403(b) Perspectives

Insights into the Administration of §403(b) Tax-Sheltered Arrangements

SUMMER 2014

Roth Five-year Clocks

A "qualified distribution" is what the designated Roth amounts are called when they have satisfied the requirements for the earnings to be distributed tax free. To become "qualified" the designated Roth account has to satisfy the five-year period (aka the five-year clock) requirement *and* one of the following distributable events must occur:

- Attainment of age 59½,
- Death of the participant, or
- Disability of the participant as defined in Code Section 72(m)(7)

Any other distribution is treated as nonqualified. Distribution of nonqualified designated Roth funds is made on a pro rata basis with a proportion of designated Roth deferrals and earnings on the Roth. The earnings on nonqualified distributions are taxable and, if the individual is under age 59½, the taxable earnings are subject to the 10% excise penalty under Sec. 72(t), unless an exception applies.

The Five-year Clock on Recapture Tax

When a participant's pretax funds in a 403(b) plan are converted either as an in-plan Roth conversion or to a Roth individual retirement account (IRA), the 10% early distribution penalty is waived at the time of the conversion. In Notice 2010-84 (Question 12), the IRS addressed special tax rules related to in-plan Roth conversions that are distributed within five years. If any of the amount converted to a Roth is withdrawn within five years of the conversion and the individual is under age 59½, the 10% penalty tax that was waived at the time of the conversion will apply on the amount withdrawn. In fact, the IRS introduced Box 10 on Form 1099-R for the reporting of in-plan Roth rollovers (IRRs) that are withdrawn within five years of the conversion. Of course, if the individual had attained age 59½ at the time of the withdrawal of the conversion, the 10% penalty will not apply.

The five-taxable-year period for determining whether the recapture tax applies starts on the first day of the participant's tax year (generally January 1) in which the in-plan Roth conversion occurred. It ends after the last day of the individual's fifth taxable year after the conversion.

When participants under age 59½ execute an in-plan Roth conversion, the 10% early withdrawal penalty under Sec. 72(t) is waived. However, participants must wait five years before withdrawing any converted amounts. If the converted funds are

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withdrawn within five years and the participant is still under age 59½, the 10% excise tax penalty that was waived will apply under the five-year recapture tax rule. The five-year recapture tax period is separate from the five-year period that applies to achieving qualified distributions. However, if, the conversion amount was the first Roth deferral the participant made, then the two clocks would run simultaneously.

A Series of Conversions

Since participants may not be able to afford to convert their entire pretax amount to a 403(b) Roth in one year, many will wish to convert over a number of years.

Example 1: A participant has $200,000 and converts $20,000 per year for 10 years. Each year's conversion would be subject to the recapture tax for five years from the year of conversion. The $20,000 amount converted in 2014 would no longer be subject to the conversion penalty as of January 1, 2019. The $20,000 amount converted in 2015 would no longer be subject to the recapture tax as of January 1, 2020. The $20,000 amount converted in 2016 would no longer be subject to the 10% recapture tax as of January 1, 2021.

Each year's conversions would need to be tracked because of the five-year recapture tax period starting with each separate year's conversion and five buckets would be needed to track the ongoing conversions properly. Specifically:

Conversions Done in	No Longer Subject to Recapture	Bucket*
2014	January 1, 2019	A
2015	January 1, 2020	B
2016	January 1, 2021	C
2017	January 1, 2022	D
2018	January 1, 2023	E
2019	January 1, 2024	A
2020	January 1, 2025	B

Etc.

* Once each bucket's funds complete the five years, those funds can be moved to the regular Roth deferral bucket.

1099-R Reporting

Page 3 of the 2014 instructions for Forms 1099-R and 5498 contains the following guidelines for reporting amounts subject to the recapture tax: "Distributions allocable to an in-plan Roth rollover (IRR). The distribution of an amount allocable to the taxable amount of an in-plan Roth rollover (IRR), made within the 5-year period beginning with the first day of the participant's tax year in which the rollover was made, is treated as includible in gross income for purposes of applying section 72(t) to the distribution. The total amount allocable to such an IRR is reported in box 10. See the instructions for *Box 10*, later."

Recap — Two Independent Clocks

Plans that allow for designated Roth contributions and in-plan Roth conversions must track the five-year Roth clock for purposes of determining if the Roth distribution is a "qualified distribution" and must also track a separate five-year Roth clock for purposes of determining whether in-plan Roth rollover amounts withdrawn from the plan are subject to a recapture tax. Separate five-year clocks must be tracked for each year in which a participant makes an in-plan Roth conversion.

Note: The post-conversion clock and the qualified distribution clock operate independently of each other unless the conversion also happened to be the first Roth deferral ever made by that participant, in which case the two clocks would run concurrently.

For a participant with designated Roth deferrals in the plan at the time he or she makes an in-plan Roth conversion, the five-year clock for purposes of determining qualified distributions is already running. It does not start over for the in-plan conversion amounts. The five-year period from the first Roth contribution applies only to the five-year requirement for tax-free earnings. The five-year period for recapture tax purposes must be tracked independently from the five-year clock for qualified distributions. ■

Universal Availability's Effective Opportunity Requirement

The 403(b) universal availability rule is required to be satisfied in lieu of the general coverage and nondiscrimination testing. Therefore, under the universal availability rules, a 403(b) arrangement does not need to perform the average deferral percentage (ADP) test. However, to satisfy the universal availability rules, if the 403(b) arrangement permits any employee to defer, then it must provide all employees, subject to certain statutory exceptions, the opportunity to make elective deferrals to the 403(b) plan. In addition, if the plan offers the ability to make a 403(b) designated Roth deferral, then it must make the designated Roth deferral option available to all employees. The universal availability rule applies to all 403(b) arrangements except church plans.

The final 403(b) regulations, (in the Federal Register of July 26, 2007), clarify the application of the universal availability rule. Satisfying universal availability consists of two aspects, "eligibility" and "effective opportunity."

Eligibility

Universal availability permits the following employees to be excluded: (1) employees who are eligible for another deferral plan of the employer, such as a 403(b), governmental 457(b), or 401(k), (2) employees who are nonresident aliens, (3) students performing work study services, and (4) employees who normally work less than 20 hours per week. A 403(b) plan may be written to exclude employees who will not be deferring at least $200 annually. Strangely, the regulations do not include an exclusion for collectively bargained employees.

Improperly excluding classes of employees, such as school janitors, school secretaries or part-timers, from the ability to defer is a common error that is an example of a universal availability eligibility failure. We have focused on eligibility in an earlier newsletter, this article will focus on satisfying the effective opportunity requirement of the 403(b) universal availability rule.

Effective Opportunity

The final 403(b) regulations require that a Section 403(b) plan will satisfy the effective opportunity requirement "only if, at least once during each plan year, the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election." Most plans allow changes more than once a year. This rule applies to common-law employees in both ERISA and non-ERISA 403(b) plans, other than church plans. The concern is how to annually satisfy the requirement to make the employee aware that he or she has the effective opportunity to defer.

Example: Butler Hospital sponsors a 403(b) plan. Dennis has worked for Butler Hospital for 29 years, is eligible to participate in the hospital's 403(b) plan, but has never chosen to participate. Despite the fact that Dennis has never contributed elective deferrals to the plan, Butler Hospital must notify Dennis at least annually that he is eligible to participate.

Whether an employee has been provided an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

Best practices would suggest that employers should develop a strategy to identify which employees are eligible for their 403(b) plan and ensure these employees are notified annually of their eligibility to participate. Since all employees are eligible with the very limited eligibility exclusions above, this should be able to be accomplished.

Although there is no formal effective opportunity notice requirement in the regulations, many employers have adopted such a notice to ensure compliance. There are various methods for an employer to satisfy effective opportunity notice requirements. Options include employer newsletters, if delivery is assured to all employees, custom "stand-alone" notices, clearly adding the language to an existing annual plan notices (safe harbor and automatic enrollment), and payroll stuffers.

Nowhere in the regulations does it specify when the employee must be entered into the plan. To satisfy universal availability, the best practice would be to have an immediate entry date for elective deferrals. Keep in mind that if the 403(b) plan has either employer matching or nonelective contributions, those contribution types may have an eligibility period of up to one or two years and a plan entry date to participate. For example, an employer may

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Universal Availability's Effective Opportunity Requirement

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impose a one-year service requirement with entry dates of January 1 and July 1 for matching and non-elective contributions.

The regulations provide a special list of universal availability exceptions in paragraph 1.403(b)-5(b)(4)(ii):

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

(B) Employees who are eligible to make a cash or deferred election under a Section 401(k) plan of the employer.

(C) Employees who are non-resident aliens with no U.S. sourced income.

(D) Employees who are students performing work-study services described in Section 3121(b)(10); (subject to the conditions applicable under Section 410(b)(4) (including Section 410(b)(4)(B) permitting separate testing for employees not meeting minimum age and service requirements)).

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

Note the special additional regulatory provision for D and E above. Specifically, although D or E may be written in the plan as a class exclusion, if any one individual in the excluded group satisfies the statutory rule of working 1,000 hours within a 12-month period, the entire group can no longer be excluded from the plan. Thus, all the employees in that group must be allowed to defer at that point. This rule is in the regulations at 1.403(b)-5(b)(4)(i):

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

IRA-to-IRA Rollover Rules

The Internal Revenue Service (IRS) recently announced (Announcement 2014-15) that individuals will be permitted only one IRA-to-IRA rollover per 12-month period. In an IRA-to-IRA rollover, an individual receives a distribution from one of his or her IRAs and has 60 days to deposit the same amount into an IRA to avoid the distribution being treated as taxable income. The guidance is significant because it is a change in position from the guidance on the subject in IRS Publication 590, *Individual Retirement Arrangements (IRAs)*, which has existed for decades. Announcement 2014-15 adopts language from the Internal Revenue Code (brought to light by a Tax Court case) specifying that an individual can perform only one tax-free IRA-to-IRA rollover per one-year period. The one-year period is measured from the date of the initial distribution and not based on a calendar year. It is important to note that the restriction does not apply to trustee-to-trustee transfers. There is no limit on the number of IRAs that may be transferred directly from one provider to another in a 12-month period.

Prior to this guidance, if an individual had multiple IRAs, the understanding was that the 12-month rule applied to each individual IRA. The rule change restricting IRA-to-IRA rollovers to one per 12-month period is based on the aggregate of an individual's IRAs. For example, if an individual has three IRAs — A, B, and C — and rolls IRA A into IRA B, the individual cannot perform a similar type of rollover for 12 months from the date of the distribution from IRA A.

IRS Publication 590 is issued annually to help taxpayers prepare their Form 1040 series tax returns. For over two decades, it has included language that contradicts the position taken by the IRS in Announcement 2014-15. As a result, the IRS will not enforce this change for rollovers that occurred prior to January 1, 2015. And it will be revising Publication 590 at some point to reflect this change in position. ■

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