PART XI: TAX SHELTERED ANNUITIES FOR EMPLOYEES OF SECTION 501(C)(3) ORGANIZATIONS AND PUBLIC SCHOOLS

3907. What are the tax benefits of a tax sheltered annuity?

A tax sheltered annuity is a deferred tax arrangement expressly granted by Congress in IRC Section 403(b). An employee can exclude from his or her gross income, within limits, the contributions paid to an annuity for the employee's retirement or amounts paid to a custodian for the purchase of stock in regulated investment companies (Q 3909). The plan may be used by only certain employers (Q 3908). An employee generally must report the payments received under the contract or custodial account as taxable income (Q 3958).

A plan must meet specific requirements (Q 3910, Q 3913), although some but not all failures to meet these requirements may be subject to correction under the Employee Plans Compliance Resolution System ("EPCRS").[1]

Planning Point: Most common problems can now be corrected under EPCRS, but many corrections are slightly different than for similar problems under 401(a) plans.

Final 403(b) Regulations. Final regulations concerning tax sheltered annuity contracts were released and became effective on July 26, 2007, and generally apply for tax years beginning after December 31, 2008.[2]

3908. What organizations can make tax sheltered annuities available to their employees?

An organization must be either a tax-exempt organization of one of the types described in IRC Section 501(c)(3) or a public school system. An organization in either of these two categories may make tax sheltered annuity benefits available to one or more of its full-time or part-time employees.

A participant must be an employee; persons working for an organization in a self-employed capacity generally are not eligible.[3]

A tax sheltered annuity also may be purchased for a duly ordained, commissioned, or licensed minister of a church by the minister himself if the minister is self-employed or by an organization that employs the minister and with respect to which the minister shares common religious bonds.[4] This definition includes chaplains (Q 3926).

IRC Section 501(c)(3) organizations are nonprofit organizations that are organized and operated exclusively for religious, charitable, scientific, literary, educational, or safety testing

[1] See Rev. Proc. 2008-50, 2008-35 IRB 464, as modified and superseded by Rev. Proc. 2013-12, 2013-4 IRB 313.

[2] Treas. Reg. §1.403(b)-11(a).

[3] IRC Sec. 403(b)(1).

[4] IRC Secs. 403(b)(1)(A)(iii), 414(e)(5).

purposes, or for the prevention of cruelty to children or animals. Organizations other than public schools that are wholly owned by a state or other local government generally are not eligible employers. Some of these organizations will qualify as 501(c)(3) organizations if they are separately organized, are not an integral part of the government, and meet the description of a 501(c)(3) organization, such as some state or city hospitals.[1]

A school or college that is operated exclusively for educational purposes by a separate educational instrumentality may qualify doubly, both as a public school and as an IRC Section 501(c)(3) organization.[2] A state department of education may qualify as a part of a public school system if its services involve the operation or direction of the state's public school program.[3] Likewise, a state agency that administers a guaranteed student loan program and is part of a state department of insurance may qualify.[4] Thus, annuities may be purchased for employees of these organizations as well as public school teachers, teachers in private and parochial schools, school superintendents, college professors, clergymen, and social workers.

A doctor who works as an employee for a hospital is eligible provided the hospital is a qualified employer. A doctor generally is not eligible, however, unless the doctor is an employee of the hospital for all purposes, such as Social Security and withholding tax purposes. If the doctor's relationship to the hospital is that of an independent contractor, the doctor is not eligible and any premiums paid on the doctor's behalf for an annuity will be currently taxable.[5]

Although teachers who are covered under a state teachers' retirement system also may participate in a tax sheltered annuity plan, the employees of the retirement system itself are not eligible.[6] The Uniformed Services University of the Health Sciences will be treated as a 501(c)(3) employer for purposes of providing tax sheltered annuities for employee members of a civilian faculty or staff with respect to service after December 31, 1979.[7]

3909. How may a tax sheltered annuity plan be funded?

Annuity Contracts. IRC Section 403(b) provides that the tax sheltered annuity rules apply if an annuity contract is purchased for an employee. Final regulations provide that an annuity contract means a contract that is issued by an insurance company qualified to issue annuities in a state and that includes payment in the form of an annuity.[8] A custodial account also is treated as an annuity contract.[9] In addition, retirement income accounts are treated as annuity contracts.[10]

[1] Rev. Rul. 55-319, 1955-1 CB 119, as modified by Rev. Rul. 60-384, 1960-2 CB 172; Rev. Rul. 67-290, 1967-2 CB 183.

[2] See *Est. of Johnson v. Comm.*, 56 TC 944 (1971), *acq.*, 1973-2 CB 2; Let. Rul. 7817098.

[3] Rev. Rul. 73-607, 1973-2 CB 145.

[4] See Let. Rul. 9438031.

[5] Rev. Rul. 66-274, 1966-2 CB 446; Rev. Rul. 70-136, 1970-1 CB 12; *Azad v. U.S.*, 388 F.2d 74 (8th Cir. 1968); see also Rev. Rul. 73-417, 1973-2 CB 332; *Ravel v. Comm.*, TC Memo 1967-182; *Haugen v. Comm.*, TC Memo 1971-294.

[6] Rev. Rul. 80-139, 1980-1 CB 88.

[7] P.L. 96-613 Sec. 104

[8] Treas. Reg. §1.403(b)-2(b)(2).

[9] Treas. Reg. §1.403(b)-8(d)(1).

[10] Treas. Reg. §1.403(b)-9(a).

An individual or group insurance company annuity contract that provides fixed retirement benefits may be used. A single group annuity contract that pools the assets of an employer's tax sheltered annuity plan and defined contribution plan also may be used where the assets of each plan are separately accounted for at the plan level and at the participant level through the use of sub-accounts.[1]

The IRS has ruled that a variable annuity contract will qualify.[2] A variable annuity contract in which the contract holder directs the investments in publicly available securities (i.e., mutual funds) will be treated as an annuity contract and the contract holder will not be treated as owning the underlying assets if certain conditions are met.

For contracts intended to qualify as annuity contracts under IRC Section 403(b), that status will be granted if no additional federal tax liability would have been incurred if the employer of the contract holder had instead paid an amount into a custodial account in an arrangement under IRC Section 403(b)(7)(A).

In other words, a contract holder will receive the same favorable tax treatment whether the investment in publicly available mutual fund shares is made through a mutual fund custodial account or variable annuity contract. The diversification rules under IRC Section 817(h) for variable annuity contracts are not applicable to IRC Section 403(b) contracts. The revenue procedure, which was effective on November 16, 1999, with respect to all taxable years, will not be applied adversely to an issuer or holder of a contract issued before November 16, 1999.[3]

Face Amount Certificates. The IRC expressly provides that so-called face amount certificates are to be treated as annuity contracts.[4]

Regulated Investment Company Stock. According to the final regulations, custodial account means a plan or a separate account under a plan in which an amount attributable to 403(b) contributions or an amount rolled over to a 403(b) contract is held by a bank or certain other entities, as discussed below, if:

(1) all of the amounts held in the account are invested in stock of a regulated investment company;

(2) the distribution restrictions that apply to custodial accounts are satisfied with respect to the amounts held in the account;

(3) the assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries; and

(4) the account is not part of a retirement income account.

[1] Let. Rul. 9422053.

[2] Rev. Rul. 68-116, 1968-1 CB 177.

[3] Rev. Proc. 99-44, 1999-48 IRB 598, *modifying* Rev. Rul. 81-225, 1981-2 CB 12.

[4] IRC Sec. 401(g). See also Treas. Reg. §1.401-9(a).

The custodial account rule is not satisfied if the account includes any assets other than regulated investment company stock.[1] The custodian must be a bank, insured federal credit union, building and loan association or other person satisfactory to the IRS.[2]

State Teachers' Retirement System. According to the final regulations, the requirement that a contract be issued by an insurance company qualified to issue annuities in a state does not apply if one of the following two conditions is, and continuously has been, satisfied since May 17, 1982: (1) benefits are provided from a separately funded retirement reserve that is subject to supervision of the state insurance department, or (2) benefits are provided from a fund that is separate from the fund used to provide statutory benefits payable under a state teachers' retirement system to purchase benefits that are unrelated to the basic benefits provided under the retirement system, and the death benefit under the contract does not at any time exceed the larger of the reserve or the contribution made for the employee.[3]

Credit Union Share Accounts. The IRS takes the position that separate nonforfeitable share accounts in a credit union may not be considered annuity contracts for purposes of IRC Section 403(b).[4]

Retirement Income Accounts of Churches. Churches are permitted to maintain a retirement income account that will be treated as a tax sheltered annuity (Q 3926).[5]

According to the final regulations, a life insurance contract, endowment contract, health or accident contract, or property, casualty, or liability insurance contract do not meet the definition of an annuity contract.[6] If a contract issued by an insurance company provides death benefits as part of the contract, however, then that coverage is permitted assuming that those death benefits do not cause the contract to fail to satisfy any requirement applicable to Section 403(b) contracts; that is, assuming that those benefits satisfy the incidental benefit rule under Treasury Regulation Section 1.403(b)-6(g). The special rule for life insurance contracts does not apply to a contract issued before September 24, 2007.[7]

Multiple contracts are considered a single contract for purposes of applying the 403(b) rules; consequently, separate insurance contracts may be purchased as part of a 403(b) annuity plan. These insurance contracts must meet the form requirements and all the limitations of an IRC Section 403(b) annuity contract. It does not appear to matter whether the form requirements and limitations are imposed by means of an endorsement to the insurance policy,[8] an addendum to the salary reduction agreement,[9] or a trust agreement.[10]

[1] Treas. Reg. §1.403(b)-8(d).

[2] IRC Sec. 403(b)(7).

[3] Treas. Reg. §1.403(b)-8(c)(3).

[4] Rev. Rul. 82-102, 1982-1 CB 62. See *Corbin v. U.S.*, 760 F.2d 234 (8th Cir. 1985).

[5] Treas. Regs. §§1.403(b)-8(e), 1.403(b)-9(a).

[6] Treas. Reg. §1.403(b)-8(c)(2); see also Treas. Reg. §1.401(f)-4(e).

[7] Treas. Reg. §1.403(b)-8(c)(2). See also Treas. Reg. §1.403(b)-11(f).

[8] See Let. Ruls. 9713022 (variable universal life policy), 9626042, 9336054, 9336053, 9327025, 9324042, 9303024.

[9] See Let. Rul. 9324044.

[10] See Let. Ruls. 9324043, 9106022.

Planning Point: It should be noted, however, that most of the rulings do not address whether such an insurance investment would be permissible if the amounts were invested in a custodial account.

Where an insurance policy endorsement failed to adequately restrict the premiums to meet the incidental benefit limit and the elective deferral limit and also contained conflicting provisions that rendered the agreement revocable, the IRS ruled that the life policy as endorsed did not constitute a 403(b) annuity contract.[1]

In Letter Ruling 9215055, the IRS concluded that it is irrelevant whether the premiums under the insurance contract are paid by contributions made by the employer on behalf of the participant under a salary reduction agreement or by dividends and interest thereon accumulated under the contract so long as the incidental benefit limit is not exceeded.

Planning Point: Revenue Ruling 90-24 has been revoked, and life insurance now cannot be purchased under a 403(b) plan.

The life insurance protection contained in a retirement income or pension plan endowment type of policy comes within the incidental limitation. An endowment policy with an annuity rider that, combined, provided in later policy years a death benefit greater than under a typical retirement income policy qualified as an annuity contract when actuarial comparison of only the endowment contract with the retirement income contract indicated the cost of the death benefit under the endowment contract was less than that of the retirement income contract.[2] However, Regulation Section 1.403(b)–8(c)(2) does not permit a life insurance contract, an endowment contract, a health or accident insurance contract, or a property, casualty, or liability insurance contract to constitute an annuity contract for purposes of section 403(b) if issued after September 23, 2007.

Contract Requirements

3910. What nine requirements must a tax sheltered annuity contract meet?

Exclusion for Contributions to Purchase 403(b) Contracts

Under final regulations (Q 3907), amounts contributed by an eligible employer for the purchase of an annuity contract for an employee are excluded from the gross income of the employee under IRC Section 403(b) only if each of the nine requirements below are satisfied.[3] The final regulations require the 403(b) plan, in both form and operation, to satisfy the applicable requirements for exclusion.[4]

(1) *Purchase by Eligible Employer*. A tax sheltered annuity contract must be purchased by an eligible employer (Q 3908).[5] Final regulations provide that the annuity contract cannot be purchased under a qualified plan (Q 3758, Q 3837), or an eligible governmental plan (Q 3586).[6]

[1] Let. Rul. 9242022.

[2] Rev. Rul. 74-115, 1974-1 CB 100.

[3] Treas. Reg. §1.403(b)-3(a).

[4] Preamble, TD 9340, 72 Fed. Reg. 41128, 41129 (7-26-2007).

[5] IRC Sec. 403(b)(1).

[6] Treas. Reg. §1.403(b)-3(a)(1).

Thus, an employer must agree to pay premiums. Although the employer must pay premiums, the premiums may be derived either directly from the employer as additional compensation to the employee or indirectly from the employee through a reduction in his or her salary. If premiums are to come from a reduction in the employee's salary, the reduction must be made under a legally binding agreement between the employer and the employee, and the agreement must be irrevocable as to salary earned while the agreement is in effect.

An employee is permitted to enter into multiple salary reduction agreements with the same employer during any one taxable year of the employer. For purposes of IRC Section 403(b), the frequency that an employee is permitted to enter into a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement generally is determined under IRC Section 401(k).[1]

All annuity contracts, including custodial accounts and retirement income accounts, purchased by an employer on behalf of an employee are treated as a single annuity contract for purposes of applying the requirements of IRC Section 403(b).[2]

Tax deferment will be achieved only for premium payments attributable to amounts earned by an employee after the agreement becomes effective; premium payments attributable to salary earned prior to the effective date, or after termination of the agreement, are includable in the employee's gross income. For this purpose, salary is considered earned when the services for which it is compensation are performed, even though payment is deferred and subject to a risk of forfeiture.[3] After-tax contributions can be made by payroll deduction to a 403(b) plan, but will not be excludable.[4]

The final regulations specify that contributions to a 403(b) plan must be transferred to the insurance company issuing the annuity contract or the entity holding assets of any custodial or retirement income account that is treated as an annuity contract within a period that is not longer than is reasonable for the proper administration of the plan. A plan may provide for elective deferrals for a participant under the plan to be transferred to the annuity contract within a specified period after the date the amounts would otherwise have been paid to the participant,[5] although in no event may that ever be longer than as soon as reasonably possible.

If a tax sheltered annuity plan is subject to Title I of ERISA, the Department of Labor requires that amounts an employee pays to the employer or has withheld from his or her salary by the employer for contribution to a plan become plan assets as soon as these amounts reasonably can be segregated from the employer's general assets, but in no event ever later than the fifteenth business day of the month following the month in which the contributions are received or withheld by the employer,[6] though the DOL generally takes the position that the required period is a matter of a few days following the payroll date. A tax sheltered annuity

[1] SBJPA '96, Sec. 1450(a).

[2] IRC Sec. 403(b)(5); Treas. Reg. §1.403(b)-3(b)(1).

[3] GCM 39659 (9-8-87).

[4] *Bollotin v. U.S.*, 76-2 USTC ¶9604 (S.D. N.Y. 1976), *aff'd*, 77-1 USTC ¶9,450 (2d Cir. 1977).

[5] Treas. Reg. §1.403(b)-8(b).

[6] Labor Reg. §2510.3-102.

plan also can qualify for the ERISA contribution safe harbor for small plans, which is generally a seven day period.

(2) *Nonforfeitable Rights*. An employee's rights under a 403(b) contract must be nonforfeitable except for failure to pay future premiums.[1] According to final regulations, an employee's rights under a contract are not nonforfeitable unless the participant for whom the contract is purchased has at all times a fully vested and nonforfeitable right to all benefits provided under the contract.[2] The effect of this requirement is that salary reduction contributions to a tax sheltered annuity must be immediately vested. Actual employer contributions can be subjected to delayed vesting by treating such non-vested contributions as being subject to 403(c) instead of 403(b).

Tax sheltered annuity plans are not subject to the vesting rules under Section 411, but may be subject to ERISA's vesting rules. PPA 2006 extended to employer non-elective contributions the faster vesting requirements that had applied to employer matching contributions since 2002. The vesting requirements are satisfied under either a three year cliff vesting schedule that reaches 100 percent after three years of service or a graduated vesting schedule, i.e., 20 percent after two years of service, 40 percent after three years, 60 percent after four years, 80 percent after five years, and 100 percent after six years. This change effectively makes all employer contributions in defined contribution plans subject to the faster vesting requirements.[3]

There are vesting rules applicable to employer contributions in plan years beginning after December 31, 2001 (Q 3785). With exceptions for governmental and certain church plans, tax sheltered annuity plans with actual employer contributions generally are subject to ERISA and must comply with ERISA's minimum vesting schedules if they delay vesting.

(3) *Participation and Coverage*. Except for contracts purchased under plans by certain churches or certain governmental plans, tax sheltered annuity contracts generally must be provided under a plan that meets minimum participation, coverage and nondiscrimination requirements if employer contributions are made to those contracts (Q 3913).[4]

(4) *Limits on Elective Deferrals*. Under final regulations, a contract must satisfy IRC Section 401(a)(30), relating to limits on elective deferrals. A contract does not satisfy this limit unless the contract requires all elective deferrals for an employee not to exceed the limits of IRC Section 402(g)(1), which include (1) elective deferrals for the employee under the contract, and (2) any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer.[5]

(5) *Nontransferable*. A contract must be expressly nontransferable.[6] An agreement between employer and employee that the employee will not transfer the contract is not sufficient.[7] For

[1] See IRC Sec. 403(b)(1)(C).
[2] Treas. Reg. §1.403(b)-3(a)(2).
[3] See IRC Sec. 411(a)(11).
[4] IRC Sec. 403(b)(1)(D); Treas. Reg. §1.403(b)-3(a)(3).
[5] Treas. Reg. §1.403(b)-3(a)(4).
[6] Treas. Reg. §1.403(b)-3(a)(5).
[7] Rev. Rul. 74-458, 1974-2 CB 138.

this purpose, an employer is considered to have purchased a new contract when it pays the first premium on a previously issued contract.[1] Although the contract must be nontransferable, the employee can surrender the contract to the insurer, borrow against the loan value, and exercise all other ownership rights. Tax results of a policy loan are discussed in Q 3937, Q 3947.

(6) *Minimum Required Distributions*. Tax sheltered annuity contracts and custodial accounts must provide that distributions of at least a minimum amount must be made.[2] These requirements may be incorporated in a plan by reference (Q 3949).[3]

(7) *Direct Rollover Option*. A plan generally must provide that if a distributee of any eligible rollover distribution (Q 3890) elects to have the distribution paid directly to a traditional IRA, another tax sheltered annuity (if applicable), or an eligible retirement plan (Q 3883) and specifies the plan to which the distribution is to be paid, then the distribution will be paid to that plan in a direct rollover (Q 3884).[4]

Before PPA 2006, amounts held in an annuity contract or account described in IRC Section 403(b) could not be converted directly to a Roth IRA.[5] Effective for distributions beginning after December 31, 2007, distributions from a 403(b) plan may be rolled over directly into a Roth IRA, subject to the rules that apply to rollovers from a traditional IRA into a Roth IRA. This eliminates the necessity for a conduit traditional IRA.[6]

The payor of a 403(b) annuity contract or custodial account must withhold 20 percent from any eligible rollover distribution that the distributee does not elect to have paid in a direct rollover (Q 3887).[7] A safe harbor explanation that a payor may give to recipients of eligible rollover distributions from tax sheltered annuities is provided in Notice 2002-3.[8]

(8) *Limitation on Incidental Benefits*. The contract must satisfy the incidental benefit requirements of IRC Section 401(a) (Q 3751, Q 3909, Q 3935, Q 3953).[9]

(9) *Maximum Annual Additions*. The annual additions to the contract must not exceed the applicable limitations of IRC Section 415(c), treating contributions and other additions as annual additions (Q 3918, Q 3920).[10]

Plan in Form and Operation

According to final regulations, a contract does not satisfy the requirements for exclusion from gross income unless it is maintained pursuant to a plan. For this purpose, a plan is a written defined contribution plan that, in both form and operation, satisfies the requirements set forth

[1] Rev. Rul. 68-33, 1968-1 CB 175.
[2] IRC Sec. 403(b)(10); Treas. Reg. §1.403(b)-3(a)(6).
[3] TAMRA '88, Sec. 1101A(a)(3).
[4] IRC Secs. 403(b)(10), 401(a)(31); Treas. Reg. §1.403(b)-3(a)(7).
[5] Treas. Reg. §1.408A-4, A-5.
[6] See IRC Sec. 408A(e).
[7] IRC Sec. 3405(c).
[8] Notice 2002-3, 2002-2 IRB 289, as updated by Notice 2009-68, 2008-2 CB 423.
[9] Treas. Reg. §1.403(b)-3(a)(8).
[10] Treas. Reg. §1.403(b)-3(a)(9).

in IRC Section 403(b) and Treasury regulations.[1] Thus, a plan must contain all of the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made (Q 3912).[2]

3911. What prohibited distribution requirements apply to tax-sheltered annuity plans?

A custodial account invested in mutual funds must provide that amounts will not be made available before the employee dies, attains age 59½, has a severance from employment, becomes disabled within the meaning of IRC Section 72(m)(7), or encounters financial hardship.[3] Hardship withdrawals may be made only on account of an immediate and heavy financial need (Q 3730). In years beginning after December 31, 1988, financial hardship distributions may be made only from assets held as of the close of the last year beginning before 1989 and from amounts contributed thereafter under a salary reduction agreement, not including earnings on these amounts.

An annuity contract must provide that distributions attributable to salary reduction contributions, including the earnings on them, may be made only after the employee attains age 59½, has severance from employment, dies, becomes disabled, or in the case of hardship, except that the earnings on salary reduction contributions may not be distributed for financial hardship.[4] These restrictions apply for years beginning after 1988, but only with respect to distributions attributable to assets other than assets held as of the close of the last year beginning before 1989.[5] Assets held prior to that date are not subject to these restrictions.

Timely distributions of excess elective deferrals (Q 3921) and excess aggregate contributions (Q 3913) may be made without regard to the above restrictions,[6] as they are amounts not attributable to salary reductions that are held in an annuity contract. For the restrictions affecting retirement income accounts, see Q 3926.

Amounts borrowed from a tax sheltered annuity and treated as a deemed distribution under IRC Section 72(p) (Q 3937) are not treated as actual distributions for purposes of these distribution restrictions and will not violate these restrictions.[7] If a participant's accrued benefit is reduced or offset to repay a loan, an actual distribution occurs for purposes of these distribution restrictions.[8] Accordingly, a plan may be prohibited from making such an offset to enforce its security interest in a participant's account balance attributable to salary reduction contributions until a date on which a distribution is permitted under IRC Section 403(b)(11).[9]

Similarly, it would seem that servicing a plan loan with tax sheltered annuity funds before a distribution is permitted would constitute a prohibited distribution. Even though a distribution

[1] Treas. Reg. §1.403(b)-3(b)(3)(i). See Treas. Regs. §§1.403(b)-1 through 1.403(b)-11. See also Preamble, TD 9340, 72 Fed. Fed. 41128, 41130 (7-26-2007).
[2] Treas. Reg. §1.403(b)-3(b)(3)(i). See Treas. Regs. §§1.403(b)-1 through 1.403(b)-11.
[3] IRC Sec. 403(b)(7)(A)(ii).
[4] IRC Sec. 403(b)(11); Treas. Reg. §1.403(b)-6(d)(1)(ii).
[5] TAMRA '88, Sec. 1011A(c)(11). See also Let. Rul. 9442030.
[6] IRC Secs. 402(g)(2), 401(m)(6).
[7] Treas. Reg. §1.72(p)-1, A-12.
[8] Treas. Reg. §1.403(b)-6(g).
[9] Treas. Reg. §1.72(p)-1, A-13(b).

may be permitted under these rules for hardship or after severance from employment, it may nonetheless be subject to a 10 percent tax in addition to income tax as a premature distribution (Q 3948). These rules also apply to custodial accounts.

A distribution to a former spouse pursuant to a qualified domestic relations order ("QDRO") will be permitted under certain circumstances (Q 3816) even though the distribution otherwise might be prohibited under the prohibited distribution rules.[1]

3912. What is the written plan requirement for 403(b) plans?

According to final regulations, a contract does not satisfy the requirements for exclusion from gross income (Q 3910) unless it is maintained pursuant to a plan. For this purpose, a plan is a written defined contribution plan that in both form and operation satisfies the requirements set forth in the regulations.[2] Thus, a plan must contain all of the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made.[3]

A plan may contain optional features that are consistent with, but not required, under IRC Section 403(b), including features with respect to hardship withdrawal distributions, loans, plan-to-plan or annuity contract-to-annuity contract transfers, and acceptance of rollovers to the plan. If a plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements.[4]

A plan may allocate responsibility for performing administrative functions, including functions to comply with the requirements of Section 403(b) and other tax requirements. Any allocation must identify responsibility for compliance with the requirements of the IRC that apply on the basis of the aggregated contracts issued to a participant under a plan, including loans under IRC Section 72(p) and conditions for obtaining a hardship withdrawal. A plan is permitted to assign responsibilities to parties other than the eligible employer, but not to participants.[5]

The final regulations do not require that there be a single plan document.[6] To satisfy the requirement that a plan include all material provisions, the regulations permit the plan to incorporate by reference other documents including the insurance policy or custodial account, which as a result then become part of the plan. Consequently, a plan may include a wide variety of documents, but it is important for the employer that adopts the plan to ensure that there is no conflict with other documents that are incorporated by reference.[7]

Notice 2009-3—Relief from immediate compliance with the written plan requirement in calendar year 2009. Effective January 1, 2009, sponsors of 403(b) plans generally were required

[1] IRC Sec. 414(p)(10); Treas. Reg. §1.403(b)-10(c).

[2] Treas. Reg. §1.403(b)-3(b)(3)(i). See Treas. Regs. §§1.403(b)-1 through 1.403(b)-11.

[3] Treas. Reg. §1.403(b)-3(b)(3)(i). See Treas. Regs. §§1.403(b)-1 through 1.403(b)-11.

[4] Treas. Reg. §1.403(b)-3(b)(3)(i).

[5] Preamble, TD 9340, 72 Fed. Reg. 41128, 41130 (7-26-2007).

[6] See Preamble, TD 9340, 72 Fed. Reg. 41128, 41130 (7-26-2007). See also "Retirement Plan FAQs Regarding 403(b) Tax Sheltered Annuity Plans" at: (http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-403%28b%29-Tax-Sheltered-Annuity-Plans).

[7] Preamble, TD 9340, 72 Fed. Reg. 41128, 41130 (7-26-2007).

to maintain a written plan that satisfies, in both form and operation, the requirements of the final regulations. In response to numerous requests for deferral of the effective date, the IRS announced in Notice 2009-3 that it will not treat a 403(b) plan as failing to satisfy the requirements of IRC Section 403(b) and the final regulations during the 2009 calendar year, provided that, (1) on or before December 31, 2009, the sponsor of the plan has adopted a written 403(b) plan that is intended to satisfy the requirements of IRC Section 403(b), including the final regulations, effective as of January 1, 2009, (2) during 2009, the sponsor operates the plan in accordance with a reasonable interpretation of IRC Section 403(b), taking into account the final regulations, and (3) before the end of 2009, the sponsor makes its best efforts to retroactively correct any operational failure during the 2009 calendar year to conform to the terms of the written 403(b) plan, with such corrections based on the general principles of correction set forth in the Employee Plans Compliance Resolution System "(EPCRS").[1] The IRS makes clear that the relief provided under Notice 2009-3 applies solely with respect to the 2009 calendar year and may not be relied on with respect to the operation of the plan or correction of operational defects in any prior or subsequent year.[2]

The IRS amended its EPCRS program to permit employers which have not timely adopted written plan documents under Notice 2009-3 to correct that error by submitting the document for approval of late adoption. This is done by filing under the Voluntary Compliance Program under the EPCRS, and paying a filing fee which specifically applies to non-adopters.

Remedial Amendment Period

The IRS has established an initial "Remedial Amendment Period" ("RAP") for 403(b) plans related to changes imposed by the 2007 regulations,[3] which has been extended for at least a year under Revenue Procedure 20014-28. Though the RAP was not specifically mentioned in the Revenue Procedure, it applies by operation of the manner in which the RAP is set under Revenue Procedure 2013-22.

The first day of the RAP will be January 1, 2010 (though plan sponsors will be permitted to amend their plans retroactively to January 1, 2009), and the last day of the period is yet to be announced. The last day of the remedial amendment period will be determined by how quickly the IRS approves the first pre-approved 403(b) prototype plans submitted under Revenue Procedure 2013-22, as extended by Revenue Procedure 2014-28.

All plan documents submitted for approval between June 28, 2013 and April 30, 2014 will be held and will eventually be approved at once as a single batch. At the same time that this "batched" approval is issued, the IRS will also announce the end of the initial remedial amendment period. This date will be "in excess of" one year from the date of its announcement.

Any employer can also correct any plan document errors which occurred between January 1, 2009 and the date of the end of the RAP by adopting one of these "batched" prototype plans by that date.

Plan document errors made after the end of the initial RAP can be corrected in accordance with the EPCRS by making a filing under the Voluntary Compliance Program.

[1] Section 6 of Rev. Proc. 2008-50, 2008-35 IRB 464, as modified by Rev. Proc. 2013-12, 2013-1 CB 313.

[2] Notice 2009-3, 2009-2 IRB 250.

[3] Rev. Proc. 2013-22, 2013-18 I.R.B. 985

Model Plan Language

In 2007, the IRS issued Revenue Procedure 2007-71, which provides model plan language that may be used by public schools either to adopt a written plan to reflect the requirements of IRC Section 403(b) and Treasury regulations, or to amend a 403(b) plan to reflect the requirements of IRC Section 403(b) and Treasury regulations.[1]

The revenue procedure also provides rules for when plan amendments or a written plan are required to be adopted by public schools or other eligible employers to comply with final IRC Section 403(b) regulations.

In addition, the revenue procedure addresses the use of the model plan language by employers that are not public schools.

The model plan language in Revenue Procedure 2007-71 is intended for a basic plan under which contributions are limited to pre-tax elective deferrals.[2]

Planning Point: The Model Plan Language has limited usefulness, as the IRS has issued extensive "sample" plan language in a "List of Required Modifications" it issued with Revenue Procedure 2013-22, which it is anticipating employers will use for those who are adopting individually designed plan documents.

403(b) Prototype Plan Program

The IRS has issued a pre-approved plan program for 403(b) plans similar to the current programs offered for IRC Section 401(a) tax-qualified plans under Revenue Procedure 2013-22. The IRS is only intending to issue determination letters to these mass submission plans, and will not issue determination letters on individually designed 403(b) plans.

Interaction between Title I of ERISA and IRC Section 403(b)

The Department of Labor is of the view that tax-exempt employers will be able to comply with the requirements in the new IRC Section 403(b) regulations and remain within the DOL's safe harbor for TSA programs funded solely by salary deferrals. The DOL noted, however, that new IRC Section 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement under a tax-sheltered annuity program. Thus, the question of whether any particular employer, in complying with the IRC Section 403(b) final regulations, has established a plan covered under Title I of ERISA must be analyzed on a case-by-case basis.[3]

3913. What nondiscrimination requirements must a tax sheltered annuity meet?

Prior to 1989, there was no requirement that all employees, or that all of any class of employees, be made eligible for participation in an employer's tax sheltered annuity plan. In years

[1] Rev. Proc. 2007-71, 2007-51 IRB 1184, *as modified by* Notice 2009-3, 2009-2 IRB 250.

[2] Employee Plans News Special Edition (November 30, 2007).

[3] Department of Labor Field Assistance Bulletin No. 2007-02 (7-24-2007).

beginning after 1988, except for contracts purchased by certain churches or church-controlled organizations, tax sheltered annuities must be provided under a plan that meets certain nondiscrimination requirements.[1]

Notice 89-23 provided that a tax sheltered annuity plan would be deemed to be in compliance with these nondiscrimination requirements if the employer operated the plan in accordance with a reasonable, good faith interpretation of the requirements.[2] Notice 89-23 provided guidance for complying with the nondiscrimination rules. Also, transitional safe harbors were generally available for tax sheltered annuities to meet most of these requirements.

The final 403(b) regulations do not include the Notice 89-23 good faith reasonable standard, however.[3] The final regulations provide that an annuity contract does not satisfy the nondiscrimination requirements unless the contributions are made pursuant to a plan (Q 3910), and the terms of the plan satisfy the nondiscrimination rules.[4]

In General

Various employees, including students employed by a school in which they are enrolled and regularly attending classes and employees who normally work fewer than twenty hours per week, generally may be excluded.[5] If any students or part-time employees are excluded, all must be.[6] An employee normally works fewer than twenty hours per week if (1) for the twelve month period beginning on the date the employee's employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours of service as defined in IRC Section 410(a)(3)(C) in that period, and (2) for each plan year ending after the close of the twelve month period beginning on the date the employee's employment commenced or, if the plan so provides, each subsequent twelve month period, the employee worked fewer than 1,000 hours of service in the preceding twelve month period.[7]

In the case of plans subject to ERISA, if an employer requires a minimum age or a minimum number of years of service, the employer may not require that the employee complete a period of service extending beyond the date the employee becomes twenty-one or, if later, completes one year of service. If an employee is given a non-forfeitable right to 100 percent of his or her accrued benefits as normally would be the case with a tax sheltered annuity, the waiting period may be as much as two years instead of one. In the case of employees of an educational institution, the age may be twenty-six instead of twenty-one if after one year of service the employee is 100 percent vested and the employee's rights are non-forfeitable.[8]

[1] IRC Secs. 403(b)(1)(D), 403(b)(12).

[2] Notice 89-23, 1989-1 CB 654, as modified by Notice 90-73, 1990-2 CB 353, Notice 92-36, 1992-2 CB 364 and Notice 96-64, 1996-2 CB 229; see also Ann. 95-48, 1995-23 IRB 13.

[3] Preamble, 72 Fed. Reg. 41128, 41134 (7-27-2007).

[4] Treas. Regs. §§1.403(b)-5(c), 1.403(b)-5.

[5] See IRC Sec. 403(b)(12)(A).

[6] See IRC Sec. 403(b)(12)(A).

[7] Treas. Reg. §1.403(b)-5(b)(4)(iii)(B).

[8] ERISA Sec. 202.

Title I of ERISA, regarding reporting, disclosure, participation, and vesting, does not apply to governmental and church plans.[1] ERISA also generally does not apply to tax sheltered annuities of other employers unless the plan is established or maintained by the employer.[2]

A salary reduction plan generally will not be considered "established or maintained" by an employer if, among other things, employee participation is voluntary, employer involvement is limited to such things as requesting and providing information and collecting and remitting premiums, and the employer permits employees at least a reasonable choice among products and annuity contractors; an employer need not seek out products and contractors.[3] An employer was found to exceed the limited involvement permitted under the regulation where the employer evaluated circumstances and exercised its judgment in determining eligibility for in-service withdrawals on account of disability or financial hardship.[4]

Planning Point: Since the issuance of the 2007 regulations, the DOL has issued extensive guidance on the circumstances when an employer may be considered establishing and maintaining a plan.[5]

3914. What nondiscrimination requirements apply to tax sheltered annuity plans offering salary reduction contributions?

Tax sheltered annuity plans offering salary reduction contributions generally are subject to a single nondiscrimination rule (the "universal availability" rule) with respect to salary reduction contributions. The requirement does not apply to contracts purchased by certain churches or church-controlled[6] organizations.[7]

If any employee may elect to have the employer make contributions to a TSA under a salary reduction agreement, then all employees of the organization other than certain excludable employees generally must be allowed to elect to have the employer make contributions of more than $200 annually pursuant to a salary reduction agreement.[8] Furthermore, the employee's right to make elective deferrals also includes the right to designate 403(b) elective deferrals as Roth contributions, if Roth contributions are otherwise permitted under the plan.[9]

The final 403(b) regulations clarify that an employee is not treated as being permitted to have 403(b) elective deferrals unless the employee is provided with an effective opportunity that satisfies certain requirements (see Q 3915).

The general thrust of this rule is to require that all employees be eligible to make salary reduction contributions if the opportunity to make salary reduction contributions is offered to any employee, as a way to prevent discrimination in favor of the highly

[1] ERISA Sec. 4(b).
[2] See ERISA Sec. 3(2).
[3] Labor Reg. §2510.3-2(f).
[4] DOL Adv. Op. 94-30A.
[5] DOL Adv. Op. 2012-02A; Field Assistance Bulletins 2010-01 2009-02 and 2007-02
[6] Treas. Reg. §1.403(b)-5(b)(2).
[7] Treas. Reg. §1.403(b)-5(d).
[8] IRC Secs. 403(b)(1)(D), 403(b)(12)(A)(ii), 403(b)(12)(B). See also Treas. Reg. §1.403(b)-5(b)(1).
[9] Treas. Reg. §1.403(b)-5(b)(1).

compensated employees. The employer may, however, require a minimum annual salary reduction contribution of more than $200, and may exclude from participation in a salary reduction agreement any employee who is not willing to reduce salary by more than $200 per year.[1] The rule probably also prohibits employer efforts to cap an employee's annual salary reduction contributions at $200 or less.

In addition, the nondiscrimination rule applicable to salary reduction contributions allows an employer to exclude certain other employees, including those who are participants in an IRC Section 457(b) deferred compensation plan of a governmental employer, a qualified cash or deferred IRC Section 401(k) arrangement of the employer, or another tax sheltered annuity.[2] Certain ministers[3] may be excluded as well.[4]

A contribution is considered not made pursuant to a salary reduction agreement if under the agreement it is made pursuant to a one time irrevocable election by the employee at the time of initial eligibility to participate.[5] The legislative history provides that if an employee has a one-time election to participate in a program that requires an employee contribution, the contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner.[6]

An employer that historically has treated one or more of its various geographically distinct units as separate for employee benefit purposes may treat each unit as a separate organization so long as the unit is operated independently on a day-to-day basis. Units located within the same Standard Metropolitan Statistical Area generally are not geographically distinct.[7]

A plan will not be treated as violating the requirements under IRC Section 403(b)(12) merely on account of the making of, or the right to make, catch-up contributions (Q 3706) by participants age fifty or over under the provisions of IRC Section 414(v), so long as a universal availability requirement is met.[8]

3915. When does an employee participating in a tax-sheltered annuity plan have an "effective opportunity" to make elective deferrals for purposes of the nondiscrimination requirements applicable to plans that offer salary reduction contributions?

An employee is not treated as being permitted to have 403(b) elective deferrals contributed on the employee's behalf unless the employee is provided an effective opportunity that satisfies the following requirements.[9]

[1] See, e.g., H.R. Rep. No. 99-426 (Tax Reform Act of 1986), at 715, *reprinted in* 1986-3 CB (vol. 2), at 715; H.R. Conf. Rep. No. 99-841 (TRA '86), at II-420, *reprinted in* 1986-3 CB (vol.4), at 420. See also Treas. Reg. §1.403(b)-5(b)(3)(i).

[2] IRC Sec. 403(b)(12)(A); Treas. Reg. §1.403(b)-5(b)(4)(ii).

[3] Described in IRC Sec. 414(e)(5)(C).

[4] See IRC Sec. 403(b)(12)(A).

[5] IRC Sec. 403(b)(12)(A).

[6] H.R. Conf. Rep. No. 99-841 (TRA '86), at II-420, *reprinted in* 1986-3 CB (vol. 4), at 420; General Explanation of TRA '86, p. 680.

[7] Treas. Reg. §1.403(b)-5(b)(3)(ii).

[8] IRC Sec. 414(v)(3)(B).

[9] Treas. Reg. §1.403(b)-5(b)(2).

Whether an employee has an effective opportunity is determined based on all relevant facts and circumstances, including (1) notice of the availability of the election, (2) the period of time during which an election may be made, and (3) any other conditions on elections.

A 403(b) plan satisfies 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 between cash or a contribution to the plan.

Furthermore, an effective opportunity includes the right to have 403(b) elective deferrals made on his or her behalf up to the lesser of (1) the applicable limits for 403(b) elective deferrals, including any permissible catch-up elective deferrals under the age fifty catch-up, and the special 403(b) catch-up for certain organizations, or (2) the applicable limits under the contract with the largest limitation, and applies to part-time as well as full-time employees.

An effective opportunity is not considered to exist if there are any other rights or benefits that are conditioned, directly or indirectly, on a participant making or failing to make a cash or deferred election with respect to a contribution to a 403(b) contract.

3916. What nondiscrimination requirements apply to a tax sheltered annuity plan that provides for contributions other than by salary reduction?

According to the final regulations, under IRC Section 403(b)(12)(A)(i), employer contributions and employee after-tax contributions must satisfy all of the following nondiscrimination requirements in the same manner as a qualified plan under IRC Section 401(a):

(1) Section 401(a)(4), relating to nondiscrimination in contributions and benefits, taking Section 401(a)(5) into account;

(2) Section 401(a)(17), limiting the amount of compensation that can be taken into account;

(3) Section 401(m), relating to matching and after-tax employee contributions; and

(4) Section 410(b), relating to minimum coverage.[1]

Section 401(a)(26), although listed in IRC Section 403(b)(12)(A)(i), no longer applies to defined contribution plans.

The final regulations do not adopt the good faith reasonableness standard of Notice 89-23 for purposes of satisfying the nondiscrimination requirements of IRC Section 403(b)(12)(A)(i).[2] The Notice 89-23 standard continues to apply to state and local public schools and certain church entities for determining the controlled group.[3] See Q 3762 through Q 3783 for the actual requirements of IRC Section 401(a)(4), IRC Section 401(a)(5), IRC Section 401(a)(17), IRC Section 401(m), and IRC Section 410(b).

[1] Treas. Reg. §1.403(b)-5(a).

[2] Preamble, T.D. 9340, 72 Fed. Reg. 41128, 41134 (7-26-2007).

[3] Preamble, T.D. 9340, 72 Fed. Reg. 41128, 41134 (7-26-2007).

Governmental plans. A governmental plan is one established by the United States government, the government of any state or political subdivision, or any agency or instrumentality of any of them.[1] The minimum participation and coverage and nondiscrimination requirements described in IRC Section 403(b)(12)(A)(i), other than IRC Section 401(a)(17), do not apply to state and local governmental plans. In particular, the requirements of IRC Sections 401(a)(4), 401(a)(5), 401(m), and 410(b) do not apply to such plans.[2] Sponsors of governmental 403(b) plans must comply with regulations under IRC Section 401(a)(17).[3]

501(c)(3) tax-exempt organizations. Regulations under IRC Sections 401(a)(4), 401(a)(5), and 410(b) generally are effective for plans maintained by tax-exempt organizations. Tax-exempt sponsors of 403(b) plans must comply with regulations under Section 401(a)(17).

All employees of a group of employers that are members of a controlled group of corporations or all employees of trades or businesses that are under common control will be treated as employed by a single employer for purposes of the minimum participation, coverage, and nondiscrimination rules (Q 3830).[4] Under the final regulations, common control exists between an exempt organization and another organization if at least 80 percent of the directors or trustees of one organization either are representatives of, or are directly or indirectly controlled by, the other organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the general power to remove the trustee or director and designate a new trustee or director. Whether a person has the power to remove or designate a trustee or director is based on facts and circumstances.[5]

Contributions

3917. What limits are there on excludable contributions to a tax sheltered annuity?

An employee generally can exclude from gross income the contributions paid by the employee's IRC Section 501(c)(3) or public school employer to a retirement annuity for the employee's benefit.[6] The amount that the employee may exclude in the employee's tax year is limited.

For taxable years beginning after 2001, there are two limits to be considered. The first is the overall limit (Q 3918). The second is the limit on the amount that may be excluded under a salary reduction agreement (Q 3921).[7]

For taxable years beginning after 2001, the exclusion allowance is permanently repealed.[8]

[1] IRC Sec. 414(d).

[2] IRC Sec. 403(b)(12)(C).

[3] Treas. Reg. §1.401(a)(17)-1(d)(4)(i).

[4] IRC Secs. 403(b)(12)(A)(i), 414(b), 414(c).

[5] Treas. Reg. §1.414(c)-5; T.D. 9340, 72 Fed. Reg. 41128, 41158 (7-26-2007).

[6] IRC Sec. 403(b)(1).

[7] IRC Sec. 403(b)(1).

[8] Sec. 811, PPA 2006; IRC Sec. 403(b)(2), as repealed by EGTRRA 2001.

If the entire contribution in the year is by salary reduction, only the lowest of the two limits may be excluded. If the contribution is partly salary reduction and partly additional contribution, the salary reduction portion is limited to the salary reduction limit, and the excludable contribution may not exceed the IRC Section 415 limit.[1] The effect of contributions that exceed these limits is explained in Q 3920, Q 3921, and Q 3927.

The IRC Section 415 overall limit applies to contributions and other additions regardless of whether they are vested or not.[2]

3918. How does the Section 415 limit affect the excludable amount for a tax sheltered annuity?

The limit on contributions and benefits applicable to qualified pension plans applies to tax sheltered annuities (Q 3917).[3] For the purpose of this limit, tax sheltered annuities generally will be treated as defined contribution plans.[4] Thus, they are subject to a limit of the lesser of 100 percent of the participant's compensation (defined below) or the applicable dollar limit ($52,000 in 2014).[5] This limit is indexed for inflation in increments of $1,000 (Q 3784).[6]

The limit is on the amount of annual additions that may be made in any limitation year to a participant's account.

Annual additions are employer contributions, including salary reduction amounts and employee after-tax contributions. Excess elective deferrals (Q 3921) that are correctly distributed under the regulations are not included as annual additions.[7] Excess matching employer contributions (Q 3913) are included, however, even if the excess is corrected by a distribution from the plan.[8]

Earnings attributable to distributed elective deferrals that are not themselves distributed will be treated as an employer contribution for the limitation year in which the distributed elective deferral was made.[9] A contribution made during a tax year is considered to be made on the last day of the limitation year that ends in or with the tax year.[10]

A limitation year is the calendar year or any other twelve month period that may be elected by the plan in the plan document. Contributions in excess of the overall limit are discussed in Q 3920.

Includable Compensation

In the case of a 403(b) annuity contract, "participant's compensation" means the participant's includable compensation determined under IRC Section 403(b)(3).[11] Includable compensation

[1] See Treas. Reg. §1.415-6(e)(1).
[2] See IRC Sec. 403(b)(1).
[3] IRC Sec. 415(a)(2).
[4] Treas. Reg. §1.415-6(e)(1)(i).
[5] IRC Sec. 415(c); IR-2013-86 (Oct. 31, 2013).
[6] IRC Sec. 415(d)(4)(B).
[7] Treas. Regs. §§1.402(g)-1(e)(1)(ii); 1.415-6(b)(1)(i).
[8] Treas. Regs. §§1.401(m)-1(e)(3)(iv); 1.415-6(b)(1)(i).
[9] Treas. Reg. §1.415-6(b)(6)(iv).
[10] Treas. Reg. §1.415-6(e)(1)(iii).
[11] IRC Sec. 415(c)(3)(E).

is based on compensation earned by the employee for the most recent period, ending not later than the close of the taxable year for which the limitation is being determined, that constitutes a full year of service and that precedes the taxable year by no more than five years.[1]

Thus, for a full time employee, includable compensation generally is the employee's salary for the current taxable year. For a part-time employee, fractional year earnings are required to be aggregated.[2] To illustrate, assume that as of the end of 2014, an employee had worked three years half-time and had the following earnings: $11,500 in 2012, $12,000 in 2013, and $12,500 in 2014. In computing the employee's exclusion allowance for 2014, the employee's includable compensation would be $24,500 ($12,000 + $12,500).

The definition of includable compensation includes any elective deferrals (Q 3921) made to the plan and any amount that has been contributed or deferred by the employer at the election of the employee and that is not includable in gross income by reason of IRC Section 125, IRC Section 132(f)(4), or IRC Section 457 (see Q 3501 concerning cafeteria plans and Q 3567 concerning IRC Section 457 deferred compensation plans).[3]

Only compensation from an employer that made the contribution can be included; compensation from any other employer or any other source cannot be included. The employer is generally the common law employer.

For purposes of determining the limits on contributions under IRC Section 415(c), amounts paid to a minister as a tax-free housing allowance may not be treated as compensation under the general or alternative definitions of compensation under the regulations.[4]

Certain payments made after an employee's severance from employment will not fail to be compensation within the meaning of IRS Section 415(c) if the compensation is paid by the later of 2½ months after severance from employment with the employer maintaining the plan or the end of the limitations year that includes the date of severance from employment with the employer maintaining the plan.[5]

3919. Are contributions to a 403(b) plan aggregated with other defined contribution plan contributions to determine the Section 415 limitation?

Contributions to a 403(b) plan generally do not need to be aggregated with other 401(a) defined contribution plans of the employer in computing the Section 415 limitation. If a person participates in a 401(a) defined contribution plan and also participates in a 403(b) plan of another employer, contributions to both plans must be aggregated for 415 purposes if that participant is in control of either employer.

In applying the IRC Section 415 limit to a combination of a 403(b) annuity and a defined contribution plan of an employer controlled by the individual, each plan separately must meet

[1] IRC Sec. 403(b)(3).
[2] IRC Sec. 403(b)(4)(B).
[3] IRC Sec. 403(b)(3).
[4] Let. Rul. 200135045; Treas. Reg. §1.415-2(d).
[5] See Treas. Regs. §§1.415(c)-2(e)(3)(ii), 1.403(b)-3(b)(4)(ii).

the limit applicable to it taking into consideration only the compensation from the employer providing the plan. In determining the combined limit, compensation from the controlled employer may be aggregated with that from the employer providing the annuity.[1]

3920. What is the effect of making contributions to a tax sheltered annuity in excess of the overall limit?

To the extent a contribution in a limitation year exceeds the overall IRC Section 415 limit, it must be included in gross income for the tax year with which or in which the limitation year ends[2] to the extent the excess is not returned in a timely manner.

As a result of excess IRC Section 415 amounts, the annuity contract or custodial account is bifurcated into a non-qualified annuity, comprised of the excess and earnings thereon, and a qualifying 403(b) annuity.[3] The entire contract fails to be a 403(b) contract if an excess annual addition is made and a separate account is not maintained with respect to the excess.[4]

An excess contribution made to a custodial account also may be subject to an excise tax (Q 3927).

3921. What is the limit on excludable amounts that may be contributed to tax sheltered annuity plans under salary reduction agreements?

The amount of elective deferrals that an individual can exclude from income for a tax year is limited. Elective deferrals are:

(1) amounts contributed to tax sheltered annuity plans under salary reduction agreements;

(2) amounts contributed under cash or deferred arrangements to 401(k) plans (Q 3696) and salary reduction SEPs ("SAR-SEPs") (Q 3653); and

(3) amounts contributed under salary reductions to SIMPLE IRAs (Q 3654).[5]

Elective deferrals do not include elective contributions made pursuant to a one time irrevocable election that is made at initial eligibility to participate in the salary reduction agreement or pursuant to certain other one time irrevocable elections specified in regulations, or pre-tax contributions made as a condition of employment.[6]

For 2014, the aggregate limit on elective deferrals is $17,500.[7] The elective deferral limit is indexed for inflation in increments of $500.[8]

[1] Treas. Reg. §1.415(f)-(2).
[2] Treas. Regs. §§1.415-6(e)(1)(ii), 1.403(b)-4(f)(1).
[3] See Treas. Reg. §1.403(b)-3(b)(2), referring to IRC Sec. 415(a)(2) (flush language).
[4] Treas. Reg. §1.403(b)-3(b)(2).
[5] IRC Sec. 402(g).
[6] IRC Sec. 402(g)(3).
[7] IRC Sec. 402(g)(1); IR-2013-86 (Oct. 31, 2013).
[8] IRC Sec. 402(g)(4).

3922. What is the special increase to the limit on amounts contributed to a tax sheltered annuity plan under a salary reduction agreement for employees who have completed fifteen years of service?

A special increased limit is provided for amounts contributed to 403(b) plans under a salary reduction agreement in the case of an employee who has completed fifteen years of service with an educational institution, hospital, health and welfare service agency (including a home health service agency or an adoption agency), a church (or a convention or association of churches), or church-related organization.[1]

The limit for any one year is increased by the lesser of the following:

(1) $3,000;

(2) $15,000, reduced by the sum of amounts already excluded for prior taxable years by reason of this special exception and the aggregate amount of designated Roth contributions for prior taxable years; or

(3) the excess of $5,000 multiplied by the number of years of service the employee has with the organization over all elective deferrals to 403(b) plans, 401(k) plans, SEPs, and SIMPLE IRAs.[2]

It is the current limit (i.e., $17,500 in 2014) that is increased by the above amount.

The fifteen years of service requirement takes into account only employment with the qualified organization. Thus, an employee who has not completed at least fifteen years of service taking into account only employment with the qualified organization is not a qualified employee.[3] For the rule coordinating the fifteen years of service catch-up with the age fifty catch-up, see Q 3924.

3923. What are the consequences of exceeding the limit on elective deferrals to a tax sheltered annuity plan?

Any elective deferral in excess of the applicable limit is included in the individual's gross income for the year of deferral. If any such amount is included, the individual may, no later than April 15 of the following year, allocate the excess deferrals among the plans under which the deferrals were made and, if plan language permits it, the plans may distribute to the individual the amounts so allocated together with income allocable to the amounts no later than April 15 of that year.[4] A timely distribution may be made regardless of prohibitions on distributions otherwise applicable (Q 3910).[5]

[1] Treas. Reg. §1.403(b)-4(c)(3). See, e.g., Let. Rul. 200934012.

[2] IRC Sec. 402(g)(7). See also IRS Publication 571, Tax Sheltered Annuity Plans (January 2009), pp. 9, 11.

[3] See Treas. Reg. §1.403(b)-4(c)(3)(iii). See Let. Rul. 200934012 ($3,000 catch-up contribution permitted where the employee had worked for the same college for twenty-four years).

[4] IRC Sec. 402(g)(2); Treas. Reg. §1.402(g)-1(e)(2). See also Treas. Regs. §§1.403(b)-4(f)(1), 1.403(b)-4(f)(4).

[5] IRC Sec. 402(g)(2).

Because an excess deferral is not excluded from gross income, the excess amount distributed under these rules by April 15 is not included in income as a distribution. Any income on the excess deferral is included in income in the taxable year in which distributed.[1]

A distribution of less than the entire amount of excess and income is treated as a pro rata distribution of deferral amount and income.[2] A distribution by April 15 of excess deferrals and income is not subject to tax as a premature distribution under IRC Section 72(t).[3] A distribution of an excess deferral is not a distribution for purposes of meeting the minimum distribution requirements.[4]

If the excess deferral is not distributed by April 15, it is subject to the regular prohibitions on withdrawals and is not included in the investment in the contract, or basis, even though it has been included in income. Thus, excess deferrals are includable in gross income when later distributed.[5] A withdrawal that occurs before the excess deferral was made does not count as a distribution of an excess deferral.[6]

The amount of salary reduction excludable in a year may actually be less than the amount permitted under the limit if the overall limit is less (Q 3917). Contributions by salary reduction are not deductible employee contributions; they are employer contributions that are excludable within limits (Q 3910, Q 3917).

3924. Can participants in a tax sheltered annuity plan who are age 50 and over contribute a "catch-up" contribution each year?

The otherwise applicable dollar limit on elective deferrals under a Section 403(b) annuity can be increased for individuals who would attain age fifty by the end of the taxable year.[7] In 2014, the applicable dollar limit is $5,500, as indexed for inflation.[8] The limit is indexed in $500 increments.[9]

Catch-up contributions by participants age fifty or over made under the provisions of IRS Section 414(v) are not subject to the elective deferral limit.[10] The elective deferral limit of $17,500 in 2014 is increased by the special catch-up limit under IRC Section 402(g)(7) and by the catch-up limit under Treasury Regulation Section 1.414(v)-1(c)(2).[11]

According to final 403(b) regulations, any catch-up amount contributed by an employee who is eligible for both an age fifty catch-up and the special 403(b) catch-up for certain organizations is treated first as an amount contributed as a special 403(b) catch-up, to the extent that

[1] Treas. Reg. §1.402(g)-1(e)(8).
[2] Treas. Reg. §1.402(g)-1(e)(10).
[3] Treas. Reg. §1.402(g)-1(e)(8).
[4] IRC Sec. 402(g)(2)(C); Treas. Reg. §1.402(g)-1(e)(9).
[5] IRC Sec. 402(g)(6).
[6] Treas. Reg. §1.402(g)-1(e)(3).
[7] IRC Secs. 414(v)(1), 414(v)(5).
[8] See IRC Sec. 414(v)(2)(B)(i); IR-2013-86 (Oct. 31, 2013).
[9] See IRC Sec. 414(v)(2)(B)(ii).
[10] See IRC Section 414(v)(3)(A); Treas. Reg. §1.414(v)-1(d).
[11] Treas. Reg. §1.402(g)-2(a).

type of catch-up is permitted and second as an amount contributed as an age fifty catch-up to the extent the catch-up amount (Q 3706) exceeds the maximum special 403(b) catch-up after taking into account IRC Sections 402(g) and 415(c), the special 403(b) catch-up, and any limits on the special 403(b) catch-up that are imposed by the terms of the plan.[1]

3925. Are the elective deferral limits for tax sheltered annuity plans coordinated with the limits applicable to IRC Section 457 plans?

For taxable years beginning after 2001, the rules requiring that the contribution limits under IRC Section 457 be coordinated with elective deferral limits are permanently repealed.[2] Consequently, an individual who participates in a 403(b) and 457 plan conceivably could defer a total of $35,000 in 2014, that is, $17,500 in each plan (Q 3568).[3]

3926. What special rules apply to tax sheltered annuities for church employees?

A duly ordained, commissioned, or licensed minister of a church or a lay person who is an employee of a church or a convention or association of churches, including a tax-exempt organization controlled by or associated with a convention or association of churches, may be able to increase his or her excludable tax sheltered annuity contributions under the special rules explained below.

For these purposes, a duly ordained, commissioned, or licensed minister who is self-employed or who is employed by an organization other than one described in IRC Section 501(c)(3), but with respect to which the minister shares common religious bonds, is considered a church employee.[4] This definition includes chaplains.

A church employee may make an election that may provide a higher IRC Section 415 annual additions limit than discussed in Q 3918. This employee may elect an annual addition limit of as much as $10,000 in any one year. Employer contributions under this election, that is, payments in excess of the otherwise applicable annual addition limit, may not aggregate more than $40,000 over the employee's lifetime.[5]

A church employee with fifteen years of service is eligible for the higher elective deferral limit explained in Q 3921.

Contributions to a defined contribution program (a "retirement income account") established or maintained by a church are considered contributions for a tax sheltered annuity contract. A program in existence on August 13, 1982, will not fail to be a tax sheltered annuity merely because it is a defined benefit plan even if it is later amended or extended to other employees.[6]

[1] Treas. Reg. §1.403(b)-4(c)(3)(iv).

[2] IRC Sec. 457(c).

[3] IR-2013-86 (Oct. 31, 2013). See, e.g., Let. Rul. 200934012 (college president allowed to defer $15,500 each to a 403(b) plan and a 457(b) plan for calendar year 2008).

[4] See IRC Sec. 414(e)(5).

[5] IRC Sec. 415(c)(7).

[6] IRC Sec. 403(b)(9); Treas. Regs. §§1.403(b)-8(e), 1.403(b)-9(a)(1); TEFRA, Sec. 251(e)(5); Let. Rul. 8837061.

Retirement income accounts can be established for self-employed ministers and chaplains and ministers who are employed by an organization other than one described in IRC Section 501(c)(3) but with respect to which the ministers share common religious bonds.

The final 403(b) regulations clarify that retirement income accounts will be expected to be maintained pursuant to a plan that affirmatively states the intent to be a retirement income account.[1]

Contributions made by a minister to a retirement income account after 2001 are allowed to the extent they do not exceed the limit on elective deferrals or the limit on annual additions.[2]

A church plan does not have to meet the participation and nondiscrimination requirements applicable to other employer tax sheltered annuity plans (Q 3913)[3] if it meets certain requirements of being a church.

In figuring the Section 415 annual additions limit, a church employee must count all years of service with organizations that are part of a particular church as years of service with one employer. Similarly, the church employee must treat contributions by the churches as made by one employer.[4] In the case of a foreign missionary, contributions and other additions for an annuity contract or retirement income contract, when expressed as an annual addition to the employee's account, are not treated as exceeding the IRC Section 415 annual additions limit if the annual addition is not in excess of the greater of $3,000 or the employee's includable compensation under IRC Section 403(b)(3).[5]

3927. What is an excess contribution and an excess aggregate contribution to a tax sheltered annuity? What excise taxes apply to them?

There are several different limitations applicable to amounts contributed to 403(b) annuities. Contributions that exceed any of these particular limits may be thought of as excess contributions, but they are treated differently depending on the limit that is exceeded and, sometimes, depending on whether the excess amount is contributed to a custodial account or toward the purchase of an annuity contract.

When contributions that exceed the lesser of the excludable amount or the overall limit are made to a custodial account for the purchase of regulated investment company stock or a retirement income account to the extent funded through custodial accounts, they are properly called excess contributions and are subject to an excise tax.[6]The tax is 6 percent (not to exceed 6 percent of the value of the account) of the following: (1) the amount by which the contributions, other than a permissible rollover contribution (Q 3890), exceed the lesser of the amount excludable from gross income under IRC Section 403(b) or the overall limitation under IRC Section 415, or whichever is applicable if only one is applicable, plus (2) any excess carried over

[1] Treas. Regs. §§1.403(b)-3(b)(3), 1.403(b)-9(a)(2)(ii).

[2] IRC Secs. 404(a)(10)(B), 414(e)(5).

[3] IRC Sec. 403(b)(1)(D); see also IRC Sec. 403(b)(12)(B).

[4] IRC Sec. 415(c)(7)(B).

[5] IRC Sec. 415(c)(7)(C).

[6] IRC Sec. 4973(c).

from the preceding tax year. An excess carried over from a previous year may be reduced by contributing in a year less than the excludable amount or the contribution limit, whichever is lower. An excess also may be reduced by income taxable distributions. [1]The tax is on the employee.

If contributions are made toward the purchase of an annuity contract, the excess is not subject to an excise tax.

For contributions in excess of the overall limit of IRC Section 415, see Q 3920.

Where salary reduction contributions are in excess of the limit on elective deferrals, the amount above the limit is not excludable from income contributed and, if not timely distributed, is included in gross income for a second time when later distributed (Q 3921, Q 3917).

Discriminatory Matching Employer Contributions. If an employer makes certain discriminatory matching contributions toward an annuity contract or to a custodial account, amounts in excess of nondiscriminatory amounts are called excess aggregate contributions and are subject to a 10 percent excise tax if not timely distributed (Q 3733).[2]

3928. What are the requirements for an automatic enrollment provision in a 403(b) plan?

The safe harbor rules for automatic contribution plans with respect to 401(k) plans also apply with respect to matching contributions under a 403(b) annuity through the application of IRC Section 403(b)(12) (Q 3707). This provision is effective for years beginning after December 31, 2007.[3]

3929. Can an employer make post-retirement contributions to a tax sheltered annuity on behalf of a retired employee?

Yes, but time limits apply.

Under the IRC, the term includable compensation (Q 3918) means compensation earned by the employee for the most recent period, ending not later than the close of the taxable year for which the limitation is being determined, that constitutes a full year of service and that precedes the taxable year by no more than five years.[4]

A former employee is deemed to have monthly includible compensation (Q 3918) for the period through the end of the taxable year in which the employee ceases to be an employee and through the end of each of the next five taxable years. The amount of the monthly includable compensation is equal to one-twelfth of the former employee's includable compensation during the former employee's most recent year of service. Accordingly, non-elective employer contributions for a former employee must not exceed the IRC Section 415(c) limit up to the lesser of the dollar amount in IRC Section 415(c) or the former employee's annual includable

[1] IRC Sec. 4973(c).

[2] IRC Sec. 4979.

[3] See IRC Secs. 401(k)(13), 401(m)(12), 414(w).

[4] IRC Sec. 403(b)(3).

compensation based on the former employee's average monthly compensation during his or her most recent year of service.[1]

3930. What is a Roth 403(b) contribution program?

Section 403(b) plans are allowed to offer a *qualified Roth contribution program*, which is basically a Roth account for elective deferrals.[2] Essentially, participants of 403(b) plans establishing these programs are able to designate all or a portion of their elective deferrals as Roth contributions. Roth contributions will be included in the participant's gross income in the year the contribution is made and then be held in a separate account with separate recordkeeping.[3] For details on Roth contribution programs under cash or deferred arrangements, see Q 3717.[4]

Changing Issuers

3931. May an employee exchange his or her tax sheltered annuity contract for another contract within the same plan?

Under the final 403(b) regulations, a non-taxable exchange or transfer is permitted for a 403(b) contract if it:

(1) is a mere change of investment within the same plan, that is, a contract exchange;

(2) constitutes a plan-to-plan transfer, so that there is another employer plan receiving the exchange (see Q 3932); or

(3) it is a transfer to purchase permissive service credit (Q 3934).[5]

Contract Exchanges within the Same Plan

Under prior law, Revenue Ruling 90-24 provided that a direct transfer between issuers of an amount representing all or part of an individual's interest in an IRC Section 403(b) annuity or custodial account was not a distribution subject to tax or to the premature distribution penalty provided that, after the transfer, the funds transferred continued to be subject to distribution requirements at least as strict as those applicable to them before the transfer.[6] The final 403(b) regulations revoked Revenue Ruling 90-24 and any exchanges now are allowed under rules that generally are similar to those applicable to qualified plans.[7]

The final regulations provide that a 403(b) contract of a participant or beneficiary may be exchanged for another 403(b) contract of that participant or beneficiary under the same 403(b) plan if each of the following conditions is satisfied:

(1) the plan under which the contract is issued provides for the exchange;

[1] Treas. Reg. §1.403(b)-4(d)(1).
[2] IRC Secs. 402A(b), 402A(e).
[3] IRC Sec. 402A(b).
[4] See also Treas. Regs. §§1.403(b)-3(c), 1.403(b)-7(e), 1.403(b)-10(d)(2).
[5] Preamble, T.D. 9340, 72 Fed. Reg. 41128, 41131 (7-26-2007); Treas. Reg. §1.403(b)-10(b).
[6] Rev. Rul. 90-24, 1990-1 CB 97.
[7] Preamble, T.D. 9340, 72 Fed. Reg. 41128, 41131 (7-26-2007).

(2) the participant or beneficiary has an accumulated benefit immediately after the exchange that is at least equal to the accumulated benefit before the exchange, taking into account the accumulated benefit under both 403(b) contracts immediately before the exchange; and

(3) the other contract is subject to distribution restrictions with respect to the participant that are no less stringent than those imposed on the contract being exchanged and the employer enters into an information sharing agreement with the issuer of the other contract.[1]

Under the information sharing agreement, the employer and the issuer agree that from time to time in the future they will provide each other with the following information:

(1) information about the participant's employment;

(2) information that takes into account other 403(b) contracts or qualified employer plans, such as whether a severance from employment has occurred for purposes of the distribution restrictions and whether the hardship withdrawal rules are satisfied; and

(3) information necessary for the resulting contract to satisfy other tax requirements, such as whether a plan loan satisfies the conditions so that the loan is not a deemed distribution under IRC Section 72(p)(1).[2]

The rule for contracts received in an exchange does not apply to a contract received in an exchange that occurred on or before September 24, 2007, if the exchange including the contract received in the exchange satisfied the rules applicable at the time of the exchange.[3]

3932. May an employee exchange his or her tax sheltered annuity contract for another contract in another 403(b) plan?

Under the final regulations, a plan-to-plan transfer from a 403(b) plan to another 403(b) plan is permitted if each of the following conditions is met:

(1) the participant is an employee or former employee of the employer for the receiving plan or, in the case of a transfer for a beneficiary of a deceased participant, the participant was an employee or former employee of the employer for the receiving plan;

(2) the transferring plan provides for transfers;

(3) the receiving plan provides for the receipt of transfers;

(4) the participant or beneficiary whose assets are being transferred has an accumulated benefit immediately after the transfer that is at least equal to the accumulated benefit immediately before the transfer;

[1] Treas. Reg. §1.403(b)-10(b)(2).

[2] Treas. Reg. §1.403(b)-10(b)(2).

[3] Treas. Reg. §1.403(b)-11(g).

(5) the receiving plan imposes restrictions on distributions to the participant or beneficiary whose assets are being transferred that are no less stringent than those imposed on the transferring plan; and

(6) if a plan-to-plan transfer does not constitute a complete transfer of the participant's or beneficiary's interest in the 403(b) plan, the receiving plan treats the amount transferred as a continuation of a pro rata portion of the participant's or beneficiary's interest in the Section 403(b) plan (e.g., a pro rata portion of the participant's or beneficiary's interest in any after-tax employee contributions).[1]

Planning Point: No transfers are permitted between contracts that are not part of a plan under Revenue Procedure 2007-71, because the 2007 regulations revoked Revenue Ruling 90-24 which had previously permitted such transfers.

Amounts Received Under the Plan

3933. May an employee, the employee's surviving spouse, or a non-spouse beneficiary rollover a distribution from a tax sheltered annuity?

Yes, but only certain distributions may be rolled over (Q 3890, Q 3893).[2]

3934. May an employee transfer funds from a 403(b) account to purchase past service credit?

Yes.

Plan participants may exclude from income amounts directly transferred from an IRC Section 403(b) tax sheltered annuity to a governmental defined benefit plan that are used to purchase permissive service credit. Likewise, a participant may use directly transferred amounts to repay contributions or earnings that previously were refunded because of a forfeiture of service credit under either the transferee plan or an IRC Section 403(b) tax sheltered annuity maintained by a governmental employer in the same state.[3]

PPA 2006 modifies the definition of permissive service credit. Under the new definition, "permissive service credit" means service credit that relates to benefits to which a participant is not otherwise entitled under a governmental plan, rather than service credit that a participant has not received under a plan.

Credit qualifies as permissive service credit if it is purchased to provide an increased benefit for a period of service already credited under the plan (e.g., if a lower level of benefit is converted to a higher benefit level otherwise offered under the same plan) as long as it relates to benefits to which the participant is not otherwise entitled.

PPA 2006 also allows participants to purchase credit for periods regardless of whether service is subject to the limits on nonqualified service. Under the provision, service as an employee

[1] Treas. Reg. §1.403(b)-10(b)(3).

[2] See IRC Secs. 402(c)(2)(A), 402(c)(11).

[3] IRC Secs. 403(b)(13), 457(e)(17). See also Treas. Reg. §1.403(b)-10(b)(4).

of an educational organization providing elementary or secondary education can be determined under the law of the jurisdiction in which the service was performed. Thus, for example, permissive service credit can be granted for time spent teaching outside of the U.S. without being considered nonqualified service credit.[1]

The limits regarding nonqualified service are not applicable in determining whether a plan to plan transfer from a Section 403(b) annuity to a governmental defined benefit plan is for the purchase of permissive service credit. Thus, the failure of the transferee plan to satisfy the limits does not cause the transferred amounts to be included in the participant's income. The transferee plan must satisfy the limits in providing permissive service credit as a result of the transfer.

Plan-to-plan transfers under IRC Section 403(b)(13) may be made regardless of whether a transfer is made between plans maintained by the same employer. The provision also provides that amounts transferred from a Section 403(b) annuity to a governmental defined benefit plan to purchase permissive service credit are subject to distribution rules applicable under the IRC to the defined benefit plan.[2]

3935. Is an employee taxed on incidental life insurance protection and waiver of premium benefits under a tax sheltered annuity contract?

The final 403(b) regulations confirm that only certain incidental insurance benefits may be part of a 403(b) contract (Q 3909).

The one year term cost of pure life insurance protection provided by an employer must be included each year in an employee's gross income. This cost is computed in the same manner and with use of the same rates as under a qualified plan (Q 3843).[3] Thus, the applicable rate is applied to the amount at risk each year to determine the amount includable in gross income. The death benefit must be provided as part of an annuity contract and cannot be part of a life insurance contract purchased after September 23, 2007.

Where insurance is provided through a group contract, the insurance company issuing the group contract is responsible for reporting the one year term costs on Form 1099-R in accordance with IRC Section 6047(d).[4] The sum of the annual one year term costs that have been taxed to an employee will constitute all or part of the employee's cost basis in computing the tax on the payments the employee receives under the contract (Q 3958).[5] In other words, the aggregate cost of insurance protection, which is the amount reported by the employee as taxable income, can be recovered tax-free from annuity payments.[6]

Because a waiver of premium provision and a disability income provision are not pure annuity features, their cost is not within the overall limit provided by the IRC. The extra premiums for

[1] See IRC Sec. 415(n)(3).
[2] See IRC Sec. 415(n)(3)(d).
[3] Treas. Reg. §1.72-16(b).
[4] See Let. Rul. 9007001.
[5] Treas. Reg. §1.72-16(b)(4).
[6] Rev. Rul. 68-304, 1968-1 CB 179.

these provisions must be included in the employee's gross income.[1] See Q 3959 for the taxation of the death benefit.

Planning Point: Life insurance contracts can no longer be purchased under a 403(b) plan.

3936. How are dividends under a tax sheltered annuity treated for income tax purposes?

Dividends are treated as earnings on 403(b) investments. The IRS treats interest on accumulated dividends as part of a retirement fund and interest is not taxed until the participant begins to receive distributions from the fund.[2]

3937. Are amounts borrowed under a tax sheltered annuity taxable income?

Loans made after August 13, 1982, under IRC Section 403(b) tax sheltered annuity plans including IRC Section 403(b)(7) custodial accounts are subject to the same rules that apply to loans under qualified plans (Q 3848).[3]Therefore, unless certain requirements are met, amounts borrowed from a tax sheltered annuity will be taxed as a deemed distribution under the plan. Specifically, a loan will be treated as a deemed distribution under the plan unless it satisfies the following:

(1) the repayment term requirement (Q 3938);

(2) the substantially level amortization requirement (Q 3939);

(3) the enforceable agreement requirement (Q 3940); and

(4) certain dollar limitations (Q 3941).[4]

According to the final 403(b) regulations, a facts and circumstances inquiry must be made when determining whether the availability of a loan, making of a loan, or failure to repay a loan is treated as a distribution directly or indirectly. Among the facts and circumstances to be considered are whether the loan has a fixed repayment schedule, whether it bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable interest rate to not be treated as a distribution.[5]

If there is an express or tacit understanding that the loan will not be repaid or, for any reason, the transaction does not create a debtor-creditor relationship, then the amount transferred is treated as an actual distribution from the plan rather than as a loan or a deemed distribution.[6] If a participant pledges or assigns any portion of his or her interest in a plan as security for a loan, the amount pledged or assigned is subject to the deemed distribution rule.[7]

[1] Let. Rul., 3-15-66, signed I. Goodman, Chief Pension Trust Branch, 1968 MDRT Proceedings, p. 221.

[2] General Information Letter, January 20, 1978.

[3] IRC Sec. 72(p)(4)(A).

[4] IRC Secs. 72(p)(1), 72(p)(2); Treas. Reg. §1.72(p)-1, A-3.

[5] Treas. Reg. §1.403(b)-6(f).

[6] Treas. Reg. §1.72(p)-1, A-17.

[7] Treas. Reg. §1.72(p)-1, A-1(b).

Other considerations. Tax sheltered annuity plans that are subject to ERISA are subject to the prohibited transaction requirements applicable to loans: they must be adequately secured, bear a reasonable rate of interest, be available to all participants or beneficiaries on a reasonably equivalent basis, be made in accordance with specific provisions regarding such loans set forth in the plan, and not discriminate in favor of a prohibited group (Q 3871).[1]

In addition, to the extent a tax sheltered annuity is not funded by salary reduction, the plan must meet nondiscrimination rules that generally would require that loans be available on a nondiscriminatory basis (Q 3913).

See Q 3947 for deduction of interest on a loan. See Q 3910 for a discussion of deemed distributions, plan loan offsets, and the distribution restrictions of IRC Sections 403(b)(7) and 403(b)(11).

3938. How long can a loan under a tax sheltered annuity remain outstanding and still avoid treatment as a deemed distribution and inclusion in the participant's taxable income?

To avoid treatment as a deemed distribution, a loan by its terms must be required to be repaid within five years. A loan used to acquire a dwelling that within a reasonable time is to be used as the participant's principal residence (as defined in IRC Section 121) is not subject to the five year repayment term requirement.[2] Although the IRC puts no specific limit on the term of principal residence loans, it is likely that the IRS will impose at least a reasonable term on the theory that a loan is not in fact a loan if there is no obligation to repay.[3] A loan need not be secured by the dwelling that is to be the participant's principal residence to qualify as a principal residence loan exempt from the five year term requirement,[4] but see Q 3947 if there is a desire to render the interest on the loan deductible as qualified residence interest.

Tracing rules under IRC Section 163(h)(3)(B) apply in determining whether a loan is treated as for the acquisition of a principal residence and, therefore, exempt from the five year term requirement.[5]

Finally, a refinancing generally cannot qualify as a principal residence loan exempt from the five year term requirement. A loan used to repay a loan from a third party will qualify as a principal residence loan if it qualifies as such a loan without regard to the loan from the third party.[6]

[1] ERISA Sec. 408(b); Labor Reg. §2550.408b-1.

[2] IRC Sec. 72(p)(2)(B); Treas. Reg. §1.72(p)-1, A-5.

[3] Compare Treas. Reg. §1.72(p)-1, A-17, above. But see *Dean v. Commissioner* (suggesting that the term of principal residence loans extends to maturity of the tax sheltered annuity contract; deciding treatment of principal residence loans taken out before effective date of level amortization requirement). See also the example under Trea. Reg. §1.72(p)-1, A-8 (involving the application of the tracing requirement to a fifteen year loan used to repay a bank loan for the purchase of a principal residence).

[4] Treas. Reg. §1.72(p)-1, A-6.

[5] Treas. Reg. §1.72(p)-1, A-7.

[6] Treas. Reg. §1.72(p)-1, A-8.

3939. What is the substantially level amortization requirement applicable to a loan taken under a tax sheltered annuity that seeks to avoid taxation as a deemed distribution?

To avoid treatment as a deemed distribution, a loan generally must provide for substantially level amortization over the term of the loan with loan repayments to be made at least quarterly.[1] The level amortization requirement does not apply, and payments may be suspended, for a period up to one year while a participant is on a leave of absence and the participant's pay from his or her employer is insufficient to service the debt; a participant taking advantage of a suspension still must repay the loan by the latest permissible term of the loan and the installments due after payments resume must be at least as great as those required under the terms of the original loan. The latest permissible term of the loan is the latest date permitted under IRC Section 72(p)(2)(B), that is, five years from the date of the loan subject to the exception for principal residence loans, plus any additional period of suspension permitted under a military service leave.[2]

With respect to a leave of absence due to military service, IRC Section 414(u)(4) allows a participant to suspend repayment of a loan during any period that he or she serves in the uniformed services. The suspension of repayment under these circumstances may extend beyond one year, unlike the suspension rules for other leaves of absence.

A participant must resume loan repayments once he or she completes military service, at which time payments must be made as frequently and in an amount no less than was made before the suspension. The full amount of the loan, including interest accrued during the suspension, must be repaid by the end of the latest permissible loan term.

The latest permissible loan term under these circumstances is the latest permissible date under IRC Section 72(p)(2)(B), that is, five years from the date of the loan, subject to the exception for principal residence loans, plus any additional period of suspension permitted for military service. For example, if a military reservist obtained a three year loan and then served two years on active duty, the officer would have up to seven years to repay the loan, calculated as the five year maximum permissible loan term plus the two year suspension period. An example in the regulations illustrates the application of a 6 percent interest rate cap under the Soldier's and Sailor's Civil Relief Act Amendments of 1942 on a reservist's monthly installments and payment period.[3]

Failure to make any installment payment when due generally results in a deemed distribution of the entire outstanding balance of the loan at the time of such failure. A plan may provide a cure period for payments so long as the cure period does not extend beyond the last day of the calendar quarter following the calendar quarter in which the required payment was due. The cure period was referred to as a grace period under the proposed regulations.[4]

[1] IRC Sec. 72(p)(2)(C); see *Est. of Gray v. Comm.*, TC Memo 1995-421.

[2] Treas. Regs. §§1.72(p)-1, A-9(a), 1.72(p)-1, A-9(c), 1.72(p)-1, A-19(c).

[3] Treas. Reg. §1.72(p)-1, A-9.

[4] Treas. Reg. §1.72(p)-1, A-10.

3940. Does a loan taken under a tax sheltered annuity plan have to be evidenced by an enforceable agreement in order to avoid taxation as a deemed distribution?

To avoid treatment as a deemed distribution, a loan must be evidenced by a legally enforceable agreement, which may include more than one document, set forth either in writing or in an electronic medium specifying the amount of the loan, the term of the loan, and the repayment schedule.

The agreement does not have to be signed if it is enforceable under applicable law without being signed.[1]

If the agreement is set forth in an electronic medium, it must be one that is reasonably accessible to the participant and provided under a system that is reasonably designed to preclude anyone other than the participant from requesting a loan, provides the participant with a reasonable opportunity to review, confirm, modify, or rescind the terms of the loan before it is made, and provides the participant with confirmation of the loan terms within a reasonable time after it is made. The confirmation may be provided in an electronic format or in a written paper document. If it is provided electronically, it must be done in a manner that is no less understandable to a participant than a written document; at the time a confirmation is provided, a participant must be advised that he or she may request and receive a written paper document at no charge.[2]

3941. Is there a dollar limit on the amount that a participant can borrow under a tax sheltered annuity and avoid the loan being treated as a taxable distribution?

Loans made after 1986 are taxable as distributions from a plan to the extent the amount of the loan, when added to the outstanding balance of all other loans, whenever made, from all tax sheltered annuities, IRC Section 457 deferred compensation plans, and qualified pension, profit sharing, stock bonus, and bond purchase plans of the employer, exceeds the lesser of the following: (1) $50,000, reduced by the excess of the highest outstanding balance of loans from the plans during the one year period ending on the day before the date the loan is made over the outstanding balance of loans from the plans on the date the loan is made, or (2) one-half of the present value of the employee's nonforfeitable accrued benefit under the plans, of at least $10,000.[3]

Loans subject to the above dollar limits are those that by their terms require repayment within five years or, if they are "principal residence" loans, within a reasonable time and that satisfy the substantially level amortization requirement and the enforceable agreement requirement. All plans of all other members of a controlled group of employers, of an affiliated service group, or businesses under common control are counted as plans of the employer.[4]

[1] Treas. Reg. §1.72(p)-1, A-3(b).

[2] Treas. Reg. §1.72(p)-1, A-3(b).

[3] IRC Sec. 72(p)(2)(A); see also Let. Rul. 8742008.

[4] IRC Sec. 72(p)(2)(D).

3942. When is a loan taken under a tax sheltered annuity considered to be a deemed distribution? How does subsequent repayment of the loan, or subsequent failure to repay the loan, impact the participant's ability to receive additional loans?

The entire amount of a loan will be treated as a distribution from the outset if the terms of the loan do not satisfy the repayment term requirement or the level amortization requirement, or if the loan is not evidenced by an appropriate enforceable agreement.[1]

If a loan satisfies the other requirements but the amount loaned exceeds the applicable dollar limitation, the amount of the loan in excess of the limit is a deemed distribution at the time the loan is made.[2]

If a loan initially satisfies all of the requirements to avoid treatment as a deemed distribution but payments are not made in accordance with the terms of the loan, a deemed distribution of the entire outstanding balance, including accrued interest, generally results at the time of such failure.[3]

A plan may provide a cure period (referred to as a grace period under the proposed regulations) for payments so long as the cure period does not extend beyond the last day of the calendar quarter following the calendar quarter in which the required payment was due. A failure to make a payment will not trigger a deemed distribution of the outstanding balance until the end of the cure period.[4]

Once a loan is deemed distributed under IRC Section 72(p), the interest that accrues on that loan is not included in income for purposes of determining the amount that is taxable under IRC Section 72. In addition, neither the income that results from the deemed distribution nor the interest that accrues thereafter increases the participant's investment or tax basis in the contract under IRC Section 72. To the extent the deemed distribution is repaid, his or her investment in the contract will be increased.[5]

A loan that is deemed distributed under IRC Section 72(p), including interest accruing thereafter, and that has not been repaid such as by a plan loan offset still is considered outstanding for purposes of determining the maximum amount of any subsequent loans to the participant or the beneficiary.[6] Thus, for example, the amount limitation would be reduced by an outstanding loan even after a deemed distribution has occurred. To the extent that a participant repays by cash any portion of a loan that has been deemed distributed, the participant acquires a tax basis in the contract in the same manner as if the repayments were after-tax contributions; however, loan repayments are not treated as after-tax contributions for other purposes, including the nondiscrimination requirements and IRC Section 415 limits.[7]

[1] Treas. Reg. §1.72(p)-1, A-4(a); see IRC Secs. 72(p)(1), 72(p)(2); *Est. of Gray v. Comm.*, above.
[2] Treas. Reg. §1.72(p)-1, A-4(a); see IRC Secs. 72(p)(1), 72(p)(2).
[3] Treas. Regs. §§1.72(p)-1, A-4(a), 1.72(p)-1, A-10(b).
[4] Treas. Regs. §§1.72(p)-1, A-4(a), 1.72(p)-1, A-10(a).
[5] See Treas. Regs. §§1.72(p)-1, A-19(a), 1.72(p)-1, A-21(a).
[6] Treas. Reg. §1.72(p)-1, A-19(b)(1).
[7] See Treas. Reg. §1.72(p)-1, A-21(a).

The final loan regulations place two conditions on loans made while the loan treated as a distribution remains unpaid.

First, the subsequent loan must be repayable under a payroll withholding arrangement enforceable under applicable law. This arrangement may be revocable, but if the participant revokes it, the outstanding balance of the loan is treated as a deemed distribution.

Second, the participant must provide the plan with adequate security in the form of collateral for the loan in addition to the participant's accrued benefit. If, for any reason, the additional collateral is no longer in force before the subsequent loan is repaid, the outstanding balance of the subsequent loan is treated as a deemed distribution. If these conditions are not satisfied, the entire subsequent loan is treated as a distribution under IRC Section 72(p).[1]

Where a loan fee is withheld from net loan proceeds actually received by a participant but is included in a participant's outstanding loan balance, the deemed distribution on a default may include the withheld loan fee.[2]

3943. What is the process for determining whether loans taken under a tax sheltered annuity are taxable income when the participant receives multiple loans?

Where a participant receives multiple loans, each such loan must separately satisfy IRC Section 72(p), taking into account the outstanding balance of each existing loan. Under the final loan regulations, there is no limit on the number of loans a participant is permitted to take out.[3]

3944. Can loans taken under a tax sheltered annuity be refinanced? What is the effect of a refinancing on determining whether the outstanding loans constitute deemed distributions?

A refinancing transaction is any transaction in which one loan replaces another. For example, a refinancing may exist if the outstanding loan amount is increased or if the interest rate or the repayment term of the loan is renegotiated.[4]

If the term of a replacement loan ends after the latest permissible term of the loan it replaces, then both loans are treated as outstanding on the date of the refinancing transaction. This generally means that the loans must collectively satisfy the requirements of IRC Section 72(p) when determining whether the loans will constitute deemed distributions.[5]

There is an exception where the replacement loan would satisfy IRC Section 72(p)(2) if it were treated as two separate loans. Under this exception, the amount of the replaced loan, amortized in substantially level payments over a period ending not later than the last day of the latest permissible term of the replaced loan, is treated as one loan. The other loan is for an

[1] Treas. Reg. §1.72(p)-1, A-19(b).

[2] See *Earnshaw v. Comm.*, TC Memo 1995-156.

[3] Treas. Reg. §1.72(p)-1, A-20(a)(3).

[4] Treas. Reg. §1.72(p)-1, A-20(a).

[5] Treas. Reg. §1.72(p)-1, A-20(a)(2).

amount equal to the difference between the amount of the replacement loan and the outstanding balance of the replaced loan.[1]

The IRS will not view the transaction as circumventing IRC Section 72(p) provided that the replacement loan effectively amortizes an amount equal to the replaced loan over a period ending not later than the last day of the latest permissible term of the replaced loan. For this reason, the outstanding balance of the replaced loan need not be taken into account in determining whether the limitations of IRC Section 72(p)(2) have been met; only the amount of the replacement loan plus any existing loans that are not being replaced are considered.[2]

If the term of a replacement loan does not end later than the latest permissible term of the replaced loan, then only the amount of the replacement loan plus the outstanding balance of any existing loans that are not being replaced must be taken into account in determining whether IRC Section 72(p) has been satisfied.[3]

3945. When are amounts borrowed under a tax sheltered annuity taxable income as actual distributions?

Loans to participants can give rise to two kinds of taxable distributions: deemed distributions under IRC Section 72(p) and actual distributions. As noted in Q 3937, sham loans are treated as actual distributions. Even bona fide loans can result in actual distributions through distributions of plan loan offset amounts.

A distribution of a plan loan offset amount occurs when the accrued benefit of the participant is reduced or offset to repay the loan. The amount of the account balance that is offset against the loan is an actual distribution of plan benefits.[4] Accordingly, a plan may be prohibited from making such an offset under the distribution restrictions of IRC Sections 403(b)(7) and 403(b)(11) (Q 3910).[5]

3946. What is the tax treatment when amounts borrowed under a tax sheltered annuity are found to constitute deemed distributions?

If a loan is treated as a deemed distribution, it is includable in gross income (Q 3958) as if it were an actual distribution.[6] A loan treated as a deemed distribution may be subject to the 10 percent tax on early distributions imposed by IRC Section 72(t) (Q 3948) as if it were an actual distribution.[7]

To the extent a loan, when made, is a deemed distribution or an account balance is reduced to repay a loan, apparently at the time a loan is made, the amount includable in income is subject to withholding. If a deemed distribution or a loan repayment by benefit offset results in income

[1] Treas. Reg. §1.72(p)-1, A-20(a)(2).

[2] Treas. Reg. §1.72(p)-1, A-20(a)(2).

[3] Treas. Reg. §1.72(p)-1, A-20(a)(1).

[4] Treas. Reg. §1.72(p)-1, A-13. See also Treas. Reg. §1.403(b)-6(f), stating that a plan loan offset is a distribution. Compare *Caton v. Comm.*, TC Memo 1995-80.

[5] Treas. Reg. §1.72(p)-1, A-13(b).

[6] See Treas. Reg. §1.72(p)-1, A-11(a).

[7] Treas. Reg. §1.72(p)-1, A-11(b); see also *Dean v. Comm.*, above.

after the date the loan is made, withholding is required only if a transfer of cash or property excluding employer securities is made from the plan at the same time.[1]

Deemed distributions under IRC Section 72(p) are not eligible rollover distributions and are not subject to the mandatory 20 percent withholding applicable to certain eligible rollover distributions.[2] Plan loan offset amounts can be eligible rollover distributions.[3] For withholding rules relevant to plan loan offset amounts that are eligible rollover distributions, see Treasury Regulation Section 31.3405(c)-1, especially A-11.

3947. Is interest on a loan under a tax sheltered annuity deductible?

Interest on a loan not treated as a distribution (Q 3937) made, renewed, renegotiated, modified, or extended after December 31, 1986, is not deductible. No basis is created in a participant's account with respect to nondeductible interest paid to a plan.[4]

Interest paid on amounts borrowed under a retirement plan for the purchase or improvement of a principal residence is deductible as qualified residence interest if the loan is secured by a recorded deed of trust, is not the participant's account balance,[5] and is deductible. Because custodial accounts and annuity carriers typically are unable to perfect a security interest, interest on these types of loans from 403(b) arrangements will not be deductible.

Distributions

3948. What distributions from a tax sheltered annuity are subject to a penalty for early or premature distributions?

If a taxpayer receives a taxable amount from a tax sheltered annuity including any amount attributable to accumulated deductible contributions and including plan loan amounts treated as deemed distributions (Q 3937), the taxpayer will be subject to an excise tax of 10 percent on that distribution unless the distribution is:

(1) made on or after the date on which an employee attains age 59½;[6]

(2) made to a beneficiary or the employee's estate on or after the death of the employee;[7]

(3) attributable to an employee's disability;[8]

(4) part of a series of substantially equal periodic payments made not less frequently than annually for the life or life expectancy of the employee or the joint lives or joint life expectancies of the employee and the employee's beneficiary and beginning

[1] Treas. Reg. §1.72(p)-1, A-15. For further guidance on withholding rules, see Temp. Treas. Reg. §35.3405-1T, Q&A F-4 and Treas. Regs. §§31.3405(c)-1, A-9, and 31.3405(c)-1, A-11.

[2] Treas. Regs. §§1.402(c)-2, A-4, 31.3405(c)-1, A-1(a); Treas. Reg. §1.72(p)-1, A-12.

[3] Treas. Reg. §1.402(c)-2, A-9.

[4] General Explanation of TRA '86, p. 729.

[5] See Let. Ruls. 8935051, 8742025; see also *Earnshaw v. Comm.*, TC Memo 1995-156.

[6] IRC Sec. 72(t)(2)(i).

[7] IRC Sec. 72(t)(2)(ii).

[8] IRC Sec. 72(t)(2)(iii).

after the employee separates from the service of the employer.[1] Q 3631 discusses acceptable methods for meeting this exception. If the series of payments is later modified other than because of death or disability before the employee reaches age 59½ or, if after the employee reaches age 59½, within five years of the date of the first payment, the employee's tax for the year the modification occurs is increased by an amount equal to the tax that, but for the exception, would have been imposed plus interest for the deferral period;[2]

(5) made to an employee on account of separation from service after attaining age fifty-five.[3] A distribution will be treated as falling within this exception if the distribution is made after the employee has separated from service and the separation occurs during or after the calendar year in which the employee attains age 55;[4]

(6) properly made to an alternate payee under a qualified domestic relations order (Q 3910);[5]

(7) made to an employee for medical care but not in excess of the amount allowable as a medical expense deduction to the employee for amounts paid during the taxable year for medical care determined without regard to whether the employee itemizes deductions for the year. Apparently, this exempts from the penalty only amounts in excess of the 10 percent floor (7.5 percent for tax years beginning before 2013) on deductible medical expenses;[6]

(8) timely made to correct an excess aggregate contribution[7] (Q 3913); or

(9) timely made to reduce an excess elective deferral (Q 3921).[8]

The costs of life insurance protection that are included in an employee's income are not considered as distributions for purposes of applying the premature distribution penalty.[9] See Q 3843 regarding the proper measure of the value of current life insurance protection.

3949. When must distributions begin from a tax sheltered annuity?

Tax sheltered annuities, including custodial accounts and church retirement income contracts, are subject to minimum distribution rules set forth in IRC Section 401(a)(9), both in form and operation.[10] Except as described below and in Q 3951 to Q 3954, Section 403(b)

[1] IRC Secs. 72(t)(2)(A)(iv), 72(t)(3).
[2] IRC Sec. 72(t)(4).
[3] IRC Sec. 72(t)(2)(A)(v).
[4] Notice 87-13, 1987-1 CB 432, A-20.
[5] IRC Sec. 72(t)(2)(C).
[6] IRC Sec. 72(t)(2)(B); see Ann. 87-2, 1987-2 IRB 38.
[7] IRC Sec. 401(m)(7).
[8] IRC Sec. 402(g)(2)(C).
[9] Notice 89-25, 1989-1 CB 662, A-11.
[10] IRC Sec. 403(b)(10); Treas. Reg. §1.403(b)-6(e)(1).

contracts are treated as IRAs for purposes of applying the minimum distribution requirements.[1] Regulations finalized in 2007 address a number of issues concerning the application of these rules to tax sheltered annuities.[2]

If a custodian has adequate records to distinguish between amounts accruing before January 1, 1987, known as the pre-1987 account balance, and amounts accruing after December 31, 1986, known as the post-1986 account balance, which includes earnings on the pre-1987 account balance, the minimum distribution requirements are imposed only on the post-1986 account balance.[3]

The issuer or custodian of the contract must be able to identify the pre-1987 balance, maintain accurate records of changes in it, and provide information on request to the participant or beneficiaries with respect to the contract. If the issuer or custodian does not keep these records, the entire balance will be treated as subject to IRC Section 401(a)(9).[4]

The characterization of distributions as coming from pre-1987 or post-1986 balances has no relevance for purposes of determining the portion of a distribution that is includable in income under Section 72.[5]

The application of IRC Section 401(a)(9) rules to tax sheltered annuities is explained in Q 3951 for lifetime distributions and Q 3954 for after-death distributions. The application of the minimum distribution incidental benefit rule is explained in Q 3953.

Guidance on the application of the minimum distribution requirements under IRC Section 401(a)(9) is found in regulations finalized in 2002 and 2004, as well as regulations under Section 403(b) finalized in 2007.[6] The 2007 regulations made minimal changes to the preexisting requirements, but clarify the treatment of pre-1987 balances.[7]

Distributions that are required under IRC Section 401(a)(9) reduce the post-1986 balance to the extent they are necessary to meet the requirements; to the extent they exceed the minimum, they permanently reduce the pre-1987 balance.[8]

Under earlier rules that are still in effect, distributions, regardless of when the amounts accrued, also must satisfy the incidental benefit or minimum distribution incidental benefit ("MDIB") rule (Q 3953).[9]

The distribution requirements under the two sets of rules are different.

First, the MDIB requirement affects only distributions required to be made to a participant during his or her lifetime although distributions to be made after death are considered in

[1] Treas. Reg. §1.403(b)-6(e)(2); see Treas. Reg. §1.408-8.
[2] Treas. Reg. §1.403(b)-6.
[3] Treas. Reg. §1.403(b)-6(e)(6)(i); Treas. Reg. §1.403(b)-3, A-2(a).
[4] Treas. Reg. §1.403(b)-3, A-2(b); Treas. Reg. §1.403(b)-6(e)(ii).
[5] Treas. Reg. §1.403(b)-6(e)(6)(v).
[6] TD 8987, 67 Fed. Reg. 18988 (4-17-02); TD 9130, 2004-26 IRB 1082; REG-155608-02, 69 Fed. Reg. 67075.
[7] Treas. Reg. §1.403(b)-6(e)(6).
[8] Treas. Reg. §1.403(b)-3, A-2(b); Treas. Reg. §1.403(b)-6(e)(3).
[9] IRC Sec. 403(b)(10); Treas. Regs. §§1.401-1(b)(1)(i); 1.403(b)-3, A-3.

determining the minimum required to be distributed to the participant during the participant's lifetime.

Second, the amounts required under the two rules may be different. If the two requirements call for different minimums, the larger of the two is the amount that must be distributed.

According to both the final 2002 regulations and the 2007 regulations, distributions attributable to the pre-1987 account balance are treated as satisfying the MDIB requirement if all distributions from a Section 403(b) contract, including distributions attributable to a post-1986 account balance, satisfy the requirements of Treasury Regulation Section 1.401-1(b)(1)(i), which the regulations cite as authority for the old MDIB rule, without regard to whether distributions under the 2002 regulations and distributions from the post-1986 account satisfy the requirements of IRC Section 401(a)(9).[1]

In the alternative, distributions attributable to a pre-1987 account will be treated as satisfying the MDIB requirement if all distributions from the contract, whether pre-1987 or post-1986 amounts, satisfy the regulations under IRC Section 401(a)(9).[2]

The IRS previously has ruled privately that for purposes of determining the minimum distribution where amounts are transferred, in installments, from an insolvent insurer to another insurer pursuant to an exchange agreement between the two insurers and a court-appointed receiver, all amounts, subject to any grandfathering of unrecovered pre-1987 account balances, under all annuity contracts of the individual, must be taken into account. This includes any amounts not yet transferred under the agreement.[3]

Rollovers and transfers. If a distribution is made from a participant's pre-1987 balance and rolled over to another tax sheltered annuity, it will be treated as part of the post-1986 balance in the second contract. If a direct transfer of pre-1987 funds is made from one contract to another, the amount transferred retains its character as part of the pre-1987 balance provided the issuer of the second contract meets the recordkeeping requirements described above.[4]

Multiple tax sheltered annuities. If an individual has more than one tax sheltered annuity, each must meet the requirements separately. However, after determining the required minimum for each 403(b) annuity separately, the amounts may be totaled and the total taken from any one or more of the annuities.

Only amounts that an individual holds as a participant may be aggregated under this rule. If an individual account holder is also the beneficiary of the tax sheltered annuity of a decedent, the required distribution from that account may not be aggregated with amounts required under contracts held by the individual for purposes of meeting the distribution requirements.[5]

[1] Treas. Reg. §1.403(b)-3, A-3; Treas. Reg. §1.403(b)-6(e)(6)(vi).
[2] Treas. Reg. §1.403(b)-3, A-3; Treas. Reg. §1.403(b)-6(e)(6)(vi).
[3] Let. Rul. 9442030.
[4] Treas. Reg. §1.403(b)-6(e)(6)(iv).
[5] Treas. Reg. §1.403(b)-3, A-4; Prop. Treas. Reg. §1.403(b)-6(e)(7).

3950. What is the effect of failure to make timely distributions from a tax sheltered annuity?

If an amount distributed from a tax sheltered annuity is not taken by the participant, or is less than the required minimum distribution, an excise tax equal to 50 percent of the shortfall is generally levied against the individual (not the plan).[1] See Q 3814. However, the tax may be waived if the payee establishes to the satisfaction of the IRS that the shortfall was due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.[2] Generally, the excise tax will be waived automatically in the case of a beneficiary who receives the entire benefit to which he is entitled under the five-year rule.[3]

Planning Point: RMDs from Section 403(a) and 403(b) defined contribution plans were waived for calendar year 2009 only. Also, the five-year rule is determined without regard to 2009. A person who received a RMD for 2009 (including a distribution for 2009 made as late as April 1, 2010) had until the later of 60 days of receiving the RMD or November 30, 2009, to roll over the RMD to an IRA or other retirement plan (assuming the rollover would otherwise qualify).[4] The plan document or the annuity contract must, however, provide for that waiver

The minimum distribution requirements will not be treated as violated and, thus, the 50 percent excise tax will not apply, where a shortfall occurs because assets are invested in a contract issued by an insurance company in state insurer delinquency proceedings. To the extent that a distribution otherwise required under IRC Section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though it is not vested.[5]

3951. What minimum distributions must be made under Section 401(a)(9) from a tax sheltered annuity during the life of the participant?

If a post-1986 account balance is not totally distributed to a participant by his or her required beginning date, distributions of the balance must begin by that date and must, at a minimum, be distributed over one of the following periods: the life of the participant, the lives of the participant and his or her beneficiary, or a period not extending beyond the life expectancy of the participant or the life expectancy of the participant and a designated beneficiary.[6] If the issuer or custodian of the account does not keep adequate records to distinguish between pre-1987 and post-1986 balances, the entire account will be treated as subject to IRC Section 401(a)(9).[7]

The minimum distribution requirements include regulations finalized in 2002.[8] Additional regulations finalized in 2004 govern annuity distributions under Section 403(b) plans.[9] Regulations finalized in 2007 apply to distributions after 2008.[10]

[1] IRC Sec. 4974.
[2] Treas. Reg. §54.4974-2, A-7(a).
[3] Treas. Reg. §54.4974-2, A-7(b).
[4] Notice 2009-82, 2009-41 IRB 491.
[5] Treas. Reg. §1.401(a)(9)-8, A-8.
[6] IRC Secs. 403(b)(10), 401(a)(9).
[7] Treas. Reg. §1.403(b)-3, A-2(b); Treas. Reg. §1.403(b)-6(e)(6)(ii).
[8] TD 8987, 67 Fed. Reg. 18988 (4-17-02).
[9] TD 9130, 2004-26 IRB 1082.
[10] TD 9340, 72 Fed. Reg. 41128 (July 26, 2007).

The Pension Protection Act of 2006 called for regulations that would provide that governmental plans are subject to a reasonable, good faith interpretation of the minimum distribution requirements.[1] This same standard is applicable under earlier guidance and compliance with the 2002 regulations, the 2001 regulations, or the 1987 regulations will be considered to meet that standard.[2]

A participant's required beginning date is April 1 of the calendar year following the later of the calendar year in which the participant attains age 70½ or the calendar year in which the participant retires.[3] For any part of a Section 403(b) contract that is not part of a government plan or church plan, regulations state that the required beginning date for a 5 percent owner is April 1 of the calendar year following the calendar year in which the employee reaches age 70½.[4]

Under 2002 regulations (as under earlier guidance), a plan is permitted to provide that the required beginning date for all participants is April 1 of the calendar year following the calendar year in which the participant attains age 70½.[5] Governmental or church plan participants are permitted under the IRC to delay distributions until April 1 of the calendar year following the later of the year in which the participant retires or turns 70½; consequently, this provision is not applicable to them.[6]

A distribution for the calendar year a participant becomes age 70½ or retires, if applicable, must be made by April 1 of the following calendar year. The distribution for each calendar year after the year the participant becomes 70½ or retires, if applicable, must be made by December 31 of that year. Thus, it is possible that distributions for the calendar year in which a participant becomes 70½ or retires and the following calendar year will be made in the same calendar year.

Non-annuity Payments

Under 2002 regulations, if distributions are not made as annuity payments under an annuity contract, the account balance generally is distributed according to a uniform lifetime table (Appendix F).[7] The minimum required to be distributed each year is determined by dividing the post-1986 account balance as of the end of the preceding year by the applicable distribution period of the participant as found in the table. For an example of a calculation under this method, see Q 3637. The amount of an individual's lifetime required distribution is calculated without regard to the beneficiary's age, except in the case of a spouse beneficiary who is more than ten years younger than the participant.[8]

[1] P.L. 109-280, Sec. 823.

[2] Rev. Proc. 2003-10, 2003-1 CB 259; Notice 2003-2, 2003-1 CB 257.

[3] IRC Sec. 401(a)(9)(C); Treas. Reg. §1.403(b)-6(e)(3).

[4] Treas. Reg. §1.403(b)-6(e)(3).

[5] Treas. Reg. §1.401(a)(9)-2, A-2(e).

[6] IRC Sec. 401(a)(9)(C).

[7] Treas. Reg. §1.401(a)(9)-9, A-2.

[8] Treas. Reg. §1.401(a)(9)-5, A-4.

If a sole designated beneficiary is a participant's spouse, the distribution period during the participant's lifetime is the longer of the uniform lifetime table or the joint and survivor life expectancy of the participant and spouse (Appendix F)[1] using their attained ages in the distribution calendar year.[2] As a practical matter, the joint and survivor life expectancy table will produce a longer and thus lower payout only if the spouse beneficiary is more than ten years younger than the participant.

Account Balance

For purposes of calculating minimum distributions, the account balance is determined as of the last valuation date in the immediately preceding calendar year, that is, the valuation calendar year.[3] Distributions in excess of the amount required in one year may not be used to reduce the amount required in subsequent years.[4]

Payments under Annuity Contract

Regulations under Section 401(a)(9) govern annuity distributions from Section 403(b) plans.[5] Under those regulations, annuity distributions must be periodic payments made at least annually, for a life or lives, or over a period certain not longer than a life expectancy or a joint and survivor life expectancy of the participant or the participant and a beneficiary, as set forth in the IRC's provisions for lifetime and after death distributions (Q 3805).[6] The annuity also may be a life annuity with a period certain, as long as the life or lives and period certain each meet the foregoing requirements.[7] The distribution of an annuity contract is not a distribution for purposes of meeting the required minimum distribution requirements of IRC Section 401(a)(9).[8]

Commencement of Distributions

Distributions from an annuity contract must begin on or before the participant's required beginning date. The first payment must be the payment that is required for one payment interval. Regulations state that the second payment need not be made until the end of the next payment interval, even if the interval ends in the next calendar year. Examples of payment intervals include monthly, bimonthly, semi-annually, and annually.[9]

All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of the life annuity payments for payment intervals ending on or after the participant's required beginning date.[10]

[1] Treas. Reg. §1.401(a)(9)-9, A-3.
[2] Treas. Reg. §1.401(a)(9)-5, A-4(b).
[3] Treas. Reg. §1.401(a)(9)-5, A-3(a).
[4] Treas. Reg. §1.401(a)(9)-5, A-2.
[5] TD 9130, 2004-26 IRB 1082.
[6] Treas. Regs. §§1.401(a)(9)-6, A-1(a); 1.401(a)(9)-6, A-3; IRC Sec. 401(a)(9)(A).
[7] Treas. Reg. §1.401(a)(9)-6, A-1(b).
[8] Treas. Reg. §1.401(a)(9)-8, A-10.
[9] Treas. Reg. §1.401(a)(9)-6, A-1(c).
[10] Treas. Reg. §1.401(a)(9)-6, A-1(c)(1).

Exceptions to Non-increasing Annuity Requirement

Except as otherwise provided, annuity payments must be non-increasing, or increase only in accordance with the following:

(1) an annual percentage not exceeding that of an eligible cost-of-living index, for example, one issued by the Bureau of Labor Statistics or certain others defined in the regulations;

(2) a percentage increase that occurs at specified times or specified ages and does not exceed the cumulative total of annual percentage increases in an eligible cost of living index (see (1)) since the annuity starting date;

(3) increases to the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death (if a beneficiary dies or is no longer subject to a QDRO, see Q 3816);

(4) increases that result from a plan amendment; or

(5) increases to allow a beneficiary to convert the survivor portion of a joint and survivor annuity into a single sum distribution on the employee's death.[1]

Additional Permitted Increases

If the total future expected payments from an annuity purchased from an insurance company exceed the total value being annuitized, payments under the annuity will not fail to satisfy the nonincreasing payment requirement merely because the payments are increased in accordance with one or more of the following:

(1) by a constant percentage, applied not less frequently than annually;

(2) to provide a final payment on the employee's death that does not exceed the excess of the total value being annuitized over the total of payments before the death of the employee;

(3) as a result of dividend payments or other payments resulting from certain actuarial gains; and

(4) an acceleration of payments under the annuity (as defined in the regulations).[2]

Period Certain Limit

The period certain for annuity distributions commencing during the life of a participant, with an annuity starting date on or after the required beginning date, may not exceed the Uniform Lifetime Table. If a participant's spouse is the sole beneficiary as of the annuity starting date and

[1] Treas. Reg. §1.401(a)(9)-6, A-14(a).

[2] Treas. Regs. §§1.401(a)(9)-6, A-14(c), 1.401(a)(9)-6, A-14(e).

the annuity provides only a period certain and no life annuity, the period certain may be as long as the joint and survivor life expectancy of the participant and spouse based on their ages as of their birthdays in the calendar year that contains the annuity starting date.[1]

The IRS privately ruled under the 1987 Regulations that an IRC Section 403(b) annuity contract that offered a settlement option under which the retirement benefit payment was determined in accordance with the individual account rules, that is, the non-annuity payments rule, and provided for non-level retirement income benefits satisfied the minimum distribution rules.[2]

3952. How is the designated beneficiary under a tax sheltered annuity determined?

A designated beneficiary means any individual designated as a beneficiary by a participant.[3] Under the 2002 regulations, a participant's designated beneficiary is determined based on the beneficiaries designated as of September 30 of the calendar year following the year of the participant's death.[4]

Thus, for example, a beneficiary who disclaims his or her interest after the death of the participant but before the September 30 deadline would not be a considered a beneficiary for this purpose. Exceptions apply if the account is payable as an annuity or if a surviving spouse beneficiary dies after the participant but before distributions have begun (Q 3809).

Under the 2002 regulations, a beneficiary designated as such under the plan is an individual, or certain trusts (Q 3809), who is entitled to a portion of a participant's benefit, contingent on the participant's death or another specified event. A designated beneficiary need not be specified by name in the plan or by the participant to the plan to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan as of the date the beneficiary is determined.

The 2002 regulations state that an individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the participant or the participant's surviving spouse specifying the beneficiary.The fact that a participant's interest under the plan passes to a certain individual under applicable state law, however, does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.[5]

3953. What is the minimum distribution incidental benefit requirement with respect to tax sheltered annuities?

The minimum distribution incidental benefit ("MDIB") requirement constitutes a second set of minimum distribution rules that must be considered in determining the minimum

[1] Treas. Reg. §1.401(a)(9)-6, A-3(a).

[2] Let. Rul. 9128035.

[3] IRC Sec. 401(a)(9)(E).

[4] Treas. Reg. §1.401(a)(9)-4, A-4(a).

[5] Treas. Reg. §1.401(a)(9)-4, A-1.

amount required to be distributed during a participant's lifetime.[1] The MDIB rules apply to the pre-1987 account balance as well as the post-1986 balance. The reason they apply to the pre-1987 account balance, while the minimum distribution rules under IRC Section 401(a)(9) do not, is that unlike those requirements, the incidental benefit rule existed in regulations for many years before it was enacted into the IRC in 1986 and amounts accumulated before 1987 were subject to its requirements. Regulations under IRC Section 403(b) required that the death benefit under a tax sheltered annuity be merely incidental to its primary purpose of providing retirement benefits.

In 2007, regulations under Section 403(b) were finalized that briefly addressed the application of the older MDIB rule. These regulations took effect after 2008.[2] They generally restated rules contained in earlier regulations, to the effect that the post-1986 balance is subject to the IRC Section 401(a)(9) regulations and that both the pre-1987 balance and the post-1986 balance are subject to the MDIB rule (Q 3949).[3]

The 2007 regulations do not interpret the old MDIB rule but describe two ways it can be satisfied. First, distributions attributable to the pre-1987 account balance are treated as satisfying the MDIB requirement if all distributions from a Section 403(b) contract, including distributions attributable to the post-1986 account balance, satisfy the requirements of Treasury Regulation Section 1.401-1(b)(1)(i) (which the regulations cite as authority for the old MDIB rule) without regard to whether distributions under the 2002 regulations and distributions from the post-1986 account satisfy the requirements of IRC Section 401(a)(9).[4]

Second, and in the alternative, distributions attributable to the pre-1987 account will be treated as satisfying the MDIB requirement if all distributions from the contract whether pre-1987 or post-1986 amounts satisfy the regulations under IRC Section 401(a)(9).[5]

Under much earlier rulings, the old rule generally was interpreted as requiring a distribution arrangement under which the present value of the aggregate payments to be made to the participant must be more than 50 percent of the present value of the total payments to be made to the participant and his or her beneficiaries.[6] The old rules generally required that distributions commence by age seventy-five.[7] It would appear that the old rules may continue to apply in determining distributions required from the pre-1987 balance.[8] Of course, nothing would prevent a participant from choosing to apply the Section 401(a)(9) rules.[9]

Final 2002 regulations state that if distributions are made in accordance with the individual account rules set forth therein (Q 3951), the MDIB requirement will be satisfied.[10]

[1] IRC Sec. 403(b)(10); Treas. Reg. §1.401-1(b)(1)(i).
[2] TD 9340, 72 Fed. Reg. 41128 (July 26, 2007).
[3] Treas. Reg. §1.403(b)-3, A-2, A-3; Treas. Reg. §1.403(b)-6(e)(6).
[4] Treas. Reg. §1.403(b)-3, A-3; Treas. Reg. §1.403(b)-6(e)(6)(vi).
[5] Treas. Reg. §1.403(b)-3, A-3; Treas. Reg. §1.403(b)-6(e)(6)(vi).
[6] Rev. Rul. 72-241, 1972-1 CB 108; Rev. Rul. 73-239, 1973-1 CB 201; Let. Ruls. 8642072, 7843043, 7825010.
[7] Let. Ruls. 9345044, 7825010.
[8] Let. Rul. 9345044.
[9] Treas. Reg. §1.403(b)-3, A-3; Treas. Reg. §1.403(b)-6(e)(6)(vi).
[10] Treas. Reg. §1.401(a)(9)-5, A-1(d).

Annuity Distributions

If a participant's benefit is payable in the form of a life annuity for the life of the participant that satisfies the requirements of IRC Section 401(a)(9), the MDIB requirement will be satisfied.[1] If a participant's sole beneficiary as of the annuity starting date is the participant's spouse, and the distributions satisfy IRC Section 401(a)(9), the MDIB requirement will be satisfied.[2] Payments under the annuity must be nonincreasing, except as explained at Q 3951.[3]

If distributions begin under a particular distribution option that is in the form of a joint and survivor annuity for the joint lives of the participant and a nonspouse beneficiary, the MDIB requirement will not be satisfied as of the date distributions begin unless the distribution option provides that annuity payments to be made to the participant on and after his or her required beginning date will satisfy the conditions set forth in Treasury Regulation Section 1.401(a)(9)-6, A-2(c). Under those provisions, the periodic annuity payment payable to the survivor must not at any time on and after the participant's required beginning date exceed the applicable percentage of the annuity payment payable to the participant using the RMD MDIB Joint and Survivor Annuity Table (Appendix F).[4]

The applicable percentage is based on how much older the participant is than the beneficiary as of their attained ages on their birthdays in the first calendar year for which distributions to the participant are required. For example, if a beneficiary is ten or fewer years younger, the survivor annuity may be 100 percent. If the age difference is greater than ten years, the maximum survivor annuity permitted is less than 100 percent. If there is more than one beneficiary, the age of the youngest beneficiary is used.[5]

If a distribution form includes a life annuity and a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain, but in the case of a joint and survivor annuity with a period certain, the amount of the annuity payments payable to the beneficiary must satisfy the foregoing requirements after the expiration of the period certain.[6]

The period certain for annuity distributions commencing during the life of a participant with an annuity starting date on or after his or her required beginning date generally may not exceed the applicable distribution period for the participant (Q 3951) for the calendar year that contains the annuity starting date.

If the participant's spouse is his or her sole beneficiary and the annuity provides only a period certain and no life annuity, the period certain may last as long as the joint and survivor life expectancy of the participant and spouse, if that period is longer than the applicable distribution period for the participant.[7] If distributions commence after the death of the participant under the life expectancy rule (Q 3806), the period certain for any distributions commencing after

[1] Treas. Reg. §1.401(a)(9)-6, A-2(a).

[2] Treas. Reg. §1.401(a)(9)-6, A-2(b).

[3] Rev. Proc. 2003-10, 2003-1 CB 259; Notice 2003-2, 2003-1 CB 257.

[4] Treas. Reg. §1.401(a)(9)-6, A-2(c)(2).

[5] Treas. Reg. §1.401(a)(9)-6, A-2(c)(1).

[6] Treas. Reg. §1.401(a)(9)-6, A-2(d).

[7] Treas. Reg. §1.401(a)(9)-6, A-3(a).

death cannot exceed the distribution period determined under the life expectancy provisions of Treasury Regulation Section 1.401(a)(9)-5, A-5(b).

The amount required to be distributed generally is the greater of the MDIB or the regular RMD amount (Q 3802 to Q 3812). If the amount required to be distributed exceeds the amount distributed, the shortfall is subject to a 50 percent excise tax, levied on the individual, not the plan (Q 3814).[1]

3954. How are the minimum distribution requirements met after the death of a tax sheltered annuity participant?

A tax sheltered annuity must satisfy the minimum distribution requirements set forth in IRC Section 401(a)(9) for qualified plans.[2] Most of the requirements were explained in regulations published in 2002.[3] Regulations governing annuity payouts from defined benefit plans were finalized in 2004 (Q 3951, Q 3699), and regulations addressing additional matters were finalized under IRC Section 403(b) in 2007.[4]

The 2002 regulations simplified the calculation process and included longer life expectancy tables (Appendix F). The final regulations took effect for required minimum distributions in 2003 and later years (Q 3805, Q 3951).

After the death of a tax sheltered annuity participant, the application of the minimum distribution requirements depends on whether he or she died before or after his or her required beginning date. For this purpose, distributions generally are treated as having begun in accordance with the minimum distribution requirements under IRC Section 401(a)(9)(A)(ii), without regard to whether payments have been made before that date.[5] If distributions irrevocably, except for acceleration, began prior to the required beginning date in the form of an annuity that meets the minimum distribution rules, the annuity starting date will be treated as the required beginning date for purposes of calculating lifetime and after death minimum distribution requirements.[6]

Planning Point: RMDs are waived for 2009. A distribution for 2009 that must be made by December 31, 2009, can be waived. A distribution in the year after death that would ordinarily be required by the end of 2009 is not required until the end of 2010. The plan document or the annuity contract must, however, provide for that waiver

3955. How are the minimum distribution requirements met after the death of a tax sheltered annuity participant who died before his or her required beginning date?

If a participant dies before his or her required beginning date, distributions must be made under one of two methods:

(1) Under the five year rule, the entire interest must be distributed within five years after the death of the participant regardless of who or what entity receives the

[1] IRC Sec. 4974.

[2] IRC Sec. 403(b)(10).

[3] TD 8987, 67 Fed. Reg. 18988 (4-17-02).

[4] Treas. Reg. §1.403(b)-6.

[5] Treas. Reg. §1.401(a)(9)-2, A-6(a).

[6] Treas. Reg. §1.401(a)(9)-6, A-10, A-11.

distribution.[1] To satisfy this rule, the entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the participant's death.[2]

Planning Point: If one of the five years is 2009, the five year period is expanded to six years.

(2) Under the life expectancy rule, if any portion of the interest is payable to, or for the benefit of, a designated beneficiary, that portion must be distributed over the life or life expectancy of the beneficiary, beginning within one year of the participant's death.[3]

To the extent that the interest is payable to a nonspouse beneficiary, distributions must begin by the end of the calendar year immediately following the calendar year in which the participant died.[4] The nonspouse beneficiary's life expectancy for this purpose is measured as of his or her birthday in the year following the year of the participant's death. In subsequent years, this amount is reduced by one for each calendar year that has elapsed since the year immediately following the year of the participant's death.[5]

If the sole designated beneficiary is the participant's surviving spouse, distributions must begin by the later of the end of the calendar year immediately following the calendar year in which the participant died or the end of the calendar year in which the participant would have reached age 70½.[6] The payout period during the surviving spouse's life is measured by the surviving spouse's life expectancy as of his or her birthday in each distribution calendar year for which a minimum distribution is required after the year of the participant's death.[7] After the surviving spouse's death, the distribution period is based on his or her remaining life expectancy. This is determined using the age of the surviving spouse in the calendar year of his or her death, reduced by one for each calendar year that has elapsed after the calendar year of the surviving spouse's death.[8]

The 2002 regulations set forth tables containing single and joint and survivor life expectancies for calculating required minimum distributions, as well as a Uniform Lifetime Table for determining the appropriate distribution periods (Q 3951, Appendix F).[9]

Unless a plan adopts a provision specifying otherwise, if distributions to a participant have not begun prior to his or her death, they must be made automatically either under the life expectancy rule described above or, if there is no designated beneficiary, under the five year rule.[10] A plan may adopt a provision specifying that the five year rule will apply after the death

[1] IRC Sec. 401(a)(9)(B)(ii), Treas. Reg. §1.401(a)(9)-3, A-1(a).
[2] Treas. Reg. §1.401(a)(9)-3, A-2.
[3] IRC Sec. 401(a)(9)(B)(iii); Treas. Reg. §1.401(a)(9)-3, A-1(a).
[4] Treas. Reg. §1.401(a)(9)-3, A-3(a).
[5] Treas. Reg. §1.401(a)(9)-5, A-5(c)(1).
[6] IRC Sec. 401(a)(9)(B)(iv); Treas. Reg. §1.401(a)(9)-3, A-3(b).
[7] Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
[8] Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
[9] Treas. Reg. §1.401(a)(9)-9.
[10] Treas. Regs. §§1.401(a)(9)-1, A-3(c), 1.401(a)(9)-3, A-4(a).

of a participant, or a provision allowing participants or beneficiaries to elect whether the five year rule or the life expectancy rule will be applied.[1]

3956. How are the minimum distribution requirements met after the death of a tax sheltered annuity participant who died on or after the required beginning date?

If the participant dies on or after the date distributions have begun (i.e., generally on or after the required beginning date), but before the entire interest in the plan has been distributed, the IRC states that the entire remaining balance generally must be distributed at least as rapidly as under the method of distribution in effect as of the participant's date of death.[2] This method of distribution will depend on whether the distribution was in the form of distributions from an individual account or annuity payments.[3]

Under the 2002 regulations, a beneficiary determination is made as of September 30 of the year after the year of the participant's death.[4] If the participant does not have a designated beneficiary as of that date, the participant's interest is distributed over the remaining life expectancy, using the age of the participant in the calendar year of the participant's death, reduced by one for each calendar year that elapses thereafter.[5] If the participant does have a designated beneficiary as of the determination date, the beneficiary's interest is distributed over the longer of the following: (1) the beneficiary's life expectancy, calculated as described above at Life Expectancy Rule (i.e., under Treasury Regulation Section 1.401(a)(9)-5, A-5(c)(1) or (2)), or (ii) the remaining life expectancy of the participant, determined using the age of the participant in the calendar year of death, reduced by one for each calendar year that elapses thereafter (i.e., under Treasury Regulation Section 1.401(a)(9)-5, A-5(c)(3)).[6]

3957. How is the designated beneficiary of a tax sheltered annuity determined after the participant's death?

To be a designated beneficiary, an individual must be a beneficiary on the date of the participant's death. The determination of the existence and identity of a designated beneficiary for purposes of minimum distributions is made on September 30 of the calendar year following the year of the participant's death.[7] Exceptions may apply if the account is payable as an annuity, or if a surviving spouse beneficiary dies after the participant but before distributions have begun. The September 30 deadline is so a distribution may be calculated and made by the deadline of December 31 following the year of the participant's death. Consequently, an individual who was a beneficiary as of the date of the participant's death, but is not a beneficiary as of September 30 of the following year, such as because he or she disclaims entitlement to the benefit or because he or she receives the entire benefit to which he or she is entitled before that date, is not

[1] Treas. Regs. §§1.401(a)(9)-3, A-4(b), 1.401(a)(9)-3, A-4(c).

[2] IRC Sec. 401(a)(9)(B)(i).

[3] Treas. Reg. §1.401(a)(9)-2, A-5.

[4] Treas. Reg. §1.401(a)(9)-4, A-4(a).

[5] Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).

[6] Treas. Reg. §1.401(a)(9)-5, A-5(a)(1).

[7] Treas. Reg. §1.401(a)(9)-4, A-4(a).

taken into account for purposes of determining the distribution period for required minimum distributions after the participant's death.[1]

Under the 2002 regulations, special rules apply if more than one beneficiary is designated as of the date on which the determination is made. Generally, the beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the distribution period.[2]

If a surviving spouse beneficiary dies after the participant, but before distributions to the spouse have begun, the five year rule and the life expectancy rule described above for surviving spouses will be applied as though the surviving spouse were the participant.[3] This provision will not allow a new spouse of the deceased participant's surviving spouse to delay distributions under the surviving spouse rules of IRC Section 401(a)(9)(B)(iv).[4]

The 2007 regulations provide that the special rule allowing a surviving spouse to treat an IRA interest as the spouse's own[5] does not apply to a Section 403(b) contract, even if the spouse is the sole beneficiary.[6]

If a beneficiary is not an individual or a permitted trust (Q 3809), the participant will be treated as having no beneficiary. A participant's estate may not be a designated beneficiary.[7]

3958. Are payments received under a tax sheltered annuity taxable income to the employee?

Yes, except to the extent the amounts are a recovery of the employee's investment in the contract including the amount of a defaulted loan or to the extent the employee rolls over an eligible distribution to another tax sheltered annuity, a qualified retirement plan, an eligible governmental 457 plan, or a traditional individual retirement plan (Q 3890).

Where an annuity contract without life insurance protection is used for funding, all payments received normally are taxable in full as ordinary income to the employee. This is the result regardless of whether contributions were made by the employer as additional compensation to the employee, were derived from a reduction in the employee's salary, or were paid in part by deductible voluntary employee contributions. Because salary reduction contributions have not been previously taxed to the employee, where they have come within the overall limit, they cannot be treated as a cost basis for the contract.[8]

In some instances, however, the employee will have a cost basis for the contract. An employee's cost basis consists of any nondeductible contributions the employee has paid and any portion

[1] Treas. Reg. §1.401(a)(9)-4, A-4(a).
[2] Treas. Reg. §1.401(a)(9)-5, A-7(a).
[3] IRC Sec. 401(a)(9)(B)(iv)(II); Treas. Reg. §1.401(a)(9)-3, A-5.
[4] Treas. Reg. §1.401(a)(9)-3, A-5.
[5] Treas. Reg. §1.408-8, A-5.
[6] Treas. Reg. §1.403(b)-6(e)(4).
[7] Treas. Reg. §1.401(a)(9)-4, A-3.
[8] IRC Sec. 403(b)(1).

of the contributions made by the employer on which the employee has paid tax, except that excess salary reduction amounts not distributed from the plan by April 15 of the year following the contribution are not included in basis even though they were included in income (Q 3921).

Where a life insurance policy is used (Q 3909), the sum of the annual one year term costs that have been taxed to the employee are included in the employee's cost basis.[1] See Q 3935 regarding the proper measure of the value of current life insurance protection.

Similarly, any portion of an employer's premiums that have been included in an employee's gross income because they exceeded the employee's overall limit are included in the employee's cost basis (Q 3917). The amount of any policy loans included in income as a taxable distribution (Q 3937) also would constitute part of the employee's cost basis.

Once a loan is deemed distributed under IRC Section 72(p), the interest that accrues thereafter on that loan is not included in income for purposes of determining the amount that is taxable under IRC Section 72. In addition, neither the income that results from the deemed distribution nor the interest that accrues thereafter increases the participant's investment or cost basis in the contract under IRC Section 72. To the extent that a participant repays by cash any portion of a loan that has been deemed distributed, the participant acquires a tax basis in the contract in the same manner as if the repayments were after-tax contributions.[2]

If an employee takes an account balance in a single lump sum cash payment, the full amount received will be ordinary income to the employee in the year of receipt unless the employee has a cost basis, except as provided in Q 3931 and Q 3933. If the employee has a cost basis, the amount in excess of the cost basis will be ordinary income.[3]

Amounts received before the annuity starting date, that is, in-service distributions, by an employee who has a cost basis are taxed under a rule that provides for pro rata recovery of cost.[4] An employee excludes that portion of the distribution that bears the same ratio to the total distribution as the employee's investment in the contract bears to the total value of the employee's accrued benefit as of the date of the distribution. Amounts received prior to July 2, 1986 were taxed under a cost recovery rule permitting recovery of basis before taxing any of the distribution as interest.[5]

The annuity starting date is the first day of the first period for which an amount is received as an annuity under a contract (Q 460).[6] If a plan on May 5, 1986 permitted in-service withdrawal of employee contributions, the pro rata recovery rules do not apply to investment in the contract prior to 1987. Instead, investment in the contract prior to 1987 will be recovered first and the pro rata recovery rules will apply only to the extent that amounts received before the annuity starting date, when added to all other amounts previously received under the contract after 1986, exceed the employee's investment in the contract as of December 31, 1986.[7]

[1] Rev. Rul. 68-304, 1968-1 CB 179.

[2] See Treas. Regs. §§1.72(p)-1, A-19(a), 1.72(p)-1, A-21(a).

[3] IRC Sec. 72(e)(5).

[4] IRC Sec. 72(e)(8).

[5] IRC Sec. 72(e)(5)(D).

[6] IRC Sec. 72(c)(4).

[7] IRC Sec. 72(e)(8)(D).

If an employee who has a cost basis for his or her contract receives life annuity or installment payments, the payments are taxed as discussed in Q 539, depending on the annuity starting date.

Where the 403(b) annuity contract or custodial account is solely liable for the payment of investment expenses, the direct payment of investment advisor fees from a participant's annuity or account is not treated as a distribution.[1] Likewise, where an annuity contract consists of different subaccounts for which a financial advisor provides asset allocation advice, if the annuity contract expenses are assessed directly against the contract value itself, those payments then are expenses of the contract itself and, therefore, are not distributions from the contract includable in the annuity contract owner's gross income. Furthermore, assessing expenses against a contract in this manner does not cause the contract to lose its qualified status under IRC Section 403(b).[2]

Withholding

With respect to distributions other than eligible rollover distributions (Q 3890), amounts will be withheld from periodic payments at the rates applicable to wage payments and from other distributions at a 10 percent rate. An employee may elect not to have income tax withheld from these payments. Tax will not be withheld on amounts distributed that it is reasonable to believe will not be includable in income.[3]

Any eligible rollover distribution made after December 31, 1992 is subject to mandatory income tax withholding at the rate of 20 percent unless the distributee elects to have the distribution paid by means of a direct rollover.[4] This mandatory withholding applies even if the employee's employment terminated prior to January 1, 1993, and even if the eligible rollover distribution is part of a series of payments that began before January 1, 1993.[5] For distributions after 1992 but before October 19, 1995, slightly different rules may be applicable under temporary regulations (Q 3883).

3959. How is a death benefit under a tax sheltered annuity taxed to an employee's beneficiary?

A death benefit under a tax sheltered annuity generally is taxed in the same way as a death benefit under a qualified pension or profit sharing plan except that there is no special treatment for a lump sum payment (Q 3865 to Q 3867).

In the case of a single sum payment where no life insurance is involved, all amounts received by a beneficiary are taxable as ordinary income except that the beneficiary may exclude from gross income the employee's unrecovered cost basis, if any.

If a death benefit consists of life insurance proceeds, the amount of the proceeds in excess of the cash surrender value of the policy immediately before the insured's death is excludable from

[1] Let. Ruls. 9332040, 9316042, 9047073.
[2] Let. Rul. 9845003.
[3] IRC Sec. 3405; Temp. Treas. Reg. §35.3405-1, A-20.
[4] IRC Sec. 3405(c); Treas. Reg. §31.3405(c)-1, A-1(a).
[5] Treas. Reg. §31.3405(c)-1, A-1(c)(1)(i).

gross income under IRC Section 101(a)(1). For the rule under the final regulations restricting the availability of life insurance in 403(b) arrangements, see Q 3909.

Cash surrender value is taxable as ordinary income to the extent that it exceeds the portion of the premiums taxed to the employee as being the cost of life insurance protection (see Q 3935 regarding the proper measure of the value of current life insurance protection), and any other unrecovered cost basis of the employee.[1]

Withholding

With respect to distributions other than eligible rollover distributions (Q 3890), payments to a surviving spouse or beneficiary are subject to income tax withholding unless the spouse or beneficiary elects not to have withholding apply. Amounts need not be withheld on any part of the distribution that it is reasonable to believe is not includable in gross income. Annuity payments are subject to withholding at the rate applicable to wages; other payments are subject to withholding at a 10 percent rate.[2] In the case of an eligible rollover distribution, a surviving spouse or other beneficiary is subject to the same mandatory withholding rules as the employee (Q 3958).

Social Security and Withholding Taxes

3960. How is a reduction in salary for a tax sheltered annuity treated for Social Security tax and income tax withholding purposes?

Excludable amounts paid into a tax sheltered annuity are not wages subject to income tax withholding, even if the amounts are derived from a salary reduction agreement.[3]

The amount of salary reduction contributions to the plan is subject to Social Security taxes even though it is excludable from the employee's gross income. Employer non-salary reduction contributions are not includable in wages for Social Security purposes.[4]

Under the final regulations, salary reduction agreement means a plan or arrangement under which payment will be made by an employer on behalf of an employee or his or her beneficiary under or to an annuity contract if the employee:

(1) elects to reduce his or her compensation under a cash or deferred election;

(2) elects to reduce his or her compensation pursuant to a one time irrevocable election made at or before the time of initial eligibility to participate in such plan or arrangement; or

(3) if the employee agrees as a condition of employment to make a contribution that reduces his or her compensation.[5]

[1] IRC Secs. 403(c), 72(m)(3)(C); Treas. Reg. §1.72-16(c).

[2] IRC Sec. 3405; Temp. Treas. Regs. §§35.3405-1, A-17; 35.3405-1, A-28.

[3] Rev. Rul. 65-208, 1965-2 CB 414.

[4] IRC Sec. 3121(a)(5); Rev. Rul. 65-208, 1965-2 CB 383; Rev. Rul. 181, 1953-2 CB 111. See also CCA 200333003; TAM 200305006; Let. Ruls. 200318074, 200234009.

[5] Treas. Reg. §31.3121(a)(5)-2.

The Seventh Circuit Court of Appeals concluded that Congress intended IRC Section 3121(a)(5)(D) to include salary reduction agreements, whether voluntary or mandatory, in the FICA wage base. Accordingly, the Seventh Circuit held that payments made under a salary reduction agreement include salary reductions made under voluntary and mandatory agreements.[1]

Amounts contributed by salary reduction by a minister or by church employees whose organizations have chosen to be exempt from FICA are not treated as wages subject to Social Security taxes to the extent the contributions are not more than the employer contribution limit.[2]

Amounts of salary reduction treated as wages for Social Security tax are creditable to the individual's Social Security account for benefit purposes.[3]

Excise Taxes

3961. What excise taxes and additional taxes apply to tax sheltered annuity contributions and distributions?

Excess Contributions to Custodial Accounts

Contributions to a custodial account for the purchase of regulated investment company stock and to a retirement income account to the extent funded through custodial accounts are subject to a tax of 6 percent, not to exceed 6 percent of the value of the account, on (1) the amount by which the contributions other than a permissible rollover contribution (Q 3890) exceed the lesser of the amount excludable from gross income under IRC Section 403(b) or the overall limitation under IRC Section 415, or whichever is applicable if only one is applicable, plus (2) any such excess carried over from the preceding tax year (Q 3927).[4]

Early or Premature Distributions

If a taxpayer receives a premature distribution from a tax sheltered annuity, he or she will be subject to an excise tax equal to 10 percent of the portion of the distribution includable in income (Q 3948).[5]

Minimum Required Distribution Failure

If the amount distributed during a tax year is less than the minimum required distribution for the year, there generally is a tax equal to 50 percent of the amount that the distribution made in the year falls short of the required amount. The tax is on the payee (Q 3949).[6]

Excess Aggregate Contributions

If an employee makes after-tax contributions or the employer makes contributions that match contributions under an employee's salary reduction agreement or match employee after-tax

[1] *University of Chicago vs. United States*, 547 F.3d 773 (7th Cir. 2008).
[2] See IRS Pub. No. 517.
[3] SSR 64-59.
[4] IRC Sec. 4973.
[5] IRC Sec. 72(t).
[6] IRC Sec. 4974.

contributions and the aggregate amount of the contributions exceeds the nondiscriminatory amount (Q 3732), a tax of 10 percent of the amount in excess of the permitted, nondiscriminatory maximum is imposed on the employer to the extent the excess amount and income attributable to it is not distributed within 2½ months after the end of the plan year (Q 3733).[1]

Plan Termination

3962. Can a 403(b) plan be frozen or terminated?

Yes, if certain conditions are met.

An employer is permitted to amend its 403(b) plan to eliminate future contributions for existing participants, or to limit participation to existing participants and employees. A 403(b) plan also is permitted to contain provisions that provide for plan termination and that allow accumulated benefits to be distributed on termination.[2]

In the case of a 403(b) contract that is subject to distribution restrictions relating to custodial accounts and 403(b) elective deferrals, termination of the plan and the distribution of accumulated benefits is permitted only if the employer does not establish a successor 403(b) plan by making contributions to any 403(b) contract that is not part of the plan during the period beginning on the date of plan termination and ending twelve months after distribution of all assets from the terminated plan, taking into account all entities that are treated as the same employer under IRC Sections 414(b), 414(c), 414(m), or 414(o) on the date of the termination.

The alternative 403(b) contract will be disregarded if, at all times during the period beginning twelve months before the termination and ending twelve months after distribution of all assets from the terminated plan, fewer than 2 percent of the employees who were eligible under the 403(b) plan as of the date of plan termination are eligible under the alternative 403(b) contract.

For a 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. For this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution. The mere provision for, and making of, distributions to participants or beneficiaries on plan termination does not cause a contract to cease to be a 403(b) contract.[3]

Employers that cease to be eligible employers. An employer that ceases to be an eligible employer may no longer contribute to a 403(b) contract for any subsequent period and the contract will fail to satisfy Treasury Regulation Section 1.403(b)-3(a), which is the exclusion for contributions to 403(b) contracts, if any further contributions are made with respect to a period after the employer ceases to be an eligible employer.[4]

Planning Point: The IRS has not recognized the distribution of custodial accounts as being terminating distributions from a plan.

[1] IRC Sec. 4979.

[2] Treas. Reg. §1.403(b)-10(a)(1).

[3] Treas. Reg. §1.403(b)-10(a)(1).

[4] Treas. Reg. §1.403(b)-10(a)(2).