403(b) Perspectives

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

SPRING 2015

IRS Audits of 403(b) Plans

Top seven issues identified during IRS examinations of 403(b) plans.

1. Excess IRC Section 402(g) contributions, including violating the 15-year rule limitations

The amount of salary reduction contributions exceeds the annual dollar limitation of $18,000 in 2015. The excess may be the result of poor internal controls or failure to aggregate deferrals made to other 403(b) or 401(k) plans. Violations of the 15-year catch-up rule occur where the employee has exceeded the $15,000 lifetime limitation or where the employee is not employed by an eligible employer.

2. Universal availability, IRC Section 403(b)(12)(A) excluding eligible employees from participation, usually part-time employees that would qualify to participate

Eligible employees are not given the right to make salary reduction contributions. Employers often misapply ERISA eligibility and coverage conditions to employees who are otherwise eligible to make salary reduction contributions under IRC Section 403(b)(12).

3. Excess Section 415 contributions made

Generally, the sum of elective deferrals and employer contributions cannot exceed the lesser of $53,000 for 2015 or 100% of includable compensation.

4. Plan loans that violate IRC Section 72(p)

Common violations include: failure to make required payments when due, resulting in default of the entire loan; poor documentation; and loans from multiple vendors that in the aggregate exceed the IRC Section 72(p) limits.

5. Hardship distribution failures (IRC Section 403(b)(11)(B))

Common violations include: inadequate documentation that the distribution is the result of a financial hardship and distributions from multiple vendors that in the aggregate exceed the amount needed to relieve the hardship.

6. IRC Section 403(b) annuity contract problems

The annuity contract is outdated and has not been updated for current requirements such as for IRC Section 402(g) contribution limitations, IRC Section 401(a)(9) required distributions, and IRC Section 401(a)(31) eligible rollover requirements. Also, new endorsements are not being given out to all annuity contract holders.

7. Ineligible plan sponsors of IRC Section 403(b) plans

IRC Section 403(b) – The organization must qualify as a public educational organization or be exempt under IRC Section 501(c)(3).

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Plan Design and After-tax Contributions

Recent IRS guidance has created a new interest in "after-tax" contributions as a plan provision because they can be used to maximize plan contributions and reduce future tax liabilities. Note: After-tax contributions are not the same as designated Roth contributions.

With proper plan design, after-tax contributions can be a valuable benefit to plan participants. Following is a discussion of some strategies and caveats.

After-tax Contribution Basics

After-tax contributions are not elective deferrals and therefore are not subject to the annual Section 402(g) maximum deferral limit ($18,000 for 2015). After-tax contributions are not counted when determining additional contributions under the "15-year catch-up" rule. However, they are subject to the annual Section 415 limit ($53,000 for 2015; $59,000 for individuals age 50 or older eligible to make catch-up contributions of $6,000).

Conversion via IRR

A plan that permits both after-tax contributions and designated Roth contributions could be designed to also permit in-plan Roth rollovers (IRRs). This would allow participants to convert after-tax contributions into designated Roth amounts. Earnings on converted after-tax amounts would be taxed in the year of the IRR. However, future earnings would not be taxed when distributed, provided they satisfy the qualified distribution requirements (generally, that designated Roth contributions began five or more years ago and the participant is age 59½ or older).

Example: Steve is age 60 and earns $225,000 in 2015. He makes $24,000 in designated Roth contributions ($18,000 + $6,000 catch-up), $20,000 in after-tax contributions, and receives a profit sharing contribution of $15,000. At the end of 2015, he converts his after-tax contributions plus earnings of $500 (a total conversion amount of $20,500) into designated Roth amounts. He will owe tax on the $500 of earnings in 2015. Steve now has an additional $20,500 in designated Roth money in his account. Assuming the additional amounts eventually become qualified distributions, Steve will have more tax-free income than if he made only designated Roth contributions to the plan.

Potential Issues

Including after-tax contributions in a plan can pose testing and administrative issues. "One-participant" plans (plans covering a business owner with no employees or a business owner plus spouse) face the fewest issues. Plans with nonhighly compensated employees (NHCEs) face the greatest number of challenges because nondiscrimination testing must be performed on after-tax contributions.

ACP Testing

Actual contribution percentage (ACP) testing is generally required for plans with employer matching contributions. After-tax contributions are also subject to annual ACP nondiscrimination testing. If a plan has both after-tax and matching contributions, they are tested together in one ACP test. Note that safe harbor 403(b) plans are required to perform an ACP test for any after-tax contributions that are made; safe harbor matching contributions are exempt from testing.

After-tax contributions are typically made by highly compensated employees (HCEs) who wish to contribute more than the annual 402(g) deferral limit allows. Since plans with HCEs often have nondiscrimination testing issues, such plans may face even greater testing issues if they allow after-tax contributions. One way to minimize the impact of after-tax contributions on nondiscrimination testing is to administratively limit the amount of after-tax contributions individuals can make for each plan year.

415 Limitations

IRC Section 415 rules limit the total amount that can be contributed to a participant's account on an annual basis. Participants who make after-tax contributions need to be aware of that limit. Otherwise, they might run into a situation where an employer contribution causes them to exceed the annual 415 limit. If the 415 limit is exceeded, the participant must receive a corrective distribution of the excess amount. After-tax contributions are generally the first type of contribution to be refunded.

Example: Ed is age 43. In 2015, he makes $18,000 of designated Roth contributions and $25,000 of after-tax contributions. After the end of the plan year, Ed's employer makes a $12,000 profit sharing contribution to his account. Ed has exceeded the Section 415 limit of $53,000 for 2015 by $2,000 and must receive a $2,000 refund from his after-tax contributions (adjusted for earnings/losses). Refunded after-tax contribution amounts are not taxable, but the earnings associated with the refunded amounts are.

Like deferrals, after-tax contributions are also not included in the employer's annual 25% deduction limit. ■

Portability Chart

Rollover to Recipient Plan/Account							
TO:	Traditional and SEP IRA	SIMPLE IRA	403(b)	Gov't 457(b)	Qualified Plan	Roth 401(k), 403(b), and 457(b)	Roth IRA
FROM:							
Traditional and SEP IRA	Y[g]	N	Y[a]	Y[a]	Y[a]	N	N[f]
SIMPLE IRA	Y[b]	Y[b]	Y[b]	Y[b]	Y[b]	N	Y[b]
403(b) other than Roth 403(b)	Y	N	Y[d]	Y	Y[d]	Y[d]	Y[e]
Gov't 457(b)	Y	N	Y	Y	Y	Y	Y[e]
Qualified plan other than Roth 401(k)	Y	N	Y[d]	Y[c]	Y[d]	Y	Y[e]
Designated Roth 401(k), 403(b), or 457(b) by direct rollover	N	N	N	N	N	Y	Y
Roth IRA	N	N	N	N	N	N	Y

SUPERSCRIPT LEGEND

a Only pretax amounts from an IRA or SEP may be rolled to these plans.

b Rollovers from SIMPLE IRAs are prohibited until after two years of participation.

c Pretax amounts only.

d After-tax amounts may be received only by direct transfer or direct rollover.

e PPA permits direct rollover from a non-Roth qualified plan source, non-Roth 403(b) source, and governmental 457(b) to a Roth IRA as of 2008. However, the direct rollover pretax amount is taxable in the year directly rolled to a Roth IRA. As of 2010, TIPRA permits conversion to a Roth IRA without AGI limit and without the joint return filing requirement for married individuals.

f Traditional and SEP IRAs may not be rolled into a Roth IRA, but there is a conversion process. As of 2010, TIPRA permits conversion to a Roth IRA without AGI limit and without the joint return filing requirement for married individuals.

g Beginning in 2015, only one IRA-to-IRA rollover per 12-month period, regardless of how many IRAs.

IRS Audits of 403(b) Plans

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Some examples of failures are of a charitable hospital with a 403(b) plan being taken over by a local government entity and not terminating the 403(b) plan.

The IRS is currently auditing 403(b) plans for the 2009 to 2012 years. They are checking for plan documents as of the 2009 plan year. Excerpts from the items on the current IRS audit list include reviewing many written procedures. Make sure to have written procedures for the following:

- Procedures for monitoring the multiple contribution limits under 403(b), including: regular limit; 15-year catch-up rule; and age 50 catch-up
- Procedures on correcting excess contributions and excess deferrals and documentation on those corrected and reported
- Written hardship procedures, including a list of all participants who received hardship distributions; copies of the application with backup info to verify the participant's hardship; copies of the Form 1099-R; copies of notification letters for the employer/employee for six-month suspension and resuming salary deferrals. If a vendor is involved in approving hardships, include a copy of their procedures, distribution notices, and forms
- Written procedures for submitting employee's deferrals to the vendors or plan and how often the deferrals are submitted
- Universal availability procedures
- Procedures for determining eligibility
- Procedure for keeping track of loans and deemed distributions of loans, reporting of deemed distributions, copies of withholding notices, and 1099-R Forms
- Procedures for distributions of participant accounts under $5,000, including automatic rollovers of under $5,000 to "deemed IRAs"
- QDRO procedures and administration information

IRS auditors are also looking for the following:

- Copies of plan documents and amendments from the inception of the plan through the audit date
- List of employees excluded from any retirement plans offered
- List of employees eligible to participate in the plans offered
- Copies of all administrative forms, including salary reduction agreements
- Copies of benefit booklets and enrollment material
- Counting years of service for permanent part-time employees (partial years), substitute teachers, temporary employees, retired rehired teachers, and regular part-time employees. Counting hours if employer excludes employees under the "20-hour rule"
- Copies of the annual vendors reviews, which should include the review of all administrative forms and custodial agreements and annuity contracts used by each vendor, including distribution procedures of periodic distributions; non-periodic distributions; vendor procedures for keeping track of when a participant reaches age 70½ (and the minimum calculation) and when the Form 1099-R is provided. Procedures must also include how the TPA's (or vendor's) system handles state withholding
- Details on how the employer keeps informed and updated on any regulatory and legislative changes affecting 457(b) and 403(b) plans
- Info on computer records that are maintained to keep track for Forms W-2, W-3, and Forms 1099, 940, and 941 and the master payroll files ■