Focus On . . . Tax-Sheltered Annuity Plans Under Code Section 403(b)

Part 1—General Rules and Limitations on Contributions

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Subject to a complex set of rules, tax-sheltered annuity plans have recently come under increased scrutiny by the IRS. This outline of the general rules and limitations on contributions for TSAs will help benefits managers ensure that their plans are in compliance with the byzantine regulations that govern them.

This is the first of a two-part examination of tax-sheltered annuity plans. Part 2 will cover the rules for nondiscrimination testing.

For many years, the Internal Revenue Code (Code) has allowed certain tax-exempt organizations to sponsor a special type of retirement arrangement, a tax-sheltered annuity plan (TSA), under Code Section 403(b). These arrangements are subject to some of the Code Section 401(a) rules for qualified plans. They are also subject to a separate set of rules that apply only to TSAs, and it is often difficult to determine precisely which rules apply. This first article on tax-sheltered annuity plans summarizes the major operating rules for TSAs, with particular emphasis on contribution limitations.

Until recently, TSAs received relatively little attention from the Internal Revenue Service (IRS). There is no IRS program for approving plan documents comparable to the determination letter program for qualified plans, and TSAs were rarely audited. However, in auditing TSA sponsors, the IRS has recently discovered a high level of noncompliance with Section 403(b) and will increase its audit activity.

Proposed audit guidelines for TSA plans should be issued by the end of 1994. The IRS may also introduce a program for correcting defects, similar to the Voluntary Compliance Resolution (VCR) program for qualified plans.

The types of errors found in 403(b) plans include:

- Errors in calculating the contribution limitations under Sections 403(b) and 415
- Exceeding the Section 402(g) dollar limitation (generally $9,500) on elective deferrals
- Failure to follow the minimum distribution requirements at age 70½ or death
- Failure to comply with restrictions on the timing of distributions
- Inadequate salary reduction agreements
- Failure to properly apply nondiscrimination tests, such as the Section 401(m) actual contribution percentage test for matching contributions and employee contributions.

In view of the complexity of the rules, and the adverse consequences that may follow an IRS audit, benefit consultants should make their tax-exempt clients aware that the environment has changed, and help them to ensure that their TSA plans are in compliance.

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Further information can be found in IRS Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*, which is updated annually.

WHICH EMPLOYERS MAY SPONSOR A TSA?

Under Code Section 403(b)(1)(A), an employer that sponsors a TSA must be either:

1. A tax-exempt organization described in Code Section 501(c)(3), namely, one that is organized and operated exclusively for religious, charitable, scientific, public safety testing, literary, or educational purposes, or to encourage amateur sports competition, or for the prevention of cruelty to children or animals; or
2. A state, a political subdivision of a state, or an agency of either. In this case, participation is limited to employees who perform services for an educational organization described in Code Section 170(b)(1)(A)(ii), namely, one which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The services may be performed directly or indirectly for the educational institution. [Reg § 1.403(b)-1(b)(5)] A state teachers' retirement system is not an educational organization for this purpose and thus may not establish a TSA for its employees. [Rev Rul 80-139]

Since enactment of the Tax Reform Act of 1986 (TRA 86), all tax-exempt employers (other than rural electric or telephone cooperatives) have been precluded from establishing new 401(k) plans. [IRC § 401(k)(4)(B)] Many tax-exempt employers (for example, unions, chambers of commerce, and social clubs, which are described in Sections 501(c)(5), (6), and (7) respectively, rather than 501(c)(3)) are not eligible to establish a TSA, even though they cannot establish a 401(k) plan. Governmental agencies generally are not 501(c)(3) organizations. However, if an organization exclusively serves a purpose described in Section 501(c)(3) and is a separate entity from the government, then it may establish a TSA. [Rev Rul 60-384]

WHO MAY PARTICIPATE IN A TSA?

An employee of, or independent contractor to, a qualifying employer may not establish a TSA for his or her own benefit, so there is no 403(b) equivalent of a Keogh plan. Also, in order to participate, the individual must be an *employee* (or a retired or former employee) of the organization, rather than an independent contractor. Any contributions made for an independent contractor will be currently taxable. Revenue Ruling 87-41 provides guidelines for determining whether an individual is an employee or an independent contractor. (See also Revenue Rulings 66-274 and 70-136; *Azad*, 388 F 2d 74 (8th Cir 1968); *Ravel*, TC Memo 1967-182; *Haugen*, TC Memo 1971-294; PLR 9149001.)

A minister who is an employee under the common-law tests is eligible for a TSA, even though his or her earnings are treated as self-employment income for social security purposes. [Rev Rul 68-395]

BASIC REQUIREMENTS

In order to qualify for tax-favored treatment, a TSA plan must satisfy the following basic requirements:

Nonforfeitability. The employee's rights under the annuity contract must be nonforfeitable, except that the contract may be forfeited for failure to pay premiums. [IRC § 403(b)(1)(C)] A TSA plan *may* include a vesting schedule for employer contributions other than salary reduction contributions.

Nontransferability. A contract issued after 1962 must expressly state that it is nontransferable. [Rev Rul 74-458]

Coverage and Nondiscrimination. Unless the employer is a church or a qualified church-controlled organization as defined in Code Section 3121(w)(3)(A) and (B), the plan must satisfy coverage and nondiscrimination rules. [IRC §§ 403(b)(1)(D), 403(b)(12)] These rules will be discussed in the second part of this article in the next issue.

Limit on Deferrals. If the plan allows pretax salary reduction contributions by employees, the plan must limit employee deferrals for any calendar year to the dollar limit in effect for that year under Code Section 402(g)(1). [IRC §§ 403(b)(1)(E), 401(a)(30)] (This is discussed further below.) The limit may be incorporated by reference. [Reg § 1.401(a)-30(a)]

Funding. The plan's funding vehicle must be one or more of the following:

- Annuity contracts, which may be individual or group, fixed, or variable. The contract may provide incidental life insurance protection, in which event the PS 58 cost is taxable to the employee each year, as under a qualified plan. [Reg § 1.403(b)-1(c)(3)] Under Revenue Ruling 82-102, the annuity contract must be purchased from an insurance company, subject to an exception for certain contracts bought before the ruling was issued.

- A custodial account (as defined in Code Section 401(f)(2)) which holds regulated investment company stock (i.e., mutual fund shares). [IRC § 403(b)(7)]; or
- A retirement income account, namely a defined contribution program established or maintained by a church or a convention or association of churches as defined in Section 414(e). [IRC § 403(b)(9)] Section 251(e)(5) of the Tax Equity and Fiscal Responsibility Act of 1992 (TEFRA) also allows some pre-1983 defined benefit plans to be treated as defined contribution plans for this purpose.

TSA assets have traditionally been kept separate from qualified plan assets. However, in PLR 9422053, the IRS ruled, relying on Revenue Ruling 81-100, that a single allocated group annuity contract could be used both to fund benefits under a qualified plan and a TSA plan.

Distributions. The plan must comply with minimum distribution requirements similar to the Code Section 401(a)(9) rules for qualified plans. [IRC § 403(b)(10)] In addition, Code Sections 403(b)(11) and 403(b)(7)(A)(ii) restrict the times at which distributions can be made.

Direct Rollovers. The plan must comply with the direct rollover rules of Code Section 401(a)(31). [IRC § 403(b)(10)]

SALARY REDUCTION CONTRIBUTIONS

In order for salary reduction contributions to be excluded from gross income, the following requirements must be satisfied [Reg § 1.403(b)-1(b)(3)(i)]:

- The exclusion applies only to salary reduction contributions earned by the employee after the salary reduction agreement becomes effective. Salary is earned when the services are performed, even if payment is deferred. [GCM 39659, Sept 8, 1987]
- The salary reduction agreement must be legally binding and irrevocable with respect to amounts earned while it is in effect; and
- The employee may not make more than one salary reduction agreement with the employer during any year. The "year" is the employee's tax year, which is almost always the calendar year, not the employment year (e.g., September through June for a school). The employee may be permitted to terminate the agreement at any time with respect to future earnings. However, the employee apparently may not resume making contributions in the same year, as this would be a second agreement. [Reg § 1.403(b)-1(b)(3)] Mere continuation of an agreement made for an indefinite period does not result in a new agreement [Rev Rul 87-114], nor does a mere change of insurer [Rev Rul 68-179].

The salary reduction may be either a fixed dollar amount or a specified percentage of compensation. If the latter, the fact that the amount of the contribution varies with the employee's compensation does not result in a new salary reduction agreement. [Rev Rul 68-58].

A contribution made pursuant to a one-time irrevocable election by the employee, at the time of initial eligibility or at other times specified in regulations, is *not* treated as a salary reduction contribution. [IRC §§ 402(g)(3), 403(b)(12)]

If, during a single year, contributions on behalf of an employee are made to two or more TSAs of one employer, all TSAs are treated as a single TSA in applying the above rules. [Reg § 1.403(b)-1(b)(4)]

LIMITATIONS ON TSA CONTRIBUTIONS

Contributions to a TSA plan are subject to three separate annual limitations:

- Elective salary reduction contributions are subject to a dollar limitation (generally $9,500 in 1995) under Section 402(g).
- Salary reduction contributions and other employer contributions are aggregated and, as aggregated, are limited by the exclusion allowance under Section 403(b)(2).
- All contributions (including after-tax employee contributions) are subject to the limitations of Section 415. IRS Publication 571 includes six worksheets which are helpful in calculating the maximum permissible contribution. Many vendors of TSA investment products make available to plan sponsors software to make these calculations.

Excess contributions to a custodial account (but not excess premiums for an annuity contract) are subject to a 6 percent excise tax, payable by the employee. [IRC § 4973] The tax is due each year until the excess is corrected, generally by contributing less than the maximum in a future year. To report and pay the tax, Form 5330 is filed by the employee on or before July 31 following the end of the employee's tax year. An extension may be requested by filing Form 5558.

Dollar Limit on Elective Salary Reduction Contributions

Like salary reduction contributions under a 401(k) plan, elective salary reduction contributions under a TSA plan are subject to a calendar-year dollar limit, adjusted annually for cost of living increases. Under Code Sections 402(g)(1) and (4), the general limit is the greater of $9,500 or the indexed dollar limit for 401(k) plans, which is $9,240 for 1995. Accordingly, for calendar year 1995, the normal dollar limitation for salary reduction contributions to a TSA plan is $9,500.

Higher Limit for Certain Employees

A higher dollar limit applies to an employee who has completed at least 15 years of service with a "qualifying employer" (an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches). [IRC § 402(g)(8)] Under this special rule, the normal dollar limit may be increased by the *least* of the following amounts:

- $3,000;
- $15,000, reduced by the total amount excluded from income for prior years by reason of this special rule; or
- The excess of (1) $5,000 multiplied by the employee's years of service with the organization over (2) the sum of (a) the total salary reduction contributions made on behalf of the employee for prior taxable years, under all TSA plans, 401(k) plans, and SEPs, and (b) post-1988 deferrals under a Section 457 plan. [IRC §§ 402(g)(8)(A), 457(c)(2)]

Accordingly, for an employee who qualifies for this special rule, the salary reduction contribution for 1995 may be as much as $12,500 ($9,500 plus $3,000).

Example 1. A has completed 15 years of service with a qualifying employer. He has not previously used the special rule. A's total salary reduction contributions are $72,500 for prior years. A's dollar limit for 1995 is calculated as follows:

1.	Normal limit	$9,500
2.	(a) Total amount excluded in prior years under the special rule	$0
	(b) Subtract line 2(a) from $15,000	$15,000
3.	(a) Multiply $5,000 by A's years of service (15)	$75,000
	(b) Total salary reduction contributions for prior years	$72,500
	(c) Post-1988 IRC § 457 deferrals	$0
	(d) Line 3(a) - 3(b) - 3(c)	$2,500
4.	Enter the least of $3,000, line 2(b), or line 3(d)	$2,500
5.	1995 limit (line 1 + line 4)	$12,000

Coordination with Other Plans

The dollar maximum is reduced by the amount of any elective deferrals made by the employee, for the same calendar year, under a 401(k) plan, a SEP, or another TSA. [IRC § 402(g); Reg § 1.402(g)-1(d)(4)] If the employee also participates in a 457 plan, the maximum deferral under the 457 plan (otherwise, the lesser of $7,500 or 33.3 percent of includible compensation) is reduced by the amount of the elective deferrals under the TSA. Because the dollar limit applies at the employee level rather than the employer level (unlike the Section 415 limitations), it is irrelevant whether the plans are maintained by related or unrelated employers.

Excess deferrals are included in income in the year of deferral. Unless they are corrected (i.e., distributed with earnings) on or before April 15 following the close of the year in which they arose, under Regulation Section 1.402(g)-1(e)(2) and (3), they are taxed again when distributed from the plan. [IRC § 402(g)(1); Reg § 1.402(g)-1(a)]

Limitations Under Code Section 415

The limitations on contributions and benefits under Code Section 415 apply to a TSA plan as well as to a qualified plan, subject to the modifications summarized below. [IRC § 415(a)(2)] Almost all TSA plans are defined contribution plans and thus are subject to Code Section 415(c), under which the "annual addition" to a participant's accounts for any "limitation year" may not exceed the lesser of (1) $30,000 (or, if greater, 25 percent of the annual benefit limitation for defined benefit plans under Section 415(b)), or (2) 25 percent of the participant's compensation for that year. For this purpose, compensation excludes pretax salary reduction contributions.

Example 2. For 1995, B wishes to contribute the maximum $9,500 under a TSA plan to which the employer does not contribute. In order to do so without violating Section 415(c), her compensation from that employer must be at least $47,500, as her salary reduction contribution of $9,500 will then equal 25 percent of her taxable compensation, $38,000 ($47,500–$9,500).

The annual addition includes salary reduction contributions, employer contributions (including matching contributions), and after-tax employee contributions.

The employee's limitation year is generally the calendar year, unless the employee chooses a different 12-month period by attaching a statement to his or her tax return. [Reg § 1.415-2(b)(7)] If the employee controls an employer (within the meaning of Sections 414(b) and (c), as modified by Section 415(h)), the employee's limitation year is the same as the employer's limitation year.

Example 3. Dr. C is an employee of a public hospital and participates in its TSA plan. She also is the sole owner of a separate professional corporation. The PC's retirement plan has a limitation year ending on June 30. Accordingly, as C controls the PC, her limitation year is also the 12-month period ending on June 30.

Special Elections

Two special elections are available to employees of "qualifying employers," as defined above.

The A Election. For the year of separation from service, there may be substituted, for the normal 25 percent of compensation limitation, the amount of the exclusion allowance which would apply if there were taken into account only the participant's years of service for the employer (as determined under Section 403(b)(2)) during the period of years (not exceeding ten) ending on the date of separation. [IRC § 415(c)(4)(A)]

Example 4. For the limitation year in which he separates from service, D's compensation is $100,000 and he makes a $4,000 salary reduction contribution to the TSA plan. Assume that his includible compensation is $105,000; that he has 20 years of service with the employer; and that prior contributions are as summarized below.

Section 415 Limitation: General Rule

1.	Section 415 compensation ($100,000–$4,000)	$96,000
2.	25% of line 1	$24,000
3.	Lesser of $30,000 or line 2	$24,000
4.	Maximum employer contribution (line 3–$4,000)	$20,000

Limitation Under the A Election

5.	Includible compensation	$96,000
6.	Years of service (not exceeding 10)	10
7.	Line 5 × line 6 × 20%	$192,000
8.	Total amount contributed by employer and excludible for all prior years	$150,000
9.	Total deferred under Section 457	$0
10.	Line 7–line 8–line 9	$42,000
11.	Lesser of $30,000 or line 10	$30,000
12.	Maximum employer contribution (line 11–$4,000)	$26,000

The B Election. For *any* year, there may be substituted for the normal 25 percent of compensation limitation the *least* of:

1. 25 percent of the participant's includible compensation (as defined below) plus $4,000;
2. The amount of the exclusion allowance for the year; or
3. $15,000

[IRC § 415(c)(4)(B)]

Under either election, the Section 415(c) dollar limitation (currently $30,000) still applies. Either election is irrevocable, and thereafter the employee may not use the other special election (or the C Election described below) for any TSA contribution made by any employer. [Reg § 1.415-(6)(e)(2)(ii)]

An employee makes the A, B, or C Election by using the special limit in calculating his or her tax liability: no seperate election is necessary. The election is treated as made only if it is needed to support the exclusion claimed on the return.

Another special election is available to church employees, who may elect a Section 415 limitation of up to $10,000 in any year. To the extent that contributions in excess of the otherwise applicable limit are made under this rule, there is a $40,000 lifetime maximum. [IRC § 415(c)(7)] This rule may not be used in the same year as the A Election.

Special Section 415 Rules for TSA Plans

In general, a Section 403(b) annuity contract or custodial account is treated as being maintained by the participant for whom the contract is purchased, rather than by the employer that makes the plan available. If that participant controls either that employer or another employer, then the TSA plan is treated as being maintained *both* by the participant and by the employer that he or she controls. [See Reg §§ 1.415-7(h), 1.415-8(d)]

Except where an employee makes the C Election under Section 415(c)(4)(C), described below, the employee need not aggregate contributions to the TSA with other plans of the employer that provides the annuity, unless he or she controls that employer. If the employee does make the C Election, then the TSA is treated as a defined contribution plan maintained both by the participant and by the employer that purchased the contract, so the employee must combine the TSA with other plans (even if terminated) of that employer. [IRC § 415(e)(5); Reg § 1.415-8(d)(2)] If one of the combined plans is a defined benefit plan and the other (the TSA) is a defined contribution plan, the sum of the defined benefit plan fraction and the defined contribution plan fraction may not exceed 1.0. [IRC § 415(e)(1), (2), and (3)] In calculating the employee's defined contribution plan fraction, where aggregation is required solely because of the C Election, contributions to the TSA in years before the election are not taken into account. [PLR 8834088]

If the TSA plan is a defined benefit plan, then it is subject to Code Section 415(b). For limitation years beginning in 1994, the annual benefit payable at social security retirement age under a defined benefit plan is equal to the lesser of $118,800 or 100 percent of the participant's average compensation. (For a more detailed discussion of the Section 415 rules, see *Journal of Pension Benefits* 1:3 (88–93).)

The Exclusion Allowance

The exclusion allowance applies only to TSA plans: it does not apply to qualified plans. The exclusion allowance limits the aggregate amount of employer contributions (including salary reduction contributions) that can be made for any year. It does not affect after-tax employee contributions. Contributions in excess of the exclusion allowance are includible in income but do not jeopardize the plan's eligibility for tax-favored treatment.

Under Code Section 403(b)(2), the exclusion allowance for any employee for a year is an amount equal to the excess, if any, of

- 20 percent of the employee's includible compensation, multiplied by the employee's years of service, as defined below; over
- The sum of (1) the total amount contributed by that employer to a qualified plan, Section 403(a) annuity plan, or TSA plan (including salary reduction contributions), and excludible from the employee's income, for all prior years, including TSA contributions in excess of the Section 415(c) limitation even though such excess amounts were not excludible, for years beginning after January 24, 1980 [see Reg §§ 1.415-1(f)(6), 1.415-6(e)(1)(ii), 1.403(b)-1(d)(3)(v); GCM 39071 (Dec 1, 1983)]; and (2) the total amount of compensation deferred under Section 457 and excludible from the employee's income for all prior years which are taken into account as years of service in calculating the exclusion allowance, even if the Section 457 plan is sponsored by a different employer. [Reg § 1.403(b)-1(d)(1)]; and (3) Certain pre-1969 contributions to any other type of nonqualified retirement plan. [Reg § 1.403(b)-1(d)(3)(iv)]

Example 5. The facts are the same as in Example 2. Assume further that B's includible compensation is $38,000, that she has seven years of service by December 31, 1995, and that she has contributed a total of $48,000 to the plan through December 31, 1994. Her maximum salary reduction contribution for 1995 is calculated as follows:

1.	Dollar limit on elective deferrals	$9,500
2.	Section 415(c) limitation (see Example 2)	$9,500
3.	Includible compensation	$38,000
4.	Years of service	7
5.	Line 3 × line 4 × 20%	$53,200
6.	Prior years' contributions	$48,000
7.	Exclusion allowance (line 5–line 6)	$5,200
8.	Maximum deferral (least of line 1, line 2, or line 7)	$5,200

Includible Compensation

The employee's includible compensation means the employee's compensation from the employer that is includible in gross income (disregarding any foreign earned income exclusion under Code Section 911) for the most recent period (ending not later than the close of the year in question) which may be counted as one year of service under Regulation Section 1.403(b)-1(f)(7). It does not include any salary reduction contribution, or any other employer contribution, to a TSA plan or to a qualified plan, even if includible in income (for instance, because it exceeds the exclusion allowance). [See Reg § 1.403(b)-1(e)(2); Rev Rul 79-221] Includible compensation is *not* synonymous with Section 415 compensation.

Years of Service

In determining the number of years of service, for purposes of calculating the exclusion allowance, there are included:

- One year for each full year during which the individual has been a full-time employee of the employer [Reg § 1.403(b)-1(f)(4)] and
- A fraction of a year (determined in accordance with Regulation Section 1.403(b)-1(f)(5)) for each full year during which the employee has been a part-time employee and for each partial year during which the individual was either a full-time or part-time employee of the employer.

The employer's annual employment year, not the employee's taxable year, is the computation period for determining years of service. [Reg § 1.403(b)-1(f)(3)]

In no case will the number of years of service be less than one. [Reg § 1.403(b)-1(f)(6)] Only service for the employer while it is eligible to sponsor a TSA plan is taken into account. [Reg § 1.403(b)-1(f)(2)]

There are special rules for calculating the length of service of ministers and lay employees of a church. [IRC § 403(b)(2)(C)] Any such employee whose adjusted gross income does not exceed $17,000 is also entitled to an alternative exclusion allowance calculation under Code Section 403(b)(2)(D).

The C Election

An employee of a qualifying employer (as defined above) may make the C Election, under Sections 403(b)(2)(B) and 415(c)(4)(C). If the employee does so, the exclusion allowance is equal to the amount that could be contributed under Section 415(c), without regard to Section 415(c)(7), if the TSA were treated as a defined contribution plan maintained by the employer. The election is irrevocable, and precludes the employee from using either the A Election or the B Election for any TSA plan of any employer. [Reg § 1.415-6(e)(2)(ii)]

As appears from Example 2, if the TSA plan is funded exclusively by salary reduction contributions, the maximum deferral allowed by Section 415(c) is 20 percent of compensation (unless the A or B Election is made). Unlike the 415(c) calculation, the exclusion allowance is calculated by reference to the employee's entire period of service. For an employee who has used the full allowance each year, the maximum deferral permitted by the exclusion allowance is 16.66 percent of compensation. The advantage of making the C Election is that it enables the employee (subject to the dollar limitation) to increase the deferral percentage to 20 percent. The disadvantage is that the TSA must then be aggregated with other plans of the employer for Section 415 purposes.

Other Rules

If an employee works for two or more employers during the year, a separate exclusion allowance is calculated for each employer, [Reg § 1.403(b)-1(d)(2)] subject to an exception for certain church employees. [IRC § 403(b)(2)(C)]

If the TSA plan is a defined benefit plan, and the actual amount contributed for any employee is not known, the amount is determined under the formula described in Regulation Section 1.403(b)-1(d)(4) or any other method using recognized actuarial principles which are consistent with plan provisions and the employer's funding method.

Vesting

Unlike the Section 415 limitations, the exclusion allowance applies only to contributions that are vested. Accordingly, if employer contributions (other than salary reduction contributions, which are always fully vested in the employee) become vested, or partially vested, in a year subsequent to the year in which they were contributed, then the value of the TSA (including investment earnings on these employer contributions) is taken into account, to the extent then vested, in that later year.

Example 6. F was hired on January 1, 1990, and participates in a TSA plan which provides five-year cliff vesting. The plan is funded exclusively by employer contributions. For each year from 1990 through 1994, F's employer contributes $2,000 to the plan for him, and as of December 31, 1994, the value of F's account is $12,000. For 1990 through 1993, F is not vested, so the amount taken into account for purposes of the exclusion allowance is zero. In 1994, the entire $12,000 is taken into account.