distributions Subject to Penalties

As with distributions from qualified plans, two sorts of penalties can apply to distributions from a 403(b) plan, even if the withdrawals are permitted under the plan:

- 10% additional tax (in addition to normal income taxes) on early withdrawals under I.R.C. § 72(t) –and–
- Loss of the special tax treatment for Roth contributions distributed within the five-year nonexclusion period under I.R.C. § 402A(d)(2)(B)

Because these limitations apply to the participant, they need not be included in the plan document. However, some plans attempt to limit plan distributions to those that will not give rise to the penalties. The 10% additional tax applies only to the amount of the distribution that is subject to income tax. For example, it would not apply to a distribution to the extent it consisted of after-tax employee contributions, but it would apply to the portion of the distribution that consisted of earnings on those contributions. It also does not apply to the extent that taxes are deferred by rolling the distribution over to another plan. The additional tax applies unless one of the exceptions under I.R.C. 72(t) is met.

For example, a 30-year-old employee could be permitted to take a distribution of elective deferrals from a 403(b) plan upon termination of employment or hardship. However, unless the distribution was rolled over, it would generate normal income taxes plus the 10% additional tax.

Distributions upon Plan Termination

Distributions can be made regardless of the above limitations upon termination of the 403(b) plan. However, if the 403(b) plan contains elective deferrals or is funded through custodial accounts, termination of the plan and the distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the employer under I.R.C. §§ 414(b), (c), (m), and (o) on the date of the termination) does not make any contributions to any 403(b) plan that is not part of the terminating plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. An exception to this rule exists when less than 2% of eligible employees are eligible under the other 403(b) plan during the restricted period. 26 C.F.R. § 1.403(b)-10(a)(1).

See also Terminating 403(b) Plans below for other issues in terminating a 403(b) plan.

Domestic Relations Orders

The 403(b) regulations include a specific exception to the distribution limitation rules for domestic relations orders. 26 C.F.R. 1.403(b)-10(c). A domestic relations order is defined as any judgment, decree, or order (including approval of a property settlement agreement) that:

- Relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant –and–
- Is made pursuant to a state domestic relations law (including a community property law)

I.R.C. § 414(p)(9).

A governmental or nonelecting church plan can comply with any domestic relations order (and may be subject to state domestic relations laws regarding distributions). Other plans can comply only if the order is a domestic relations order that meets certain requirements for qualified domestic relations orders (QDROs) under I.R.C. § 414(p) and ERISA § 206(d)(3) (29 U.S.C. § 1056(d)(3)). See Rev. Proc. 2007-71.

Remember that sponsors of non-ERISA 403(b) plans should not conduct any discretionary administration of the plan's domestic relations order distributions.

Plan Loans

Loans from 403(b) plans are permissible, depending on the facts and circumstances of the loan arrangement, including whether there is a fixed repayment schedule, the reasonability of the interest rate, and the presence of repayment safeguards that a prudent lender would rely on. As for 401(k) plan loan programs, the prohibited transaction exemption requirements under ERISA § 408(b)(1) (29 U.S.C. § 1108(b)(1)) apply for ERISA-governed plans, and tax treatment is governed by I.R.C. § 72(p).

The plan document (or ancillary document) must contain material terms and conditions for the loans and identify the person responsible for administering the program. If the participant fails to repay a 403(b) plan loan, the participant's account under the plan can be used for repayment similar to other qualified plan loans. 26 C.F.R. § 1.403(b)-6(f); see also 29 C.F.R. § 2550.408b-1 and 26 C.F.R. § 1.72(p)-1.

The taking out of a loan is not treated as an impermissible distribution. A loan that is in default is generally treated as a taxable distribution from the plan of the entire outstanding balance of the loan (a deemed distribution). A deemed distribution is treated as an actual distribution for purposes of determining the tax on the distribution, including any early withdrawal penalty. However, a deemed distribution is not treated as an actual distribution for purposes of determining whether a plan satisfies the limitations on in-service distributions. 26 C.F.R. §§ 1.403(b)-7(d), 1.72(p)-1, Q&A12, 13.

For more information on the rules for qualified plan loans, see 401(k) Plan Participant Loan Program and Plan Loan Checklist for Qualified Retirement Plans.

Exchanges and Transfers Not Treated as Distributions

Subject to applicable requirements, three types of in-service exchanges or transfers, described further in the following sections, are permitted without violating the 403(b) plan distribution (or nontransferability) rules:

- Contract exchanges
- Plan-to-plan transfers –and–
- Asset transfers to governmental plans for purchase of permissive service credit

26 C.F.R. § 1.403(b)-10(b)(1); see also I.R.S. Retirement Plans FAQs regarding 403(b) Tax-Sheltered Annuity Plans.

Such exchanges and transfers are distinguished from rollovers (even direct rollovers from one plan to another). As discussed in the section entitled "Rollover Distribution Requirements" under Qualification Requirements above. Rollovers are available only when a distribution event has occurred. Remember that sponsors of non-ERISA 403(b) plans should not undertake any discretionary actions concerning such exchanges or transfers.

Contract Exchanges

A 403(b) annuity contract or custodial account can be exchanged for (1) another 403(b) contract or custodial account issued by an approved vendor under the same plan that receives plan contributions, or (2) another 403(b) contract or custodial account issued by a vendor that is not expressly authorized by the 403(b) plan terms (an unapproved vendor). However, an unapproved vendor exchange is permitted only if:

- The 403(b) plan permits exchanges with unapproved vendors
- The amount of the transferred accumulated benefit after the exchange is at least the same as before the exchange
- The unapproved vendor's contract is subject to distribution restrictions at least as stringent as the plan's terms –and–
- The 403(b) plan sponsor and the unapproved vendor enter an agreement to share information for tax reporting and plan compliance purposes (including information under 26 C.F.R. § 1.403(b)-10(b)(2)(i)(C))

26 C.F.R. § 1.403(b)-10(b)(2); Rev. Proc. 2007-71.

Plan-to-Plan Transfers

A 403(b) plan may transfer a contract or custodian account to a different employer's 403(b) plan (e.g., on behalf of transferring employees upon a corporate transaction), subject to the following conditions:

- The participant whose assets are being transferred is an employee (or former employee) of the employer (or business of the employer) sponsoring the receiving plan (or the assets belong to a beneficiary of such a participant)
- The terms of both plans allow for such plan-to-plan transfers
- The amount of the accumulated benefit after the transfer is at least the same as before the transfer
- The receiving plan imposes distribution restrictions on the transferred assets that are at least as stringent as the transferring plan's rules –and–
- If the transferred assets are not the participant's entire interest in the plan, then the receiving plan treats the amount transferred as a continuation of a pro rata portion of their interest in the transferring plan (e.g., with respect to pre-tax versus after-tax contributions)

26 C.F.R. § 1.403(b)-10(b)(3); Rev. Proc. 2007-71.

Certain Contract-to-Plan Transfers to Governmental Plans

A 403(b) plan may transfer assets held in the plan to an I.R.C. § 414(d) governmental defined benefit plan in three circumstances:

- **Purchase of permissive service credit.** A governmental plan that allows participants to make voluntary contributions (in addition to any employee contributions required under the plan) to acquire deemed service credit that will be used for purposes of calculating plan benefits (so-called permissive service credit, described in I.R.C. § 415(n)(3)) may accept such additional permissive service credit contributions through the transfer from a 403(b) plan. 26 C.F.R. § 1.403(b)-10(b)(4)(ii)(A). This is an exception from the general rule prohibiting assets transfers between 403(b) plans and plans qualified under I.R.C. § 401(a) or eligible governmental deferred compensation plans under I.R.C. § 457(b). 72 Fed. Reg. 41,132.
- **Repayments of contributions.** The assets from a 403(b) plan account can be transferred to a governmental plan where the amount is treated as a repayment of contributions for an amount previously refunded upon a forfeiture of service credit under the plan, as described in I.R.C. § 415(k)(3). 26 C.F.R. § 1.403(b)-10(b)(4)(ii)(B).
- **Rollovers.** Participants may choose to roll over any eligible rollover distribution from a 403(b) plan to a governmental defined benefit that accepts rollovers. I.R.C. § 403(b)(8).

Implementation and Operation

To receive and maintain tax-favored treatment, 403(b) plans must comply in form and operation with the requirements described in this practice note. For plan document compliance, employers who adopt prototype and volume submitter pre-approved plans are able to rely on the IRS determination letter program established for pre-approved plans, described below under "Pre-approved 403(b) Plans." By contrast, sponsors of individually designed plans have no way to receive IRS blessing on their 403(b) plans, since the IRS decided not to adopt a determination letter program for such plans. See Rev. Proc. 2013-22, 2013-1 C.B. 985.

Adopting a pre-approved plan simplifies 403(b) plan administration for employers since the sponsor of the pre-approved plan is responsible for plan updates, among other things. Individually designed 403(b) plan sponsors must remain vigilant regarding required plan amendments due to changes to the Internal Revenue Code, Treasury Regulations, or other guidance published by the IRS.

All 403(b) plan sponsors (whether directly or via a third-party administrator) must ensure that the day-to-day operational requirements concerning eligibility, nondiscrimination, contributions, funding vehicles, and distributions continue to be satisfied. Non-ERISA 403(b) plan sponsors may take an active role in ensuring compliance (including facilitating corrections of noncompliance) without jeopardizing the plan's safe harbor status. FAB 2007-02; Dep't of Labor Information Letter (Feb. 27, 1996).

ERISA Considerations

If ERISA applies to the 403(b) plan (see ERISA Coverage of 403(b) Plans above), the plan must satisfy the disclosure and reporting obligations under ERISA Title I, such as:

- Providing updated summary plan descriptions and, as needed, summaries of material modifications to participants for amendments
- Making plan-related documents available
- Filing Form 5500 annual reports
- Meeting ERISA fiduciary responsibilities and avoiding prohibited transactions

For a summary of ERISA responsibilities, see Fundamentals of ERISA Title I.

Pre-approved 403(b) Plans

The IRS has established a pre-approved 403(b) plan program for prototype and volume submitter plans. The sponsors of such pre-approved plans can obtain opinion or advisory letters on their plan designs, providing reassurance that their plan documents meet the necessary requirements. I.R.S. Announcement 2009-34, 2009-1 C.B. 916. The determination letter application procedures are found in Rev. Proc. 2013-22, as modified by Rev. Proc. 2014-28, 2014-1 C.B. 944, and Rev. Proc. 2015-22, 2015-1 C.B. 2015-11. Rev. Proc. 2017-4, 2017-1 I.R.B. 146.

See IRS, 403(b) Preapproved Plan Program – Key Provisions for an overview of the process and obligations of pre-approved 403(b) plan sponsors. The first favorable determinations for pre-approved 403(b) plans are expected to arrive in 2017, and the IRS has announced that the initial remedial amendment period for 403(b) plans will be March 31, 2020. This means that employers who adopt a pre-approved plan by that date can obtain retroactive relief for qualification defects arising since 2010. Rev. Proc. 2017-18, 2017-5 I.R.B. 743.

After receipt of the favorable opinion or advisory letter from the IRS, the preapproved plan sponsor for a prototype plan or volume submitter plan must take the steps below to maintain compliance:

- **Amend plan for legal changes.** Amend the plan pursuant to changes in the Internal Revenue Code, Treasury Regulations, or other guidance published by the IRS.
- **Document adopting employers.** Maintain a written record of the eligible employers that have adopted the prototype plan or volume submitter plan. The list must include the names, addresses, and employer identification numbers of all eligible employers that, to the best of the plan sponsor's knowledge, have adopted the plan. The plan sponsor must present the list to the IRS, if requested.
- **Disclose plan-related documents.** Provide to the adopting employers the plan document, any restatements thereof, all amendments, and all opinion or advisory letters, in electronic or hard copy form, and comply with the notice requirements under the program or other written guidance.
- **Adopt notification procedures.** Establish a procedure to notify adopting employers of plan amendments and restatements and of the need to timely adopt the plan and any plan restatements and the consequences for failing to do so or failing to operate the plan in accordance with plan changes.
- **Meet obligations upon discovery of noncompliance.** Upon determining that a 403(b) preapproved plan as adopted by an employer may no longer satisfy the requirements of 403(b) (in a manner that is not or cannot be corrected by the preapproved plan sponsor under the EPCRS):
    - Notify the employer that the plan may no longer satisfy I.R.C. § 403(b)
    - Advise the employer that it may incur adverse tax consequences –and–
    - Inform the employer about the availability of the EPCRS

Rev. Proc. 2013-12, as modified by Rev. Proc. 2014-28 and Rev. Proc. 2015-22.

Pre-approved Plan Document Must Prevail over Conflicting Investment Arrangement

In the event of any conflict between the terms of the preapproved plan and the terms of investment arrangements under the plan (or of any other documents incorporated by reference into the plan), the terms of the preapproved plan must govern. An eligible employer may not rely on an opinion or advisory letter issued for a 403(b) preapproved plan if any investment arrangement under the plan provides that the terms of the investment arrangement govern in the event of a conflict. Rev. Proc. 2013-12, § 4.01(9).

Limited Reliance

Even for preapproved plans, however, the opinion or advisory letter addresses whether the plan document complies with I.R.C. § 403(b). It does not address ERISA requirements (if applicable), investment arrangement terms, other documents incorporated by reference, or whether the plan operates in a compliant fashion.

For general information on pre-approved plans, see Implementing Pre-approved Master & Prototype and Volume Submitter Plans.

Correcting 403(b) Plan Errors

EPCRS for Qualification Errors

The Employee Plans Compliance Resolutions System (EPCRS) is the IRS correction program to address noncompliance issues in tax-favored retirement plans, including 403(b) plans. IRS guidance issued in 2013 substantially expanded the program's application to 403(b) plans. The most recent iteration of EPCRS is found in Rev. Proc. 2016-51, I.R.B. 2016-42. See IRS, Updated Retirement Plan Correction Procedures for an overview. Rev. Proc. 2017–18, 2017-5 I.R.B. 743, discusses the application of EPCRS to employers that amend their 403(b) plans by adopting pre-approved plan language.

The EPCRS can resolve 403(b) plan operational and documentation failures within one of the three EPCRS units:

- **Self Correction Program (SCP)**
    - No filing with the IRS or penalty is involved, but the sponsor or administrator must have reasonably designed compliance practices and procedures in place.
    - Available for unintentional (1) operational violations that are either insignificant, or (2) nonegregious significant failures that are timely addressed (generally before the end of the year after the year the violation occurred).
    - Not available for documentation errors.
- **Voluntary Correction Program (VCP)**
    - Formal filing with the IRS along with the payment of a penalty is required.
    - Available for (1) documentation errors (i.e., failing to have, or follow the terms of, a compliant plan document), and (2) operational failures.
    - Results in a compliance statement showing IRS approval of proposed correction method.
- **Audit Closing Agreement Program (Audit CAP)**
    - Program for plans under IRS audit.
    - Involves negotiated correction of an identified failure and the payment of a sanction varying depending on nature and severity of the error.

Common 403(b) plan errors corrected under SCP include failures to follow the terms of the plan document, to permit eligible employees to make salary deferrals in violation of the universal availability rule, and to comply with the annual addition limits in I.R.C. § 415. The VCP must be used for documentation errors, including to unwind a plan upon discovery that the employer is not eligible to sponsor a 403(b) plan, to correct a plan document that fails to satisfy the applicable requirements, and to correct a failure to follow the plan document or a significant operational failure after the SCP timeliness limit.

Significance of an error is based on the facts and circumstances, taking into consideration factors such as the extent, scope, and duration of the violation, the percentage of plan assets involved and number/percentage of participants affected, the timeliness of correction, and the reason for the failure.

Fiduciary Violations

Certain fiduciary errors can be corrected using the DOL's Voluntary Fiduciary Correction Program (VFCP), such as prohibited purchases, sales, and exchanges; improper loans; delinquent participant contributions; and improper plan expenses. For a 403(b) plan subject to ERISA experiencing these types of violations, a VFCP correction would generally be needed in addition to an EPCRS correction, where applicable. 71 Fed. Reg. 20135 (April 19, 2006); Dep't of Labor, Voluntary Fiduciary Correction Program.

General IRS Correction Guidance

The 403(b) Plan Fix-It Guide also serves as a quick reference for practitioners handling potential 403(b) plan mistakes. This guide contains information on how to identify and avoid errors, along with corrective actions. The Guide contains links to other relevant IRS resources on 403(b) plan rules and compliance topics.

Terminating 403(b) Plans

The 403(b) plan regulations explicitly permit employers to terminate their plans. 26 C.F.R. § 1.403(b)-10(a)(1); see also Rev. Rul. 2011-7, 2011-1 C.B. 534 (analyzing the termination of 403(b) plans and an annuity benefit money purchase plan).

In some circumstances, however, plan termination is not possible. As a precondition to termination, all plan assets must be distributed. Id. However, in some cases, plan sponsors cannot distribute some custodial accounts because the participants have not cooperated. The regulation states that "delivery of a fully paid individual insurance annuity contract is treated as a distribution," but does not refer at all to a custodial account. 26 C.F.R. § 1.403(b)-10(a)(1). And vendors of custodial accounts often take the position that because the contracts are owned by the participants, the plan sponsor has no right to force a distribution of cash without participant consent. In some cases, participants with custodial accounts cannot be cashed out because they cannot be located or refuse to consent to the distribution. This issue was highlighted in ACT, 2015 Report of Recommendations, pp. 43-48.

The inability to terminate a 403(b) plan extends the obligations of the sponsor (e.g., if covered by ERISA, it must continue to file an annual Form 5500). A sponsor that attempts to terminate a plan without fully complying with the rules risks tainting the termination and invalidating any rollover distributions made to participants who would not have had a distribution event were it not for termination of the plan.

EP Subcommittee Report: 403(b) Plan Issues and Recommendations

A 2015 report by the Employee Plans (EP) Subcommittee of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT), titled "Employee Plans: Analysis and Recommendations Regarding 403(b) Plans," analyzes several issues affecting 403(b) plans and their sponsors. ACT, 2015 Report of Recommendations, pp. 15-83. The report identifies specific areas of widespread noncompliance and recommends enhanced IRS formal or "soft" guidance and educational outreach. These areas of concern include the following:

- **Universal availability nondiscrimination rule.** As discussed above, many employers, particularly those with many short-term or part-time personnel, struggle over interpreting or implementing the universal availability rule regulations. Others are simply unaware of its existence. But the consequences of noncompliance are severe (disqualification of the plan in its entirety). The subcommittee recommended steps to increase awareness of the rule and singled out employee exclusion rules as an area deserving further clarification.

- **Orphan 403(b) contracts.** The 403(b) regulations required written plans to be in place generally by 2010, and for available contract vendors to be listed in the plan documentation. Plan sponsors are also required to coordinate plan administration with the vendors of former contracts via information-sharing agreements if any further contributions were to be made during or after 2008. 26 C.F.R. § 1.403(b)-10(b). So-called orphan contracts, issued before 2009 and frozen to new contributions (as described in Rev. Proc. 2007-71) raise some compliance questions not directly addressed in the regulations. For example, there is uncertainty as to whether operational compliance under an employee's orphan contract could taint the status of his or her active 403(b) plan contracts and accounts.

- **403(b) plan terminations.** The EP Subcommittee raised the issue discussed above under Terminating 403(b) Plans wherein some employers intending to terminate a 403(b) plan are unable to because of participant or vendor noncooperation or due to missing participants. Recommendations include further clarification of the current IRS position and, if possible, creation of a good faith or de minimis rule allowing employers to treat their 403(b) plans as terminated.

The EP Subcommittee also had several recommendations to improve the EPCRS program as it relates to 403(b) plans:

- Expand the SCP to allow corrections of certain plan loan errors.

- Extend the availability of the DOL's VFCP Earnings Calculator to compute lost earnings in more circumstances.

- Develop new VCP schedules focused specifically on common 403(b) plan problems.

- Consider lower fees for 403(b) plan sponsors due to their nonprofit status.

ACT, 2015 Report of Recommendations, pp. 49–55.

Advantages and Disadvantages of 403(b) Plans

Compared with a qualified plan such as a 401(k) plan, a 403(b) plan has several advantages:

- **Simplicity.** Often vendors will fulfill most functions.
- **No nondiscrimination testing required.** A 403(b) plan avoids the actual deferral percentage (ADP) test applicable to elective contributions in 401(k) plans and merely requires that elective contributions be universally available. This simplifies testing for the employer and means that highly compensated employees will not have their contributions limited because lower paid employees make low or no contributions.
- **Plan language available.** The IRS provides prototype language that can be used directly by preapproved plans and as a guide for individually designed plans.
- **Generous catch-up contributions.** Catch-up limitations on elective deferrals are more favorable than for 401(k) plans.
- **Limited excise taxes.** Excise taxes on excess contributions apply only if the 403(b) contract is a custodial account described in I.R.C. § 403(b)(7), as opposed to an annuity contract.
- **Excess contributions do not disqualify plan.** If excess contributions are made, only the amount in excess of the contribution limits is taxable, as opposed to disqualifying the entire plan due to the separate accounting rules under 26 C.F.R. § 1.403(b)-3.
- **Ability to avoid ERISA for nongovernmental/nonchurch employers.** By adopting a non-ERISA 403(b) plan, an eligible 403(b) plan sponsor that would normally be subject to ERISA can avoid ERISA coverage.

Notwithstanding the advantages noted above, 403(b) plans have some disadvantages compared with qualified plans that need to be considered:

- Employees, particularly those who have not previously worked for tax-exempt or governmental employers, may have less familiarity with 403(b) plans.
- Hardship withdrawals are available only for elective deferrals themselves, not for income on them as they would be under a 401(k) plan.
- In-service withdrawals are available for employer contributions only upon attainment of age 59½. This contrasts with a 401(k) plan, which can provide for in-service withdrawals of employer contributions as early as:
    - Five years after the employee begins plan participation –or–
    - Two years after the money is contributed to the plan (Rev. Rul. 1968-24, 1968-1 C.B. 150; Rev. Rul. 71-295, 1971-2 C.B. 184)
- Some states (e.g., New Jersey and Pennsylvania) impose income taxes on all 403(b) contributions.
- Fewer providers and more limited types of providers for 403(b) plans may result in relatively higher fees.