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403(b) Basics

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403(b) Basics

Three Kinds of 403(b) Annuity Programs

- 403(b)(1) annuity contract
- 403(b)(7) custodial account
- 403(b)(9) church retirement income account

403(b) Basics

Requirements for 403(b) Programs

- 403(b) program must be sponsored by eligible employer (e.g., 501(c)(3) organization)
- Must be for benefit of eligible employees
- **Proposed Regulations** require written plan document which must contain all the material terms and conditions for:
 - Eligibility
 - Benefits
 - Applicable limitations
 - Contracts available under the plan
 - Time and form under which benefit distributions would be made

403(b) Basics

Requirements for 403(b) Programs (cont'd)

- Must comply with incidental benefit requirement
- Must comply with contribution limits under Code section 415(c)
- Employee's rights under 403(b) contract must be nonforfeitable

Note: **Proposed Regulations** confirm that vesting schedule can be built into the program (**403(c) annuities issue**)

403(b) Basics

Requirements for 403(b) Programs (cont'd)

- Must be nontransferable
- Must include eligible rollover distribution rules
- Must include minimum required distribution rules

403(b) Basics

Requirements for 403(b) Programs (cont'd)

- If salary reduction contributions are permitted, plan document must include:
 - Statutory limit on amount of salary reduction contributions (currently \$15,500)
- Nondiscrimination requirements – not applicable to churches and qualified church-controlled organizations (“QCCOs”)

403(b) Basics

Types of Contributions

- Salary reduction contributions — this includes:
 - Age-50 catch-up contributions
 - Designated Roth contributions

Note: All salary reduction contributions are modeled after 401(k) rules; must be pursuant to legally binding agreement

- Employee after-tax contributions
- Employer “basic” contributions

403(b) Basics

Types of Contributions (cont'd)

- Employer matching contributions
- Rollover contributions
- Transfer contributions pursuant to Rev. Rul. 90-24

Special 403(b) Church Rules

Special 403(b) Church Rules

403(b)(9) Retirement Income Accounts

A church can establish a 403(b)(9) retirement income account program

- Plan document must specifically identify plan as a 403(b)(9) retirement income account (**Proposed Regs.**)
- Not limited to investments in insurance company annuities or regulated investment company stock (but any asset that is owned or used by a participant will be treated as a distribution)

Special 403(b) Church Rules

403(b)(9) Retirement Income Accounts (cont'd)

- Not subject to nondiscrimination requirements (except in the case of non-QCCOs)
- Self-employed ministers and chaplains working for non-501(c)(3) organizations may participate in denomination's 403(b) plan
- Exempt from ERISA requirements

Special 403(b) Church Rules

403(b)(9) Retirement Income Accounts (cont'd)

- All years of service as employee of church or church-related organization within the same denomination are considered as years of service for one employer
- All amounts contributed by each church are considered to have been contributed by one employer

Special 403(b) Church Rules

403(b)(9) Retirement Income Accounts (cont'd)

- Assets of plan may be commingled in common fund, but if so –
 - Assets must be separately accounted for
 - Assets must be available for exclusive benefit of plan participants and beneficiaries
 - Investment performance must be based on gains and losses on the retirement income account's assets

Special 403(b) Church Rules

Special Contribution Limits for Church Employees

Special 402(g) Limit on Salary Deferrals

- Employees who meet certain service requirements are eligible to make special “catch-up” salary reduction contributions

Note: This is in addition to the special age-50 catch-up contributions.

Special 403(b) Church Rules

Special Contribution Limits (cont'd)

Special rule for foreign missionaries

- Foreign missionaries can put in up to \$3,000 as long as AGI is \$17,000 or less

Special 403(b) Church Rules

Special Contribution Limits (cont'd)

Special Church Election Under 415(c)

Church employees can contribute up to \$10,000 each year (\$40,000 maximum) whether or not they have includible compensation

Special 403(b) Church Rules

Special Rules Applicable to Self-Employed Ministers and Chaplains

- Self-employed minister considered church employee – earned income from the ministry is included in determining contribution limits
- Self-employed ministers are eligible employers with respect to 403(b)(9) account established for such ministers
- Years of service for minister includes those years in which he/she was self-employed

Special 403(b) Church Rules

Special Rules Applicable to Self-Employed Ministers and Chaplains (cont'd)

- Special rule prohibiting the double use of compensation – of primary importance to ministers serving outside the church proper
- Includible compensation for self-employed ministers means earned income (computed without regard to section 911)

Question: Can housing allowance be counted as “compensation” under 415(c) for self-employed minister?

Special 403(b) Church Rules

Special Rules Applicable to Foreign Missionaries

- Foreign missionary contributions included in “investment in contract”
- Employer may make contributions and foreign missionary will still receive tax basis (post-1996 only)

Note: Foreign missionary includes both clergy and lay employees

Special 403(b) Church Rules

Payment of Annuity Benefits (**Proposed Regs.**)

403(b)(9) plans can provide annuities only if:

- Amount of annuity distribution must have an actuarial present value equal to participant's accumulated benefit, based on reasonable actuarial assumptions
- Plan sponsor must guarantee benefits in the event that a payment is due that exceeds participant's or beneficiary's accumulated benefit

Special 403(b) Church Rules

Defined Benefit 403(b)(9) Plans

- **Proposed Regulations** confirm that church-related organizations may have 403(b)(9) DB plan if plan was in effect on 9/3/82
- Under the **Proposed Regulations**, accruals under 403(b)(9) DB plan must be converted to “annual additions” and tested under 415(c) contribution limit (This means that the 415(b) benefit limit cannot be used)

Note: Church Alliance effort to permit these plans to use the 415(b) limit

Contribution Limits

Contribution Limits

Two contribution limitations

- 402(g) limitation on salary deferrals
- 415(c) limits

Contribution Limits

402(g) Limit on Salary Deferrals

Basic Limit

- \$15,500 annually
- Limit may be increased by IRS to reflect cost of living adjustment
- 402(g) limit applies to all salary reduction contributions (including designated Roth contributions) to 401(k) and 403(b) plans combined

Contribution Limits

402(g) Limit on Salary Deferrals (cont'd)

Special Catch-Up Election

Available to employees with 15 years of service with “qualified organization” (church service within same denomination can be aggregated)

Qualified Organization:

- Church
- Tax-exempt organization controlled by or associated with a church
- Educational organization
- Hospital
- Home health service agency
- Health and welfare service agency

Contribution Limits

402(g) Limit on Salary Deferrals

Special Catch-Up Election (cont'd)

Amount of Special Catch-Up Election

LEAST OF FOLLOWING:

- \$3,000, or
- \$15,000 reduced by prior special 402(g) catch-up amounts, or
- excess of \$5,000 times years of service over prior elective deferrals (**Proposed Reg. comment**)

Contribution Limits

415(c) Limit

“Annual additions” cannot exceed

Lesser of:

- \$45,000; or
- 100% of taxable compensation

Annual additions =

- employer contributions (including salary deferrals)
- employee after-tax contributions
- allocated forfeitures

Contribution Limits

415 Limit (cont'd)

- Limit applies to all contributions, whether or not vested
- “Compensation” = “includible compensation” as defined under 403(b)
 - Full-time vs. part-time employee rules

Contribution Limits

415 Limit (cont'd)

Includible compensation is taxable compensation, plus:

- salary reduction contributions to 401(k) or 403(b) plan
- elective deferrals to section 125 cafeteria plan
- elective deferrals to 457 plan (but not to church nonqualified plan)
- contributions to qualified transportation fringe benefit plans

Note: Includible compensation does not include any tax-excludable clergy housing allowance

Contribution Limits

Special Five-Year Rule

- Contributions for former employees
 - Non-elective contributions only
 - Contributions may be made through 5th year following year of termination of employment
 - Nondiscrimination rules apply (but not to churches and QCCOs)

Contribution Limits

415 Limit (cont'd)

Special Church Plan Election

- Available to employees of:
 - Church (or convention or association of churches)
 - Tax-exempt organization controlled by or associated with a church (or convention or association of churches)
- May contribute up to \$10,000 per year
- \$40,000 lifetime limit

Contribution Limits

Special Rules Applicable to Foreign Missionaries

- Section 911 income is considered includible compensation even though not taxable
- Special 415(c) limit – Foreign missionaries can put in \$3,000, as long as AGI is \$17,000 or less

Contribution Limits

Age 50 Catch-up Contributions

- Participants can make additional elective contributions beginning the year they turn 50
- Contributions limited to:
 - \$5,000
 - Limit is indexed for cost of living

Note: Age 50 contributions are in addition to other limits.

Contribution Limits

Ordering of Elective Deferrals (**Proposed Regs.**)

For participants who are eligible for two different catch-up contributions –

- Elective contributions first treated as “15 years of service” catch-up contributions
- Treated as “age 50” catch-up contributions only after any available “15 years of service” catch-up contributions have been made

Contribution Limits

Correcting Excess Contributions

Correcting Excess 402(g) Contributions

- Distribute by April 15 of following year (distributions must include allocable income)
- Plan must specify how excess contributions are to be treated
- 402(g) limit failure only affects individual who has made excess contributions; not entire plan

Contribution Limits

Correcting Excess Contributions

Correcting Excess 402(g) Contributions (cont'd)

If excess contributions not corrected by April 15 –

- Excess must stay in plan if distribution would violate 403(b)(11) (**403(c) annuity issue**)
- Participant taxed twice on excess
 - in year of contribution; and
 - at time of distribution

Note: Also can correct through EPCRS program if not corrected by April 15.

Contribution Limits

Correcting Excess Contributions

Contributions in Excess of 415 Limits

Can only correct if excess due to:

- Allocation of forfeitures
- Reasonable error in estimating annual compensation
- Reasonable error in determining amount of elective deferrals
- Other limited circumstances as may be determined by IRS

Note: Any correction must include income attributable to excess

Distributions and Transfers

Distributions and Transfers

Minimum Distribution Requirements

- Plan document must include minimum distribution requirements
- Penalty for failure to make required minimum distribution =
50% excise tax
(imposed on participant)

Distributions and Transfers

Minimum Distribution Requirements (cont'd)

Basic Rules

- Distributions must begin no later than “Required Beginning Date”
- Distributions must be made over a period no longer than:
 - the life expectancy of the participant
 - the joint life expectancy of the participant and a designated beneficiary

Distributions and Transfers

Minimum Distribution Requirements

Basic Rules (cont'd)

- Distributions must be made not less frequently than annually (by Dec. 31)
- Life expectancy calculated based on uniform life tables (ULT) used for virtually all participants, regardless of beneficiary
- Tables generally assume a beneficiary is 10 years younger than participant

Distributions and Transfers

Minimum Distribution Requirements

Basic Rules (cont'd)

- Special rule if spouse is sole designated beneficiary. Distribution period can be longer if spouse is more than 10 years younger (use J&SLT)
- Joint life expectancy is redetermined annually

Distributions and Transfers

Minimum Distribution Requirements

Amount of Required Distribution

- Distributions in form of annuity payments meet requirements (if 100% of account balance is annuitized)
- Installment payments each year must be at least equal to:
$$\frac{\text{participant's accumulation}}{\text{applicable distribution period}}$$
- Participant's "accumulation" is account balance as of prior year-end (December 31)

Distributions and Transfers

Minimum Distribution Requirements

Required Beginning Date

Must begin distributions no later than April 1 following the later of:

- Calendar year in which participant attains age 70½
- Calendar year in which participant retires
 - Question: What does “retirement” mean?
- Special grandfather rule applicable to pre-1987 balances (can delay payment until age 75)

Note: Two minimum distributions are generally required in first year (one on April 1 and a second by December 31)

Distributions and Transfers

Minimum Distribution Requirements

Distributions After Death of Participant

Death of participant after distributions begin:

- Distribute remainder just as rapidly as under distribution method used prior to death

Note: “At least as rapidly” rule is loosely interpreted in the final RMD regulations – RMD amount may actually increase or decrease depending on designated beneficiary

Distributions and Transfers

Minimum Distribution Requirements

Distributions After Death of Participant (cont'd)

Death of participant before distributions begin:

- General Rule – Distributions over life of beneficiary (or over period no greater than life expectancy of beneficiary); payments must begin by December 31 of calendar year following participant's death – use single life table (SLT)
- Five-year Rule – If the General Rule does not apply (e.g., if there is no designated beneficiary), distributions must be completed by December 31 of calendar year in which fifth anniversary of death occurs

Distributions and Transfers

Minimum Distribution Requirements

Distributions After Death of Participant

Death of participant before distributions begin (cont'd):

- Spousal Exception – Same as General Rule, except payments may be delayed until December 31 of the calendar year in which participant would have reached 70½

Distributions and Transfers

Minimum Distribution Requirements

Three IRS Life Expectancy Tables

- Uniform Lifetime Table (ULT) – Default Table
 - Applies to distributions to participants, regardless of marital status, except where sole beneficiary is spouse who is more than 10 years younger
 - Does not apply after participant dies
- Joint and Last Survivor Table (JLST)
 - Applies to participant and spouse more than 10 years younger
- Single Life Table (SLT)
 - Applies to surviving designated beneficiaries, including spouse (Does not apply if participant is alive)

RMDs During Life

<u>Participant's Age</u>	<u>Spouse's Age</u>	<u>IRS Table</u>	<u>Life Expectancy</u>
70	60+	ULT	27.4
70	55	J&LST	31.1

<u>Participant's Age</u>	<u>Beneficiary's Age</u>	<u>IRS Table</u>	<u>Life Expectancy</u>
70	5	ULT	27.4
70	55	ULT	27.4
70	70	ULT	27.4

Examples

Example 1: Participant retires in 2004 at age of 73. He dies in 2005 at age 74; surviving spouse (who is 68 in 2005) is sole designated beneficiary.

- For 2004, the Distribution Period (DP) is 24.7 (ULT for participant, age 73). Payment must be made by April 1, 2005.
- For 2005, the DP is 23.8 (ULT for participant, age 74). Payment must be made by December 31, 2005.
- For 2006, the DP is 17.8 (SLT for DB age 69). Payment must be made by December 31, 2006.
- For 2007, DP is 17.0 (SLT for DB age 70). Payment must be made by December 31, 2007.

Examples

Example 2: Same facts as Example 1, except that spouse is 60 when participant retires in 2004 at age of 73.

- For 2004, the DP is 26.8 (J&LST for participant, age 73 and spouse age 60). Payment must be made by April 1, 2005.
- For 2005, DP is 25.9 (J&LST for participant, age 74, and spouse age 61). Payment must be made by December 31, 2005.
- For 2006, DP is 23.5 (SLT for DB age 62). Payment must be made by December 31, 2006.
- For 2007, DP is 22.7 (SLT for DB age 63). Payment must be made by December 31, 2007.

Examples

Example 3: Participant retires in 2004 at age 73. He subsequently dies in 2006 at age 75, leaving daughter, age 40, as sole designated beneficiary.

- For 2004, DP is 24.7 (ULT for participant, age 73)
Payment must be made by April 1, 2005.
- For 2005, DP is 23.8 (ULT for participant, age 74)
- For 2006, DP is 22.9 (ULT for participant, age 75)
- For 2007, DP is 43.6 (SLT for DB age 40)
- For 2008, DP is 42.6 ($43.6 - 1 = 42.6$)

Examples

Example 4: Same facts as for Example 3, except that the sole designated beneficiary is participant's older brother, who is age 78 when participant dies in 2006. Brother's DP in 2007 is 10.8.

It is more advantageous to use participant's remaining DP (participant's DP in 2007 under SLT is 12.4).

- For 2006, DP is 22.9 (ULT for participant, age 75)
- For 2007, DP is 12.4 (SLT for participant, age 75, is 13.4)
- For 2008, DP is 11.4 ($13.4 - 2 = 11.4$)

Examples

Example 5: The participant was born 1/15/1943. His spouse was born 3/21/1947. Participant dies in 2003 at the age of 60 and his surviving spouse is his sole designated beneficiary.

- Distributions must begin by December 31, 2013 (year in which participant would have turned 70½).
- For 2013, DP is 20.2 (SLT for spouse who is age 66).
- For 2014, DP is 19.4 (SLT for spouse, who is age 67).
- For 2015, DP is 18.6 (SLT for spouse age 68).

Examples

Example 6: Same facts as for Example 5, except that the participant's sole beneficiary is his daughter who was born in 1981. The participant dies in 2003 at age 60; his daughter is 22.

- Distributions to daughter must begin by December 31, 2004.
- For 2004, DP is 60.1 (SLT for DB who is age 23).
- For 2005, DP is 59.1 ($60.1 - 1 = 59.1$).
- For 2006, DP is 58.1 ($60.1 - 2 = 58.1$).

Distributions and Transfers

Trusts as Designated Beneficiaries

For purposes of extending life expectancy when measuring minimum distribution requirements, beneficiaries of trust will be treated as designated beneficiaries for RMD purposes if –

- Trust is valid trust under state law (or would be but for fact that there are no trust assets)
- Trust is irrevocable (or will become irrevocable upon participant's death)
- Beneficiaries of trust identifiable from trust instrument
- Copy of trust instrument provided to the plan, or special certification requirements met

Distributions and Transfers

Trusts as Designated Beneficiaries (cont'd)

Note: Special trust rule allows distributions to be calculated based on the life expectancy of trust beneficiary with shortest life expectancy. If special trust rule does not apply, distributions beginning prior to participant's death must be made over participant's life expectancy and distributions beginning after participant's death must be made within 5 years

Distributions and Transfers

Distribution Restrictions – Salary Reduction Contributions

May not distribute any amounts attributable to salary reduction except:

- After participant attains age 59½
- After participant has a severance from employment
- If participant becomes disabled
- If participant dies
- In the event of hardship (**Proposed Regs.**)

Note: The above restrictions apply to all contributions to a 403(b)(7) custodial account, both employer and employee

Distributions and Transfers

Distribution Restrictions – Employer Contributions

Proposed Regulations provide that employer contributions may be distributed only upon:

- Severance from employment
- Prior occurrence of an event specified in the plan document

Note: The same restrictions may apply to after-tax contributions.

Rollover Contributions – no distribution restrictions

Distributions and Transfers

Proposed Regulations provide that severance from employment –

- Occurs when participant no longer employed by eligible employer that maintains 403(b) plan
- Chaplain working for non-501(c)(3) in exercise of ministry has severance from employment if he/she ceases to perform services as a minister

Distributions and Transfers

Distribution Restrictions – Penalty

10% penalty tax applicable on early distributions of all types of contributions

but

No penalty tax applies to distributions made –

- After participant attains age 59½
- After death of participant
- On account of disability
- After separation from service after participant attains age 55

Note: No exception from penalty for hardship distribution

Distributions and Transfers

Distribution Restrictions – Penalty (cont'd)

No penalty tax applies to distributions made –

- As part of series of substantially equal periodic payments for the life or life expectancy of the participant (or joint life or joint life expectancies of participant and the designated beneficiary) where payments begin after separation from service
- Provided no change in payment for at least 5 years

Distributions and Transfers

Hardship Distributions

Basic Rule

Hardship distributions can be made only if:

- Participant has immediate and heavy financial need; and
- Distribution is necessary to satisfy financial need

Can make hardship distributions of all contributions and income thereon except income attributable to salary reduction contributions made after 1988

Distributions and Transfers

Hardship Distributions (cont'd)

General Rules

Immediate and heavy financial need –

- Determined based on all relevant facts and circumstances
- Financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred

Distributions and Transfers

Hardship Distributions (cont'd)

General Rules

Distribution necessary to satisfy financial need –

- Cannot exceed amount required to relieve need
- Need must not be able to be satisfied from other reasonably available sources (including assets of spouse and minor children)

Distributions and Transfers

Hardship Distributions (cont'd)

General Rules

Distribution necessary to satisfy financial need –

- Can rely on employee's written representation that need cannot be relieved:
 - Through reimbursement or compensation by insurance or otherwise
 - By liquidation of assets
 - By cessation of elective or employee contributions
 - By other distributions or nontaxable loans from employer plans

Distributions and Transfers

Hardship Distributions (cont'd)

General Rules

New PPA provision –

To the extent permitted under the plan, an event that would constitute a hardship under the plan if it happened to the participant's spouse or dependent constitutes a hardship if it happens to a person who is a primary beneficiary under the plan with respect to the participant

Distributions and Transfers

Hardship Distributions (cont'd)

Safe Harbor – Immediate and Heavy Financial Need

- Medical expenses incurred by participant, spouse or dependents
- Purchase of participant's principal residence
- Payment of next 12 months of post-secondary tuition and related educational fees for participant, spouse or dependents
- Prevention of eviction from or foreclosure on principal residence
- Funeral expenses for participant, spouse, parents, children or dependents
- Repair of damage to principal residence that is eligible for casualty deduction

Distributions and Transfers

Hardship Distributions (cont'd)

Safe Harbor – Immediate and Heavy Financial Need

Note: If participant borrows money from another source to pay for one of above needs, he/she cannot obtain hardship distribution to pay off that loan under safe harbor

Distributions and Transfers

Hardship Distributions

Safe Harbor – Distribution necessary to satisfy financial need

- Distribution cannot be in excess of need
- All other distributions and loans have been taken from all employer plans
- Suspension of employee elective deferrals and employee contributions for at least 6 months

Note: The early distribution 10% penalty tax applies to a hardship distribution unless another exception to the early distribution tax applies

Distributions and Transfers

Hardship Distributions (cont'd)

“Mix and Match”

Can combine safe harbor and general rule

Example: Use safe harbor for what qualifies as immediate and heavy financial need and use general rule for what qualifies as distribution necessary to satisfy financial need, or vice versa

Distributions and Transfers

Transfers (Rev. Rul. 90-24 Transfers)

- 403(b) plans may make tax-free direct transfers to another 403(b) plan
- 403(b) plans are not required to make direct transfers
- 403(b) plans can accept transfers if plan document so provides
- Direct transfer is not a distribution (not the same as a rollover) – no taxation at time of transfer (No 1099R required)

Distributions and Transfers

Transfers (Rev. Rul. 90-24 Transfers) (cont'd)

- Direct transfers must be made directly to transferee plan – cannot be made to participant for participant to transfer
- Participant whose assets are being transferred must be employee of the employer sponsoring the receiving plan (**Proposed Regs.**)
- Transferred funds retain any prior withdrawal restrictions after transfer. Transfer must be coded under most restrictive rules if no detail given

Distributions and Transfers

Transfers (Rev. Rul. 90-24 Transfers) (cont'd)

- Direct transfer need not be for entire account balance – but for partial transfer, different types of funds are transferred on *pro rata* basis (Proposed Regs.)
- Proposed Regs. would make Rev. Rul. 90-24 obsolete, with transfers permitted under final regulations

Distributions and Transfers

Rollovers

- 403(b) plan must specifically provide for rollovers of “eligible rollover distribution” amounts
- But 403(b) plan not required to accept rollovers
- Rollover is a distribution – it is not same as Rev. Rul. 90-24 Transfer
- Eligible rollover distributions are subject to mandatory 20% tax withholding unless directly rolled over into eligible plan

Distributions and Transfers

Rollovers (cont'd)

- Must issue 1099R with appropriate code
- If distribution is made to participant, plan must withhold tax (mandatory 20%), even if participant intends to roll distribution over to eligible retirement plan within 60 days
- Notice requirement

Distributions and Transfers

Rollovers (cont'd)

Eligible Rollover Distribution does not include:

- Any portion that is minimum required distribution
- Distribution that is one of series of substantially equal periodic payments made at least annually:
 - For the life or life expectancy of employee (or joint life or joint life expectancies of employee and beneficiary); or
 - For a period of 10 years or more
- Hardship distribution

Distributions and Transfers

Rollovers (cont'd)

Additional Rollover Rules

- Plan must permit rollover of distributions to participant or to participant's spouse must

Note: New PPA provision – distribution to nonspousal beneficiary may be rolled over to IRA

- Eligible Rollover Distribution now includes after-tax amounts, but only if rolled over to another 403(b) plan which separately accounts for after-tax amounts or to an IRA
- Can only rollover into an “eligible plan”

Distributions and Transfers

Rollovers (cont'd)

Eligible Plan:

- 403(b) plan – can be any kind of 403(b) plan
- 401(a) plan
- 457(b) governmental plan
- IRA

Note: Special rollover rules apply to designated Roth accounts – those accounts can be rolled over only to Roth 403(b) or Roth IRA

Distributions and Transfers

Rollovers (cont'd)

Automatic rollovers of cash-out amounts

- Applies to cash-out distributions of more than \$1,000
- Applies to all plans (even non-ERISA plans) with cash-out provisions
- Plans must have been amended by end of 2005 to comply with new automatic rollover requirements

Miscellaneous Provisions from **Proposed Regulations**

Termination of 403(b) Plans

Proposed Regulations permit plan termination, subject to following rules:

- All accumulated benefits must be distributed as soon as administratively practicable following termination
- Employer cannot make contributions to another 403(b) plan during the 12 months before or after termination

Note: Termination is currently not a distributable event

Miscellaneous Provisions

- Crediting contributions – must be transferred within period not longer than reasonable for proper plan administration
 - Example: The ERISA rule
- Nondiscrimination requirements (anti-conditioning rule; elimination of 89-23 safe harbors)
- Incidental life insurance – not permitted (but special transition rule allowed contracts to be written until 2/14/2005)

Miscellaneous Provisions

- FICA tax on all salary deferrals, including those pursuant to one-time election or those made as condition of employment (Note: Not applicable to clergy)
- Controlled group rules
 - Inapplicable to churches and QCCOs
 - Basic rule – control/common representation of 80% of directors/trustees
 - Permissive aggregation
 - Permissive disaggregation for non-QCCO church plans

Effective Dates

- Basic effective date – Taxable years beginning after December 31, 2008
- Special effective date for some church plans
- FICA tax provisions – effective immediately
- Restriction on incidental life insurance – effective 2/14/2005

Plan Loans

Plan Loans

403(b) plan may offer loans

Plan may permit more than one loan – but total amount of all outstanding loans cannot exceed maximums

Plan Loans

Minimum Loan Requirements

Maximum amount of loan cannot exceed –

- \$50,000; or
- greater of 50% of value of participant's nonforfeitable (i.e., vested) accrued benefit or \$10,000

Note: Plan may permit participant with \$10,000 in account to borrow entire account

Plan Loans

Minimum Loan Requirements (cont'd)

Loans treated as distributions unless they meet following minimum requirements:

- Must be evidenced by legally enforceable agreement
- Agreement must clearly identify amount borrowed, loan term, and repayment schedule
- Loan must be repaid within 5 years (unless loan to be used to acquire home)
- Loan must be repaid through substantially level payments made at least quarterly

Plan Loans

Repayment

- Plan may require repayment by means of payroll deduction
- Suspension permitted during leave of absence for maximum of one year but only if participant's pay from employer is insufficient to make payment – Suspension does not affect repayment schedule
- Can also suspend for participants covered by USERRA – Repayment schedule may be adjusted
- Grace period for repayments – last day of calendar quarter following quarter in which loan payment was due. But must be “current” in loan payments at end of grace period – cannot re-amortize

Plan Loans

Defaults

Examples of events that may cause a default include:

- Participant's failure to pay any loan installment when due
- Death of the participant
- Election by the participant of a lump-sum distribution from the participant's account
- Participant's revocation of the payroll deduction authorization if the plan requires repayment by payroll deduction

Plan Loans

Defaults (cont'd)

If there is a default –

- Loan treated as deemed distribution – taxable to participant
- May need to wait to distribute until employee eligible for distribution (e.g., loans from salary reduction contributions)
- Plan documents must spell out the specific events constituting default and any steps the participant may take to “cure” the default

Plan Loans

Defaults (cont'd)

Reporting in event of default –

- Employers should report the deemed distributions to IRS using Form 1099R
- Participants must pay taxes, including any penalty taxes, on deemed distributions

Plan Loans

Remember: Truth in Lending requirements (Regulation Z) apply to participant plan loans

Spousal Consent

Spousal Consent

Only participant can make beneficiary designation

Beneficiary Designation of Person Other Than Participant's Spouse

- Spousal consent not necessary for church plan (but probably is advisable)
- Situations where spousal consent might be advisable:
 - Participant wants to select beneficiary other than spouse to receive plan benefits on participant's death
 - Participant wants to select life annuity (or other form of benefit) instead of a joint and survivor annuity with spouse as beneficiary

Spousal Consent

Beneficiary Designation of Person Other Than Participant's Spouse

- Situations where spousal consent might be advisable (cont'd):
 - Participant wants to select a partial lump sum or complete withdrawal
 - Participant wants to have account balance rolled over into another eligible retirement plan (this is equivalent to lump sum distribution)
 - Hardship distributions
 - Plan loans

Spousal Consent

Beneficiary Designation of Person Other Than Participant's Spouse (cont'd)

- Method for obtaining spousal consent:
 - Spousal signature on plan distribution form (with witness)
 - Separate spousal consent form explaining effect of consent (signed by spouse and witness)
- Question: What happens if participant's spouse dies and participant remarries?

Correcting 403(b) Plan Errors

Correcting 403(b) Plan Errors

Special Church Plan Correction

- A church plan is not treated as not meeting the requirements of Code section 401 or 403 if –
 - By reason of any change in any law, regulation, ruling, or otherwise the plan is required to be amended to meet such requirements, and
 - The plan is so amended at the next earliest church convention or such other time as the Secretary of the Treasury or his delegate may prescribe

Correcting 403(b) Plan Errors

Corrections procedures are consolidated under Employee Plans Compliance Resolution System (“EPCRS”)

Three methods for correcting violations:

- Voluntary Correction Program (“VCP”) which incorporates the former Voluntary Correction of Tax-Sheltered Annuity Failures (“VCT”)
- Self-Correction Program (“SCP”)
- Audit CAP

Note: VCP and SCP are not available if plan is under examination

Correcting 403(b) Plan Errors

Correction Principles

Basic Rules

- Correction must be made with respect to all participants/beneficiaries
- Correction must be made for all taxable years
- Restoration of benefits (put plan in position it would have been if no violation had occurred)
- Correction must be reasonable and appropriate
- If possible, correction method should resemble ones otherwise provided in Code or regulations

Correcting 403(b) Plan Errors

Correction Principles

Basic Rules (cont'd)

- Should keep assets in plan as much as possible
- Consistency requirement – where more than one correction method could be used, the same method should be applied for all operational failures of that type
- If applicable correction procedures satisfied, IRS will not pursue income inclusion for affected participants or liability for withholding

Correcting 403(b) Plan Errors

Correction Principles

Correcting “Excess Amounts” (i.e., 415 excess contributions, 402(g) excess elective deferrals)

Distribution of Excess Amounts

- Distributed to participants (including earnings)
- Included in gross income in year of distribution
- Distribution reported on Form 1099R
- Must inform participant that distribution is not eligible for rollover

Correcting 403(b) Plan Errors

Correction Principles

Full Correction

Generally, must make full correction unless full correction is unreasonable or not feasible

Exceptions to full correction:

- If not possible to make precise calculations, can use reasonable estimates
- In case of very small benefits (if total corrective distribution due a participant is \$100 or less and the reasonable costs of processing would exceed amount of distribution), correction not necessary

Correcting 403(b) Plan Errors

Correction Principles

Full Correction (cont'd)

- No correction if cannot locate lost participants (but must try to locate through either the IRS Letter Forwarding Program or SSA Reporting Service)

Correcting 403(b) Plan Errors

Correction Principles (cont'd)

Correction of Plan of Ineligible Employer

- Cessation of all contributions beginning no later than date VCP submission is filed
- Assets remain in annuity contract or custodial account until eligible for distribution
- Plan treated as subject to all requirements and provisions of 403(b) (i.e., must correct all operational, demographic, and eligibility failures)

Correcting 403(b) Plan Errors

Types of Violations

Demographic Failure

Failure to satisfy nondiscrimination or coverage requirements (not applicable to churches or QCCOs)

Correcting 403(b) Plan Errors

Types of Violations (cont'd)

Employer Eligibility Failure

- Ineligible employer
- Violation of nontransferability rules
- Failure to establish or maintain a custodial account pursuant to 403(b)(7) (not applicable to 403(b)(9)s)
- Failure to purchase either annuity contract from an insurance company or a custodial account from a regulated investment company (not applicable to 403(b)(9)s)

Correcting 403(b) Plan Errors

Types of Violations (cont'd)

Operational Failure

- Failure to comply with distribution restrictions
- Failure to satisfy incidental death benefit requirements
- Violation of minimum required distribution requirements
- Failure to provide for direct rollovers of eligible rollover distribution
- Failure to limit salary reduction contributions under 402(g) limit

Correcting 403(b) Plan Errors

Types of Violations

Operational Failure (cont'd)

- Violation of 415 contribution limitations
- Any other failure to satisfy Code requirements that result in the loss of 403(b) status
- No universal availability of salary reduction contributions (not applicable to churches and QCCOs)
- Failure to comply with 401(m) requirements (not applicable to churches and QCCOs)

Correcting 403(b) Plan Errors

SCP

- Voluntary, employer-initiated program – no IRS approval needed
- No submission required
- No fee or sanction payment required

Correcting 403(b) Plan Errors

SCP (cont'd)

Who Can Use SCP?

- Available to correct operational failures; not for demographic failures or eligibility failures
- Cannot use SCP to correct operational failure by plan amendment that conforms terms of plan to plan's prior operations

Correcting 403(b) Plan Errors

SCP

Who Can Use SCP? (cont'd)

- Can use SCP to correct excess amounts only if amounts are distributed to participants
- Must have compliance practices and procedures reasonably designed to promote and facilitate overall compliance; procedures must have been in place and routinely followed
- Operational failure must have occurred through oversight or mistake in applying procedures

Correcting 403(b) Plan Errors

SCP (cont'd)

SCP for “Insignificant” Operational Failures

Must correct failure(s)

Factors in determining whether failure is “insignificant”:

- Whether other failures occurred during period being examined
- The percentage of plan assets and contributions involved
- Number of years failure occurred
- Number of participants affected relative to total number in plan failure

Correcting 403(b) Plan Errors

SCP (cont'd)

SCP for “Insignificant” Failures

Factors in determining whether failure is “insignificant” (cont'd):

- Whether correction made within reasonable time after discovery of failure
- Specific reason for failure
- In case of multiple failures, must be insignificant in aggregate

Correcting 403(b) Plan Errors

SCP (cont'd)

SCP for “Significant” Failures

- Must correct failure
- Correction must be completed or substantially completed by last day of correction period (generally the last day of the 2nd plan year following year of failure)
- Significant failures are those which are not insignificant

Correcting 403(b) Plan Errors

VCP

Defects Available for Correction under VCP

- Demographic Failure
- Eligibility Failure
- Operational Failure

Note: If defects are discovered during VCP that are not part of submission but are eligible for VCP, these defects may be added

Correcting 403(b) Plan Errors

VCP (cont'd)

Compliance Correction Fee

- Fee for all failures is generally: \$750 to \$25,000 (based on size of employer/number of employees)
- Fee for egregious failures: generally 40% of maximum tax that could be imposed as result of failure

Correcting 403(b) Plan Errors

VCP (cont'd)

Submission Requirements

Must include letter with following information:

- Description of defects (including year in which defects occurred)
- Explanation of how and why each defect arose
- Description of administrative procedures in effect at time failures occurred
- Detailed description of method for correcting the failures

Correcting 403(b) Plan Errors

VCP

Submission Requirements (cont'd)

- Description of methodology used to calculate earnings or actuarial adjustments on any corrective contributions or distributions
- Specific calculations for each affected employee (or for a representative sample of affected employees)

Correcting 403(b) Plan Errors

VCP

Submission Requirements (cont'd)

- Method used to locate and notify former employees and beneficiaries affected by failures
- Description of proposed measures to ensure that same failures will not recur
- Statement by the employer that, to the best of his/her knowledge, the plan for which correction is being submitted is not under examination
- Statement that employer has contacted all other entities involved in arrangement and has received assurances of cooperation from all, if necessary

Correcting 403(b) Plan Errors

VCP

Submission Requirements (cont'd)

Other required documents:

- Statement as to the type of employer submitting VCP application
- Copy of pertinent portions of any relevant 403(b) documents
- Compliance correction fee
- Penalty of perjury statement
- Checklist
- First 2 pages of most recent 5500 (not required for church plans)

Correcting 403(b) Plan Errors

Audit CAP

Applies for operational failures, demographic failures and/or eligibility failures discovered during audit

Employer must:

- Correct failure
- Pay sanction
- Adopt appropriate administrative procedures
- Enter into closing agreement with IRS

Not available for failures relating to a misuse or diversion of plan assets

Correcting 403(b) Plan Errors

Audit CAP (cont'd)

Sanction:

- Negotiated percentage of “Maximum Payment Amount” (amount approximately equal to tax IRS could collect as a result of failure)
- Bears reasonable relationship to nature, extent, and severity of failures
- EPCRS procedures indicate that sanction amount “will not be excessive”

Correcting 403(b) Plan Errors

Audit CAP

Sanction (cont'd):

- Factors in determining amount of sanction:
 - Steps taken by plan sponsor to ensure that the plan had no failures
 - Steps taken to identify failures that may have occurred
 - Extent to which correction had progressed before the audit

Correcting 403(b) Plan Errors

Audit CAP

Sanction:

- Factors in determining amount of sanction (cont'd):
 - Number and type of employees affected by failure
 - Number of non-HCEs who would be adversely affected if plan lost tax-favored status
 - Whether failure is nondiscrimination or coverage failure
 - Whether plan has combination of failures
 - Period over which the failure occurred
 - Reason for failure

Tax Reporting and Withholding

Tax Reporting and Withholding

Withholding and reporting required on “designated distributions”

Note: “Designated distribution does not include amounts which it is reasonable to believe are not includible in gross income

Types of distributions

- Periodic payments – annuities or installments
- Nonperiodic distributions
- Eligible rollover distributions (ERD)

Note: Eligible rollover distribution may be either a nonperiodic distribution or a periodic payment.

Tax Reporting and Withholding

Periodic Payments (other than ERDs)

- Report on Form 1099R
- Federal withholding not required; can withhold if participant requests same using Form W-4P
- State withholding may be required depending on state
- Provide participant with Notice of Federal Income Tax Withholding

Tax Reporting and Withholding

Periodic Payments (other than ERDs) (cont'd)

Tax Notices

- Payor must give distributees notice of right not to have withholding
 - No earlier than 6 months prior to first payment and
 - No later than the time of the first payment

BUT – If notice provided in advance, it must also be provided when first payment is made

- Must provide notice at least once each calendar year

Tax Reporting and Withholding

Periodic Payments (other than ERDs) (cont'd)

Notice on withholding must include:

- Notice of right to elect to have no withholding
- Information on how to make the election to have no withholding
- Notice of right to revoke election at any time
- Statement that election is effective until revoked
- Statement to advise payees of penalties under estimated tax payment rules if estimated tax is not adequate and sufficient tax is not withheld

Tax Reporting and Withholding

Periodic Payments (other than ERDs) (cont'd)

Notice on withholding may include (but not required):

- Statement that election not to have withholding apply is prospective only and that any election made after a payment or distribution to the payee is not an election with respect to that payment or distribution

Note: IRS has not issued model tax notice for distributions that are not eligible rollover distributions

Tax Reporting and Withholding

Nonperiodic distributions (other than ERDs)

- Report on Form 1099R
- Non-periodic distribution; 10% withholding tax (may be waived by payee)
- State withholding may be required depending on state

Examples:

- Lump sum payments made to beneficiary other than spouse
- Minimum required distributions
- Hardship distributions

Tax Reporting and Withholding

Nonperiodic Distributions (other than ERDs)

Tax Notice

- Payor must give distributees notice of right not to have withholding
 - No earlier than 6 months prior to first payment; and
 - No later than time that will give payee a reasonable time to elect not to have withholding apply

Note: No notice or withholding required if payor reasonably believes amounts not included in gross income (e.g., designated housing allowance)

Tax Reporting and Withholding

Nonperiodic Distributions (other than ERDs)

Tax Notice must include:

- Notice of right to elect to have no withholding
- Information on how to make the election to have no withholding
- Notice of right to revoke election at any time
- Statement that election is effective until revoked
- Statement to advise payees of penalties under estimated tax payment rules if estimated tax is not adequate and sufficient tax is not withheld

Tax Reporting and Withholding

Nonperiodic Distributions (other than ERDs)

Tax Notice may include (but not required):

- Statement that election not to have withholding apply is prospective only and that any election made after a payment or distribution to the payee is not an election with respect to that payment or distribution

Note: IRS has not issued model tax notice for distributions that are not eligible rollover distributions

Tax Reporting and Withholding

Eligible rollover distributions

- Report on Form 1099R
- Mandatory 20% federal withholding
- State withholding may be required depending on the state

Tax Reporting and Withholding

Eligible Rollover Distributions (cont'd)

- May be rolled over to another 403(b) plan, a 401(a) plan, a governmental 457(b) plan or an IRA
- Special rules for rollovers of designated Roth contributions – can only be rolled over to another Roth 403(b) or to Roth IRA

Tax Reporting and Withholding

Eligible Rollover Distributions

- Provide participant with Special Tax Notice on Rollover Distributions and Federal Tax Withholding Notice
 - Payor must give distributees notice within reasonable period of time before making distribution
- IRS has issued a Model Notice that can be provided to distributees (IRS Notice 2002-3)

Note: This Model Notice needs to be updated

Tax Withholding and Reporting

Eligible Rollover Distributions (cont'd)

- Tax Notice must include the following information:
 - Provisions allowing the direct rollover to an eligible plan
 - Provisions requiring 20% federal income tax withholding if distribution is not directly rolled over to another eligible plan
 - Provisions under which the distribution will not be subject to income tax if the participant rolls the amount over within 60 days of the date it is received (plan must still withhold 20% when distributed to participant)

Tax Reporting and Withholding

Early Distributions

Early distributions reported in Box 7 of Form 1099R

- Code 1 – if there is no exception to early distribution rules; participant must also file Form 5329
- Code 2 – if early distribution exception applies

Participant is responsible for paying any applicable 10% penalty tax on early distribution; withholding of this amount is not required

Tax Reporting and Withholding

Rev. Rul. 90-24 Direct Transfers

Rev. Rul. 90-24 direct transfer is not a distribution so –

- No reporting requirements
- No withholding requirements

Tax Reporting and Withholding

Defaulted Loans

- This is a deemed distribution; distribution is for entire outstanding amount of loan (not just defaulted payment)
- Must file Form 1099R for year of deemed distribution
- Not eligible for direct rollover

Tax Reporting and Withholding

Housing Allowance

Reporting Housing Allowance –

1099 R: *Alternative 1* – Include all distributions (including housing allowance) in Box 1. Check “Taxable amount not determined” in Box 2b

Alternative 2 – Show total distributions in Box 1 and taxable distributions (net of housing allowance) in Box 2a

Church benefit board can designate amount that is eligible as housing allowance; designation should be done annually (before beginning of year to which designation applies)

Tax Reporting and Withholding

Housing Allowance (cont'd)

Amount minister excludes as housing allowance cannot be more than amount designated by plan administrator (or other appropriate entity) as eligible for housing allowance

Note: Minister is responsible for verifying amount spent on housing allowance; plan cannot make that determination

Qualified Domestic Relations Orders “QDROs”

Qualified Domestic Relations Orders

Requirements for “QDROs”

- Court order
- Made under state’s domestic relations law or community property law
- Relates to provision of property rights, alimony, or child support to a spouse, child or other dependent
- Specifies plan to which order applies
- Specifies name and last known mailing address of participant
- Specifies name and last known mailing address of “alternate payee”

QDROs

Requirements for QDROs (cont'd)

- Recognizes, creates, or assigns to alternate payee a right to receive all or a portion of participant's benefit under plan
- Specifies the fixed or determinable amount of the participant's account balance payable to alternate payee
- Specifies the number of payments or the period to which the order applies
- Does not require plan to provide additional vesting

QDROs

Requirements for QDROs (cont'd)

- Does not require plan to provide additional benefits
- Does not require plan to provide form of benefit not otherwise provided
- Does not require plan to pay alternate payee benefits that are required to be paid to another alternate payee under another QDRO
- Cannot require plan to pay alternate payee until earliest date participant is entitled to distribution

QDROs

Who can be Alternate Payee

- Spouse
- Former Spouse
- Child
- Other Dependent of Participant

QDROs

Review of Domestic Relations Order

- Plan administrator must review order to determine if qualified
- Plan administrator must establish reasonable procedures for making determination. Procedures should:
 - Be in writing
 - Be reasonable
 - Provide for giving participant and alternate payee prompt notice of receipt of order and the procedures
 - Permit alternate payee to designate representative to receive notices concerning domestic relations order

QDROs

Review of Domestic Relations Order (cont'd)

- Should segregate amounts that would be paid to alternate payee if order is determined to be qualified (maximum segregation period of 18 months)
- May offer participant/alternate payee model QDRO
- Determination of whether order is a QDRO must be completed within a reasonable period of time
- Must promptly notify participant and alternate payee of determination

Special Securities Law Notice

Special Securities Law Notice

Church plan must provide notice to all participants that the plan is not subject to state and federal securities laws

- Separate notice to all participants
- Notice in Summary Plan Description

Special Securities Law Notice

Sample Notice

The plan or any company or account maintained to manage or hold assets of the Plan and interests in such plan, companies, or accounts (including any funds maintained by the plan) is not subject to registration, regulation, or reporting under the Investment Company Act of 1940, the Securities Act of 1933, the Securities Exchange of 1934, Title 15 of the United States Code, or State securities laws. Therefore, the plan participants and beneficiaries will not be afforded the protections of those provisions.