Tax Facts on IRC Section 403(b) and Tax Sheltered Annuity Plans

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. The plan may be used by only certain employers. An employee generally must report the payments received under the contract or custodial account as taxable income.

A plan must meet specific requirements (see below) although some but not all failures to meet these requirements may be subject to correction under the Employee Plans Compliance Resolution System (“EPCRS”).

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.

How does the IRS limit the tax benefits of a tax sheltered annuity?

The IRS limit on contributions and benefits applicable to qualified pension plans applies to tax sheltered annuities For the purpose of this limit, tax sheltered annuities generally will be treated as defined contribution plans. 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). This limit is indexed for inflation in increments of $1,000.

Annual additions to a tax sheltered annuity are employer contributions, including salary reduction amounts and employee after-tax contributions. Excess elective deferrals that are correctly distributed under IRS regulations are not included as annual additions. Excess matching employer contributions are included, however, even if the excess is corrected by distribution from the plan.

Earnings attributable to distributed elective deferrals that are not themselves distributed will be considered as an employer contribution for the limitation year in which the distributed elective deferral was made. A contribution made during a tax year is treated as if made on the last day of the limitation year that ends in or with the tax year. A limitation year is the calendar year or any other twelve month period that may be elected by the plan in the plan document.

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). Includable compensation 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.

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. To illustrate, assume that as of the end of 2013, 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 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. 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.

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.

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 (see below). This definition includes chaplains.

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

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. 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. Likewise, a state agency that administers a guaranteed student loan program and is part of a state department of insurance may qualify. 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.

Although teachers who are 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. 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.

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 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. This definition includes chaplains.

A church employee may make an election that may provide a higher annual additions limit than discussed above. 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.

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.

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.

What are the IRS requirements that a tax sheltered annuity contract must meet?

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. The final regulations require the 403(b) plan, in both form and operation, to satisfy the applicable requirements for exclusion.

(1) *Purchase by Eligible Employer.* A tax sheltered annuity contract must be purchased by an eligible employer. IRS regulations provide that the annuity contract cannot be purchased under a qualified plan or an eligible governmental plan.

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).

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).

IRS 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, 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. A tax sheltered annuity plan also can qualify for the ERISA contribution safe harbor for small plans.

(2) *Nonforfeitable Rights.* An employee’s rights under a 403(b) contract must be nonforfeitable except for failure to pay future premiums. 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. 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 IRC Code Section 403(c) instead of 403(b).

(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.

(4) *Limits on Elective Deferrals.* Under IRS 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) *Nontransferable.* A contract must be expressly nontransferable. An agreement between employer and employee that the employee will not transfer the contract is not sufficient. For this purpose, an employer is considered to have purchased a new contract when it pays the first premium on a previously issued contract. 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.

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

(7) *Direct Rollover Option.* A plan generally must provide that if a distributee of any eligible rollover distribution elects to have the distribution paid directly to a traditional IRA, another tax sheltered annuity (if applicable), or an eligible retirement plan 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.

Prior to 2006, amounts held in an annuity contract or account described in IRC Section 403(b) could not be converted directly to a Roth IRA.[]](http://pro.nuco.com/taxfacts2014/tfempb/p12-tsas/contreq/Pages/3883-00-TF1.aspx?k=3883" \l "_ftn22) 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.

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.

(8) *Limitation on Incidental Benefits.* The contract must satisfy the incidental benefit requirements of IRC Section 401(a) which provides limitations on the cost of incidental benefits in proportion to the cost of providing all benefits under the plan.

(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.

IRS regulations require that 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 in IRC Section 403(b) and Treasury regulations. 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.