403(b) Perspectives

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

WINTER 2015

Allocating Pretax and After-tax Amounts Among Multiple Distributions

Since 2010, the IRS model 402(f) notice stated that a partial direct rollover of assets from a participant who had pretax and after-tax amounts was to include a pro rata amount of pre-tax and after-tax. This was not entirely correct and thus, the IRS recently issued guidance and a new 402(f) model notice explaining how distributions for participants with after-tax are to be handled when a participant schedules the distribution to go to multiple destinations at the same time.

Here's an example: A participant wants a portion of a distribution to go to a new employer's 403(b), a portion to a traditional IRA, and the balance to come to him. According to the guidance, all plan distributions that are scheduled to be made at the same time will be treated as a single distribution without regard to whether the distributed amounts are made to a single destination or multiple destinations. These rules apply to distributions from §403(b) plans, from qualified plans, such as 401(k) plans, and to governmental §457(b) plans.

Background

Internal Revenue Code Section 72(e)(8) requires that partial distributions from participant accounts that contain both pretax and after-tax amounts include pro rata shares of both amounts. IRS Notice 2009-68 provided two model distribution notices with safe harbor explanations that plans can give individuals who will be receiving eligible rollover distributions. The explanations state that when individuals have one portion of their account directly rolled over and another portion paid to themselves, each of the payments will include an allocable portion of the after-tax contributions.

The new guidance incorporates Section 402(c)(2), which says that when the amount transferred to a new employer plan or a traditional IRA contains pretax and after-tax amounts, the pretax amount will be distributed first. Thus, this guidance provides an ordering of the application of the two code sections, i.e., first 72(c)(8) is applied to the partial distribution (to calculate a proportional after-tax and pretax amount) and then 402(c)(2) is used

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to send the pretax amount first, when multiple destinations are scheduled at the same time.

Applying the new rules

The IRS notice contains examples that clarify how payouts that include after-tax amounts and go to multiple destinations will work under the new rules.

The following facts apply in all four examples:

- The plan has no designated Roth provisions
- The participant has a total account balance of $250,000: $200,000 pretax, $50,000 after-tax
- $200,000 (pretax) ÷ $250,000 (account total) = 80% is pretax
- Participant severs service and requests a distribution of $100,000
- Pro rata amounts = $80,000 pretax and $20,000 after-tax

In example one, the participant specifies a distribution of $70,000 by direct rollover to the qualified plan of a new employer

- All $70,000 is pretax

The participant requests that $30,000 be paid to him

- $10,000 is pretax, subject to the 20% income-tax withholding
- $20,000 is after-tax

Within 60 days, the participant rolls $12,000 into a traditional IRA

- $10,000 is pretax
- $2,000 is after-tax

In example two, the participant specifies a distribution of $82,000 by direct rollovers

- $50,000 to the qualified plan of the new employer
- $32,000 to a traditional IRA
- $80,000 of this amount is pretax and $2,000 is after-tax
- The participant is permitted to allocate the pretax amounts between the IRA and the qualified plan and is to inform the administrator of the choice

The participant requests $18,000 to be paid to himself

- All $18,000 is after-tax

In example three, the participant specifies a distribution of $100,000 by direct rollovers

- $80,000 to a traditional IRA
- $20,000 to a Roth IRA
- The participant is permitted to allocate the entire pretax portion to the traditional IRA and the entire after-tax portion to the Roth IRA

Effective date and other issues

The new rules generally apply to distributions made on or after January 1, 2015. However, taxpayers are permitted to apply the rules to distributions made on or after September 18, 2014. The IRS also updated safe harbor explanations that can be used to satisfy §402(f) notice requirements.

The IRS also issued a proposed rule to change the rollover distribution regulations for designated Roth accounts so that a direct rollover and a 60-day rollover by a participant are not treated as separate distributions.

Some plan sponsors are considering adding an after-tax source so that more money could be added to the plan. After-tax funds could also be rolled over (i.e., converted) to a designated Roth 403(b) account within the 403(b) plan. However, please note that after-tax contributions are subject to the Section 415 annual additions limit ($53,000 for 2015) and to ACP testing. ■

403(b) and Qualified Plan Annual Additions Issue

The Section 415 annual additions limit is applicable to 403(b) plans. There is an aggregation of all 403(b) plans of the same employer for the annual additions limit ($53,000 in 2015), including related employers. Like qualified plans, if an employee participates in more than one 403(b) plan in a year with unrelated employers, the Section 415 limit applies separately for each employer. However, with a 403(b), the 415 annual additions limit is generally applied as if the *employee, and not the employer*, maintains the plan. Thus, generally, the 403(b) plan is not aggregated with the qualified plan for 415 purposes.

Example 1

A tax-exempt hospital has two plans, a 403(b) plan and a profit sharing qualified plan. There is no 401(k) provision in the profit sharing plan.

- Doctor A defers $18,000 to hospital 403(b) for 2015.
- Hospital matches it with $6,000.
- Hospital allocates $43,000 in profit sharing plan for Doctor A.
- Between the two plans, a total of $67,000 is allocated for Doctor A for the year.

The $24,000 in the 403(b) plan is treated as Doctor A's own plan while the $43,000 in the profit sharing plan is treated as the hospital's plan. Thus, the Section 415 annual additions limit is not violated, because neither amount exceeded the annual additions limit.

415 Limitation Issues

Special aggregation rule requires 403(b) plan to be aggregated with qualified plans for annual additions limit **if** the participant controls an employer. In such a case, for 415 annual additions purposes, the 403(b) plan will be aggregated with all the defined contribution plans that the participant maintains as the one in control of the employer. For 415 limitation purposes, the employer will be treated as if it also maintains the 403(b) plan. Further, control for 415 additions purposes is defined as having more than 50% ownership in the other business (lowered from the 80% usually used for controlled group purposes).

Example 2

Doctor B works for a tax-exempt hospital and has controlling ownership of his outside medical practice. The hospital has a 403(b) plan. Doctor B maintains a profit sharing plan for his medical practice. Due to Doctor B's controlling interest, the hospital's 403(b) and his qualified plan are combined for 415 annual additions. However, the aggregation is only with respect to the annual additions for Doctor B's benefits under the 403(b) plan and the profit sharing plan. Other employees who work for both entities have no control over the medical practice; thus, they are not subject to aggregating 403(b) and profit sharing annual additions.

Occurrence of Excess Annual Additions in a 403(b), Example 3

Expanding the fact set in example 2, Doctor B works for a hospital with a 403(b) plan. Doctor B owns 100% of Corporation B, with a profit sharing plan.

In 2015, the hospital has a great year and contributes $25,000 for Doctor B to the 403(b) plan.

Corporation B contributes $40,000 to the profit sharing plan for Doctor B. As Doctor B controls Corporation B, the 403(b) plan and profit sharing plan are to be aggregated.

Doctor B's aggregate annual addition is $65,000. Thus, there is a $12,000 Excess Annual Addition ($65,000-$53,000).

The excess annual addition is to be corrected from the 403(b) plan. $12,000 of the $25,000 contributed to the 403(b) plan is considered a disqualified contribution and is currently includable in Doctor B's gross income. 403(b) compliance requires a separate account to be maintained for the disqualified contributions. Citation: §§1.415(a)-1(b)(2) and 1.403(b)-3(b). There is a similar example in §1.415(g)-1(b)(3)(iv)(C)(2).

Correction of Excess Annual Additions in a 403(b)

If the §415(c) annual additions limit is exceeded, the amount in excess is treated as a §403(c) contract, (rather than a §403(b)). The remaining portion of the contract continues to be subject to IRC §403(b), ***if*** separate accounts are maintained for 403(b) and 403(c) portions of the contract for the year of the excess and each year thereafter. Failure to separately account for the excess annual additions can result in the immediate taxation of the affected participant's entire 403(b) contract. Citation: §1.415(a)-1(b)(2) and §1.403(b)-3(b)(2). (The Regulations were written so that the term contract includes both 403(b)(1) annuity contracts and 430(b)(7) custodial arrangements.) ■

2015 COLA Limits

The IRS has released the cost-of-living adjustments applicable to the dollar limitations for pension plans (and other items) for the 2015 tax year.

IRS Limits	2015	2014
401(k), SARSEP, 403(b), and 457 plan deferrals/catch-up	$18,000/$6,000	$17,500/$5,500
SIMPLE plan deferrals/catch-up	$12,500/$3,000	$12,000/$2,500
Compensation defining highly compensated employee*	$120,000	$115,000
Compensation defining key employee/officer	$170,000	$170,000
Defined benefit plan limit on annual benefits	$210,000	$210,000
Defined contribution plan limit on annual additions	$53,000	$52,000
Maximum compensation limit for allocation and accrual purposes	$265,000	$260,000
IRA contributions/catch-up	$5,500/$1,000	$5,500/$1,000
SEP minimum compensation for an allocation	$600	$550
QLAC maximum	$125,000	$125,000
SSA compensation limit	$118,500	$117,000

* 2014 amount for use in 2015 plan year tests

Traditional IRA changes. There are also changes in 2015 to the adjusted gross income (AGI) "phaseout" limits for determining what portion of contributions to a traditional IRA are deductible. For taxpayers who are active participants filing a joint return (or a qualified widow(er)), the deduction is at a phase out with a combined AGI of $98,000 to $118,000 (up from $96,000 to $116,000). For taxpayers other than "married filing separate returns," the deduction phaseout is $61,000 to $71,000 AGI (up from $60,000 to $70,000). For a taxpayer who is not an active participant but whose spouse is an active participant, the deduction phaseout range is at a combined AGI of $183,000 to $193,000 (up from $181,000 to $191,000).

Roth IRA changes. There is also an AGI-based limitation for determining the maximum Roth IRA contribution. For married taxpayers filing a joint return (or a qualified widow(er)), the contribution phaseout is from $183,000 to $193,000 (up from $181,000 to $191,000). The AGI phaseout range for single taxpayers is $116,000 to $131,000 (up from $114,000 to $129,000). ■

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