Introduction to QRPs and 403(b) Plans

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Learning Objectives

At the completion of this course you will be able to

- ✓ learn the benefits associated with 401(k) and 403(b) plans;
- ✓ review plan features, including eligibility and contribution requirements and distribution options;
- ✓ discuss plan design issues, such as safe harbor plans and automatic enrollment;
- ✓ differentiate between pretax and Roth 401(k) deferrals;
- ✓ understand the difference between an ERISA and a non-ERISA 403(b) plan;
- ✓ examine the nondiscrimination testing requirements, including ADP and ACP testing; and
- ✓ discuss the concept and requirements of 403(b) information-sharing agreements.

Icon Legend

Individual Exercise

Group Exercise

Group Discussion

Example

Job Aid

Additional Information

What is a Qualified Retirement Plan?

A qualified retirement plan (QRP) is an employer-sponsored employee benefit arrangement established for the purpose of providing retirement income for eligible employees. The term "qualified retirement plan" generally means that the written arrangement and the operation of the plan meet specific qualification requirements outlined in Internal Revenue Code section (IRC Sec.) 401(a).

Qualified plans must be maintained for the exclusive benefit of the plan's participants and their beneficiaries.

- When a plan meets these requirements, the business establishing the plan and the employees benefiting from the plan are entitled to special tax considerations.
- Many types of plans qualify under IRC Sec. 401(a). A 401(k) plan is a common example.

These tax benefits have become even more favorable since the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was signed into law in June 2001. Collectively, this legislation increased the benefits and simplicity of employer-sponsored retirement plans and created the most sweeping changes to retirement plans in nearly two decades.

- EGTRRA dramatically affected contribution limits, deductibility, testing, portability of assets, distributions, and other important areas.
- Although EGTRRA provisions were set to expire after 2010, the Pension Protection Act of 2006 (PPA) made many EGTRRA provisions permanent and increased plan asset portability.

Qualified Retirement Plan Types

Defined Contribution Plans

A defined contribution plan is an employer-sponsored retirement plan that bases employee benefits solely upon the amount contributed to each participant's account (plus earnings). Annual contributions on behalf of any plan participant are limited to the lesser of 100 percent of compensation or $56,000 for 2019 (plus catch-up contributions, if eligible).

Defined contribution plans offer no guarantees as to an employee's benefit at retirement. Instead, the employee bears the investment risk. A wide range of plans fall under this category—including profit sharing plans, money purchase pension plans, target benefit plans, employee stock ownership plans (ESOPs), and IRC Sec. 401(k) plans.

Profit Sharing Plans

Contributions to a profit sharing plan were designed to allow employees to share in a business's profits (although profits generally are not required). Employers may design their plans to make a discretionary profit sharing contribution each year. Therefore, the contribution that an employer makes to a profit sharing plan may vary .

Although an employer is not required to make a contribution each year, if an employer elects to make a contribution, the same contribution amount or percentage generally must be made for all eligible employees unless the employer has elected an allocation method that uses permitted disparity (IRC Sec. 401(l)) or cross-testing.

- The maximum deductible contribution that an employer can make to a profit sharing plan is 25 percent of eligible compensation (IRC Sec. 404(a)(3)).
- Eligible compensation is defined as all the compensation paid to eligible plan participants during the employer's tax year, including participant deferrals (e.g., 401(k) plan deferrals) (IRC Sec. 404(a)(12)).

Money Purchase Pension Plans

Unlike a profit sharing plan, a money purchase pension plan requires an employer's annual commitment to fund a plan according to the formula specified by the employer in the plan documents. A 10 percent funding deficiency penalty tax is assessed if the employer fails to make a contribution when required (IRC Sec. 4971). The funding deficiency penalty tax applies even if the plan has only a single participant. The maximum deductible contribution an employer may make to a money purchase pension plan is 25 percent of eligible compensation (IRC Sec. 404(a)(3)(A)(v)).

Because the profit sharing plan deduction limit increased to 25 percent of eligible compensation under EGTRRA, the appeal of money purchase pension plans has diminished.

Target Benefit Plans

A target benefit plan is a type of defined contribution plan that has some characteristics of a defined benefit plan. Contributions to each employee covered under the plan generally are determined based on factors such as the employee's age, years of service, and the retirement benefit "targeted" by the employer. While the contributions are designed to provide a specific benefit at retirement (based on defined benefit assumptions), no benefits are guaranteed. This lessens the financial risk for the employer compared to a defined benefit plan.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) is either a stock bonus plan with a discretionary contribution formula, or a combination stock bonus and money purchase pension plan. ESOPs require a minimum funding amount, which is contributed in the form of company stock—or used to purchase company stock.

Defined Benefit Plans

A defined benefit plan provides a predetermined benefit. For example, an employee who works for a specified number of years may be promised a monthly retirement benefit equal to a specific percentage of average preretirement pay, determined over the employee's last three years of employment.

Once the retirement benefit objective is set, the employer contributions needed to meet the benefit objective are determined actuarially each year. If the investments in a defined benefit plan perform poorly, the employer must contribute increased amounts in subsequent years to ensure that the plan satisfies the predetermined benefit objectives.

Although defined benefit plans allow for a greater dollar contribution than other employer plans, the costs of maintaining a defined benefit plan generally are higher than defined contribution plans.

Defined Benefit Plan

WJM Media has a defined benefit plan with an annual retirement benefit at age 65 equal to 2% times the years of service, up to a maximum of 50% of compensation. Mary retires at age 65 with 20 years of service. Her average compensation for her last 3 years of service is $60,000. Her annual retirement benefit is 2% x 20 x $60,000 ($24,000 per year).

QRP Benefits

Employer Benefits

Employers that establish a QRP receive both tax- and nontax-related benefits.

Tax Benefits

- As with other business expenses, QRP employer contributions generally are tax-deductible.
- Elective deferrals made by participants are deductible by the employer (but do not reduce the amount an employer can contribute and deduct).
- An employer with 100 or fewer employees that establishes a new eligible employer-sponsored retirement plan may receive a tax credit of up to 50 percent of the plan start-up costs—up to $500 per year—for a period of up to three years. The plan must have a least one non-highly compensated employee (non-HCE) to qualify. To claim the credit, the employer must file Form 8881, *Credit for Small Employer Pension Plan Startup Costs*, with the business's tax return.
- Employers are not taxed on plan contributions or earnings.

Nontax Benefits

An employer-sponsored retirement plan as part of a business's overall benefits package can help attract high quality employees.

Employee Benefits

Tax Benefits

Participants may make elective deferrals on a pretax basis, which gives them immediate tax savings. Contributions and earnings generally are tax-deferred until distributed from the plan.

If the employer offers a qualified Roth contribution program, employees also may make designated Roth contributions to a 401(k) plan. Plan participants must pay tax on Roth 401(k) contributions in the year they are made, but may distribute Roth 401(k) account assets—including earnings—tax- and penalty-free if certain requirements are met.

An eligible taxpayer (i.e., someone who is at least 18 years of age, not a dependent of another taxpayer, and not a full-time student) may receive up to a $1,000 federal income tax credit on 401(k) deferrals and IRA contributions. To claim the credit, taxpayers must file IRS Form 8880, *Credit for Qualified Retirement Savings Contributions*, with their federal income tax returns.

Nontax Benefits

Participating in a 401(k) plan helps employees prepare for financial security in retirement. Many 401(k) plans include hardship withdrawal provisions that allow employees to withdraw their elective deferrals to address certain financial shortfalls. Many plans also allow participants to take plan loans.

401(k) Plans

A 401(k) plan is a type of profit sharing plan that allows employees to defer a portion of their compensation into the plan. A 401(k) plan—sometimes called a "cash or deferred arrangement" (CODA),—allows employees to receive taxable compensation in a current year, or to defer taxation by electing to have the employer contribute some of their compensation into a deferral account. The amounts deferred generally are taxed when distributed to the employee. The plan may allow employees to make designated Roth (after-tax) contributions in addition to or in lieu of pretax salary deferrals.

A 401(k) plan may allow for employer matching contributions, employee after-tax contributions, and employer profit sharing contributions. If an employer makes matching contributions, the plan also must meet the requirements of IRC Sec. 401(k) and IRC Sec. 401(m).

As with other profit sharing plans, the overall deductible contribution limit under a 401(k) plan is 25 percent of the aggregate unreduced compensation (i.e., compensation including salary deferrals) paid to plan participants during the employer's tax year.

Plan Establishment Deadline and Election to Defer

An employer generally must establish a QRP by the end of the tax year for which a tax deduction is desired. Because most businesses use calendar tax years, most plans must be established by December 31. Funding the plan may occur later.

Deferral elections for a 401(k) plan may be made only for compensation that is not "currently available" before the employer signs the plan document. Compensation is considered currently available if the participant has received compensation or may receive the compensation at his sole discretion. For purposes of a salary reduction election, a self-employed person's earned income is not treated as being currently available until the last day of the business' tax year according to Treasury Regulation (Treas. Reg.) 1.401(k)-1(a)(6)(iii). A self-employed individual may not make a salary reduction election after the last day of the business' tax year (Treas. Reg. 1.401(k)-1(a)(6)(iii)) and allocate it for the plan year that includes the last day of the taxable year (Treas. Reg. 1.401(k)-2(a)(4)(ii)).

Eligible Employers

Almost any employer may establish a 401(k) plan—regardless of how the business entity is structured.

The types of employers that can establish plans are sole proprietorships, partnerships, tax-exempt organizations (as of January 1, 1997), and corporations. Tax-exempt organizations (including Native American tribal governments and related entities) also may establish 401(k) plans.

Ineligible Employers

State and local governments or governmental agencies cannot (with certain grandfathered exceptions) maintain 401(k) plans (IRC Sec. 401(k)(4)(B)). Other plan types are available to these organizations.

Owner-Only Businesses

Before 2002, a sole proprietor with no employees would not have been a good candidate for a 401(k) plan. Because deferrals were considered employer contributions that applied toward the employer's maximum deductible contribution, nothing was gained by adopting a 401(k) plan instead of a profit sharing plan. But under EGTRRA, employers no longer count elective deferrals as employer contributions when determining their maximum deductible contribution amount. As a result, sole proprietors may contribute up to 25 percent of their compensation, plus defer the maximum amount allowed under IRC Sec. 402(g).

401(k) Plan Investments

QRPs may invest in an almost unlimited range of investments. The plan document or the plan document sponsor (or volume submitter practitioner), under certain circumstances, may narrow the range of permissible investments. Examples of common QRP investments include

- stocks,
- bonds,
- notes,
- debentures,
- options,
- limited partnership interests,
- mortgages,
- real estate,
- Treasury Bills and other government obligations,
- savings accounts,
- time deposits,
- life insurance, and
- annuity contracts.

While the list of permissible investments is extensive, plans must avoid prohibited transactions when selecting various investments.

The responsibility for selecting plan investments generally belongs to the plan trustee. Employers, if they use an outside trustee, may retain investment selection responsibility. In some plans, individual participants may be permitted to select their own investments within the guidelines set by the plan.

To take advantage of the relief provided to fiduciaries under ERISA Sec. 404(c), fiduciaries must permit a broad range of investments. At least three investment alternatives must be made available to individuals. The regulations do not specify the types of investments that must be used. But the investment categories must be diversified enough to minimize the risk of loss to participants and beneficiaries. To minimize the risk of loss, diversification is required both between the investment categories and within each investment choice. Each investment offered under the plan must be materially different from the others in terms of risk and return.

401(k) Employee Eligibility and Exclusions

When an employer establishes a 401(k) plan, the employer may set eligibility requirements to control which employees (or class of employees) may participate in the plan. Employers may exclude employees who do not meet the plan's eligibility requirements. The plan documents contain the eligibility requirements.

Statutory Exclusions

Age Exclusions

An employer may specify that employees must attain a certain age, not to exceed age 21, before they are eligible to participate in the 401(k) plan.

NOTE: *An employer may include employees under age 21 if the employer specifies an age less than 21 in the adoption agreement.*

Years-of-Service Exclusions

The maximum amount of service an employer can require for employees to become eligible to make salary deferrals is one year. For matching or profit sharing contributions, the maximum amount of service an employer may require is two years.

A year of service is defined as a minimum number of hours (up to 1,000) during a prescribed 12-month period.

Exclusion of Certain Employees

Although a plan generally must include all employees who have met the age and years-of-service requirements, a plan may exclude some employees.

- Union Employees
  A plan may exclude all union employees who are covered by a collective bargaining agreement, provided that retirement benefits were a subject of good-faith bargaining.
- Nonresident Aliens
  A plan may exclude employees who are nonresident aliens and who earn no U.S. income.
- Business Acquisition or Merger
  A plan may exclude employees as a result of an asset or stock acquisition, merger, or similar transaction involving a change in the employer or the employees of a trade or business. These employees may be excluded during the transition period beginning on the date of the change of ownership and ending on the last day of the first plan year beginning after the date of the change.

Other Exclusions

A nonstandardized plan or individually designed plan may exclude employees from participation based on employee classification. Such exclusions include leased employees, employees at certain locations or in particular business units, or employees with specific types of compensation (e.g., hourly wages). Some job classifications, such as "part-time employees" or "seasonal employees," are impermissible exclusions.

A standardized plan is designed to satisfy the IRC Sec. 410(b) coverage test and does not allow certain elective provisions that could cause a testing failure. A nonstandardized plan may offer more restrictive provisions. Such provisions could create nondiscrimination testing issues for the employer.

NOTE: *If the employer owns or controls any other business entity, the employer may have to include the employees of the other business in the plan or in a similar plan. If this is the case, the employer should seek competent tax advice.*

The plan design may affect the plan's ability to satisfy the coverage test. Employers may select options that restrict certain employees from participating in the plan, or limit the type of contributions they are eligible to receive. For example, a plan may have trouble satisfying coverage if receiving a profit sharing contribution is contingent on being employed as of the last day of the plan year.

The annual minimum coverage test, known as the 410(b) test, is required to ensure that plan coverage does not discriminate in favor of highly compensated employees as defined in IRC Sec. 414(q) (HCEs). This test compares the percentage of HCEs who "benefit" under the plan to the percentage of non-HCEs who "benefit" under the same plan. In general, the percentage of non-HCEs who benefit must be at least 70 percent of the percentage of HCEs who benefit.

401(k) Contributions

Employee Contribution Types

Pretax Employee Deferrals

An employee who is eligible to participate in a 401(k) plan may choose to defer a percentage or dollar amount of her wages into the plan each pay period. Employees may have the option to receive bonuses in cash or to defer all or a portion into the 401(k) plan. Employee pretax deferrals are not subject to federal income tax, but are subject to Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA) tax withholding. Deferrals are always 100 percent vested. Employee deferrals must be made prospectively based on income earned after a deferral election is made, and may not exceed the annual dollar limit described in IRC Sec. 402(g).

Designated Roth Contributions

Employers may allow participants to make Roth elective deferrals to the plan. After-tax Roth contributions are treated as elective deferrals for most purposes, but must be placed in a separate account where the employer can maintain a record of the contribution basis and the earnings. The contributions are aggregated with any pretax 401(k) deferrals to meet the annual dollar limit under IRC Sec. 402(g). The plan document dictates whether Roth contributions are permitted.

QRPs allowing elective deferrals must always allow a pretax option. QRPs can allow Roth deferrals only if they permit pretax deferrals.

IRC Sec. 402(g) Deferral Limit

The amount of elective deferrals that a participant may contribute in a year is limited under IRC Sec. 402(g). This limit is subject to cost-of-living-adjustments (COLAs) in $500 increments. The 2019 deferral limit is $19,000, plus catch-up contributions, if eligible. Roth elective deferrals are aggregated with pretax deferrals to meet the participant's annual elective deferral limit.

If a 401(k) plan participant is covered by more than one 401(k) plan (including unrelated plans) or also participates in a 403(b) plan, salary reduction simplified employee pension (SAR-SEP) plan, savings incentive match plan for employees of small employers (SIMPLE) IRA plan, or SIMPLE 401(k) plan, then the salary deferrals under those plans also are applied toward the individual's annual deferral limit. There is no aggregation with 457(b) plans.

Catch-Up Deferrals

Participants age 50 or older (by the end of the calendar year) who defer wages into 401(k), 403(b), or governmental 457(b) plans may make catch-up deferral contributions. The 2019 catch-up contribution limit is $6,000. The catch-up limit is subject to COLAs in $500 increments. A catch-up contribution

- does not count against an employer's deduction limit under IRC Sec. 404,
- does not count against a participant's annual additions dollar limit under IRC Sec. 415(c) ($56,000 for 2019),
- does not count against the IRC Sec. 402(g) limit or the IRC Sec. 415 dollar limit,
- is made in addition to an individual's IRC Sec. 402(g) limit ($19,000 for 2019),
- does not count in top-heavy testing, and
- does not contribute to actual deferral percentage (ADP) testing failures.

NOTE: *Except for 457(b) plans, all plans of the employer are aggregated.*

Coordination of IRC Sec. 402(g) Limit With Other Salary Deferral Plans

The deferral limit applies in aggregate to multiple 403(b) and 401(k) plans. Lou has a single $19,000 deferral limit for the 2019 calendar year if he participates in a 401(k) plan and a 403(b) plan. The deferral limit applies separately for 403(b) or 401(k) and governmental 457(b) plans. If Lou participates in a 401(k) or a 403(b) plan and a governmental 457(b) plan, he will have a separate $19,000 deferral limit under the governmental 457(b) plan for 2019.

Employee Deferral Deadline

Employers must deposit salary deferrals as soon as administratively possible. The outside limit for all plans is no later than 15 business days after the end of the month in which the plan participant deferred the contribution.

For retirement plans with fewer than 100 participants, the DOL provides a safe harbor deadline for employers to deposit salary deferrals. According to the regulations, these small employers are deemed to have deposited salary deferrals as soon as administratively possible if they deposit the deferrals within seven business days after withholding them from the plan participant's pay.

The final regulations clarify that the safe harbor is available on a deposit-by-deposit basis. If an employer cannot meet the safe harbor during one deposit cycle, and must rely on the "as soon as administratively-possible" rule, the safe harbor remains available for subsequent deposit cycles. Plans are not required to use the seven-business-day safe harbor, and may still use the general "as soon as administratively-possible" rule.

Contribution Timing

According to the final regulations, 403(b) contributions must be deposited into the annuity contract or custodial account (i.e., contracts) "within a period that is no longer than is reasonable for the proper administration of the plan." If a 403(b) plan is an ERISA plan, however, the plan is subject to the more stringent DOL regulations that apply to QRPs. These rules dictate that employers must remit employee deferrals to investment providers as soon as administratively feasible—and no later than 15 business days after the end of the month in which the amounts were otherwise payable to employees (DOL Reg. 2510.3-102).

For QRPs the DOL generally takes the position that if deferrals are not remitted within a few business days, there could be a problem, unless the employer has a valid business reason as to why the process required a longer period.

CAUTION: *It is prudent for even a non-ERISA 403(b) plan to follow the DOL deposit guidelines for remitting salary deferrals. Non-ERISA 403(b) plans may become subject to state law requirements. New Jersey, for example, has a five-day time frame to remit salary deferrals.*

Employer Contribution Types

An employer generally has until its tax return due date, including extensions, to make employer contributions to a 401(k) plan. The plan administrator is responsible for calculating and allocating contributions. Under most 401(k) plans, contributions are allocated based on an individual's compensation. An employer may make several types of contributions to a 401(k) plan.

Profit Sharing Contributions or Nonelective Employer Contributions

Profit sharing contributions are an election of the plan administrator; they are not required. These contributions may be discretionary or fixed formulas. Allocations may range from 0 to 25 percent of the aggregate covered compensation earned by eligible plan participants during the employer's tax year.

Matching Contributions

Matching contributions are not required. An employer may make matching contributions to a 401(k) plan on behalf of those employees making elective deferrals Matching contributions may be discretionary or fixed. The plan document could require a matching allocation, or it could allow the plan administrator to determine whether any matching contribution will be made for each plan year. For example, the plan may be designed to require a match on employee deferrals in an amount equal to 50 percent of each dollar deferred into the plan up to six percent of the participant's compensation.

Employers may contribute matching contributions on an ongoing basis throughout the year or make a contribution at the end of the year.

Other Statutory Contribution Limits

Compensation Cap

Although the definition of compensation can differ between plans, many employers use Form W-2, *Wage and Tax Statement*, compensation as the basis for making plan contributions.

- An employer may consider only a certain amount of an employee's compensation for plan purposes.
- The maximum amount of compensation (the compensation cap) that may be taken into account on behalf of any plan participant when calculating contributions is $280,000 for 2019. This figure may be increased for COLAs.
- The 401(a)(17) compensation cap does not apply to church plans.

Annual Allocation Limit

For qualified plans, the maximum contribution amount allowed per year, per participant, may not exceed the lesser of 100 percent of the participant's compensation or $56,000 for 2019.

- This limit is called the IRC Sec. 415 "annual additions" limit and includes all employer contributions, employee contributions, and forfeitures made to any one participant's account. (While the "100 percent limit" applies for all annual additions, the dollar limit—$56,000—does not have to include catch-up contributions.)
- The annual additions limit applies separately to each plan participant and to each "unrelated employer."
- The annual additions limit applies for a "limitation year," which is a 12-month period (usually the plan year) defined in the plan document.

The definition of compensation for annual additions testing for 403(b) plans is found in IRC Sec. 403(b)(3). This definition of compensation generally incorporates all of a participant's wages, salaries, fees, and other amounts received for personal services rendered, paid by the employer and includible in gross income. Compensation includes elective deferrals.

Integration Rules

A 403(b) plan may use Social Security integration (permitted disparity) rules. The permitted disparity rules allow allocations of employer contributions to be increased for higher-paid employees, within certain limits as described in IRC Sec. 401(a)(5).

Top-Heavy Plan Consequences: Minimum Contributions

The employer must make a three percent minimum contribution on behalf of non-key employees if any key employee receives a contribution or makes a deferral for the plan year. But if no key employee receives a contribution (including salary deferrals and employer contributions) of three percent or more, the minimum contribution need only equal the same percent as that of the key employee with the highest contribution percentage.

Employer profit sharing/nonelective and matching contributions may be used to satisfy the minimum three percent contribution. All eligible non-key employees employed at year end must receive the top-heavy contribution.

Minimum Contributions

If no key employee received more than a 2% contribution, the employer need only make a 2% top-heavy contribution for non-key employees.

401(k) and ERISA 403(b) Vesting

Vesting describes the extent to which employer contributions made on behalf of a participant are nonforfeitable. For example, if participants have employer profit sharing plan balances of $10,000, are 60 percent vested, and become eligible to take distributions, they generally are entitled to withdraw $6,000 from the plan.

When an employer establishes a plan, the employer usually can choose among several vesting schedules provided in the adoption agreement.

- Vesting schedules require employment for a specified period before a plan participant is entitled to keep employer contributions made to the plan.
- Some employers may wish to attract and retain workers by offering a shorter vesting schedule, while others may choose a longer one to encourage employee longevity.

Immediate Vesting

Under an immediate vesting schedule, the plan participant is entitled to employer contributions as soon as the dollars are allocated and contributed to the plan. (Employer dollars are still subject to distribution eligibility requirements, so a participant may be entitled to plan assets but may not be eligible to withdraw them.)

- In certain situations, length of service is irrelevant. For example, salary deferrals are always 100 percent vested.
- If a plan participant reaches normal retirement age (as defined in the plan), if the plan is terminated, or if the plan requires more than one year of service for eligibility, all assets allocated to a participant must be 100 percent vested.
- The employer also may select plan provisions that require full vesting when a plan participant dies, becomes disabled, or attains a certain early retirement age.

Graded Vesting

Graded vesting entitles a plan participant to increasing percentages of an employer's contributions depending on his length of service. A vesting schedule provides an incentive to remain in service longer to receive the entire amount of employer contributions.

- For plan years beginning before January 1, 2007, the maximum graded schedule was seven years (six years for matching contributions and top-heavy plans).
- For plan years beginning after December 31, 2006, plan participants with at least one hour of service after the effective date must vest at least as rapidly as the six-year graded schedule for all employer contributions.

6-Year Graded Vesting	
Years	**6 Year**
1	0%
2	At least 20%
3	At least 40%
4	At least 60%
5	At least 80%
6	100%

Cliff Vesting

Cliff vesting provides no vesting until a participant works a specified number of years. Cliff vesting may encourage employees with several years of service to remain with their current employer, but may offer little incentive for relatively new employees, who may view their employer's contributions as a distant, uncertain benefit.

- For plan years beginning before January 1, 2007, cliff vesting was allowed over a maximum five-year period (three years for matching contributions and top-heavy plans).
- For plans beginning after December 31, 2006, plan participants with at least one hour of service after the effective date must be fully vested in all employer contributions after three years if cliff vesting applies.

3-Year Cliff Vesting	
Years	**3 Year**
1	0% or greater
2	0% or greater
3	100%
4	100%
5	100%

Accrued Benefits

Once an employer establishes a 401(k) plan or ERISA 403(b), changes made to the eligibility or vesting requirements must not reduce any plan participant's accrued benefits.

Non-ERISA 403(b) Plans Considerations

In most cases, if a 403(b) plan is not subject to ERISA but would like to impose a vesting schedule on the nonelective or matching contributions, the plan will voluntarily comply with the vesting requirements of ERISA Sec. 204. 403(b) and comply with the rules that apply to the cliff or graduated vesting schedules. 403(b) plans, however, that are not subject to ERISA are not required to comply with the above ERISA vesting requirements. Instead, they must comply only with the pre-ERISA vesting schedules that were applicable to QRPs.

401(k) and 403(b) Forfeitures

Forfeitures typically are created when participants who are not fully vested separate from service and take distributions of their vested balances. The unvested portions of their accounts are given up (i.e., forfeited), with some minor exceptions. Depending on plan provisions, these forfeitures may be allocated to other plan participants, used to pay plan expenses, or used to reduce future employer contributions.

401(k) Plan Testing

Because of the unique contributions in 401(k) plans, nondiscrimination testing under 401(k) plans is more complex than it is for most other types of defined contribution plans. At the heart of 401(k) plan operations is determining the maximum amount that plan participants may receive as contributions, including pretax deferrals, Roth contributions, matching contributions, and employee after-tax contributions. The actual deferral percentage (ADP) and actual contribution percentage (ACP) tests are used to make these determinations. Both of these tests compare the HCE group to the non-HCE group.

ADP Testing

The ADP test compares the salary deferral contributions of HCEs and non-HCEs to make sure that HCEs do not receive a disproportionate amount of deferrals. Put another way, the ADP test limits the percentage of compensation that HCEs may defer into the plan each year based on the percentage deferred by the plan's non-HCEs. Designated Roth contributions are included in ADP testing.

ACP Testing

The ACP test is conducted the same way as the ADP test. The ACP test measures employer matching contributions and employee after-tax contributions to ensure that they are not discriminatory in favor of HCEs.

HCE Definition

An HCE is someone who

- was a five percent owner at any time during the current year or preceding year or
- earned more than an indexed amount during the preceding year ($120,000 for 2018 and $125,000 for 2019). For example, for the 2020 plan year, look back to the compensation amount in effect for 2019 ($125,000).

In addition to the compensation requirement, an employer may apply an additional condition when determining HCEs: membership in the top-paid group. An employee generally is a member of the top-paid group of employees for a year if, during the year, the employee is in the group consisting of the top 20 percent of employees ranked on the basis of compensation. This election might reduce the number of HCEs (and may be revoked).

Testing Methods

The ADP or ACP test is satisfied by passing either the "1.25 Test" or the "2 Times/2 Percent Test." The employer may use whichever test gives the plan the best result.

The "1.25 Test"

For the 1.25 Test, the HCE group's ADP or ACP (whichever test is being performed) may not exceed 125 percent of the non-HCE group's ADP or ACP.

The "2 Times/2 Percent Test"

For the 2 Times/2 Percent Test, the HCE group's ADP (or ACP) must not exceed the lesser of

- 2 times (i.e., 200 percent of) the non-HCE group's ADP (or ACP); or
- the non-HCE group's ADP (or ACP), plus 2 percentage points.

Conducting the ADP Test

The employer may perform the ADP or ACP test by completing the following steps. The ACP test is based on employer matching contributions and employee after-tax contributions.

STEP 1: Determine the individual deferral ratio for each employee who is eligible to defer. The individual deferral ratio is determined by dividing each eligible employee's 401(k) deferrals by his compensation. (For purposes of this test, refer to the plan documents to determine what definition of compensation applies and whether the prior-year or current-year testing method should be used.)

STEP 2: Categorize each eligible employee either as an HCE or as a non-HCE.

STEP 3: Determine the ADP for the HCE group and the ADP for the non-HCE group. The ADP for each group is determined by adding together the individual deferral ratios of all participants within the respective group and dividing the resulting figure by the number of participants in that group.

NOTE: *If an employee is eligible to defer but elects not to defer, she is included in the test by counting her actual deferral ratio as zero.*

STEP 4: Perform the ADP test using either the 1.25 Test or the 2 Times/2 Percent Test.

Conducting the ADP Test

Georgette, Ted, and Sue Ann are the only non-HCEs who work for All About Cars, Inc. All three are eligible to defer under All About Cars' 401(k) plan. Georgette defers 8%, Ted defers 4%, and Sue Ann elects not to defer (0%). The ADP for All About Cars' non-HCEs is calculated as follows.

$$\text{ADP} = \frac{8\% + 4\% + 0\%}{3}$$

ADP = 4%

1.25 Test: 4% x 1.25 = 5% (maximum HCE ADP)

2 Times/2Percent Test: the lesser of the following = 6% (maximum HCE ADP)

4% + 2 = 6%

4% x 2 = 8%

Conducting the ACP Test

Georgette, Ted, and Sue Ann are the only non-HCEs who work for All About Cars, Inc. All three are eligible to defer and receive matching contributions under All About Cars' 401(k) plan. Georgette receives a match of 1% of compensation; Ted receives a match of 6% of compensation; and Sue Ann receives a match of 2% of compensation. The ACP for All About Cars' non-HCEs is calculated as follows.

$$\text{ACP} = \frac{1\% + 6\% + 2\%}{3}$$

ACP = 3%

1.25 Test: 3% x 1.25 = 3.75% (maximum HCE ACP)

2 Times/2Percent Test: the lesser of the following = 5% (maximum HCE ACP)

3% + 2 = 5%

3% x 2 = 6%

ADP/ACP Excesses

ADP Excess Contributions

When an HCE defers more into the plan than is allowed under the ADP test, there is an excess contribution. To avoid an employer penalty tax of 10 percent on the excess (IRC Sec. 4979), the amount of the excess and the earnings generally must be returned to the participant within 2½ months after the close of the plan year in which the excess occurred, starting with the HCE that deferred the greatest dollar amount. If the excess contribution is returned later than the deadline but before the close of the plan year following the year in which the excess contribution occurred, the employer will be subject to a 10 percent penalty tax on the excess. If the excess contribution is not corrected by the end of the plan year following the year in which the excess contribution was made, the 401(k) arrangement risks disqualification.

ACP Excess Aggregate Contributions

An excess aggregate contribution exists when an HCE's after-tax or employer matching contributions exceed the limits of the ACP test. As with the ADP test correction methods, a plan may correct excess aggregate contributions by distributing contributions to HCEs. The unvested portion of excess matching contributions is forfeited. If the excess aggregate contribution is returned later than 2½ months following the close of the plan year in which the excess aggregate contribution was made, but before the close of the plan year following the year in which the excess aggregate contribution was made, the employer will be subject to a 10 percent penalty tax on the excess. If the excess aggregate contribution is not corrected by the end of the plan year following the year in which the excess aggregate contribution occurred, the 401(k) arrangement risks disqualification.

QNEC and QMAC Requirements

As an alternative to distributing excess contributions, some plans allow an employer to correct excess contributions by making additional contributions to the non-HCEs in the form of qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs). If an employer uses QNECs or QMACs to correct an excess contribution, it may avoid the 10 percent penalty tax described previously, provided the QNECs or QMACs are contributed to the plan no later than the last day of the 12-month period following the close of the plan year for which they are allocated. Plans that use current-year testing data have some time to decide whether to make QNECs or QMACs after the plan year end. But plans using prior-year data for the ADP test must make any QNECs or QMACs by the last day of the plan year in which the excess contribution occurs. QNECs and QMACs are 100 percent vested when made.

Nondiscrimination Tests

As a QRP, 401(k) plans are subject to the same fundamental principles of pension law that ensure that highly compensated employees (HCEs) or key employees do not receive or otherwise have available to them disproportionately more valuable benefits than are available to lower-paid workers. Each compliance test compares the benefits of lower-paid rank-and-file employees to the benefits of HCEs or key employees. Tests include the general nondiscrimination tests (IRC Sec. 401(a)(4)), the minimum coverage test (IRC Sec. 410(b)), and the top-heavy test (IRC Sec. 416).

Top-Heavy Test

Under the top-heavy test, a plan is deemed top-heavy if more than 60 percent of the plan assets are in the accounts of key employees.

A key employee is defined as

- an officer of the employer having annual compensation greater than $180,000 for 2019 (subject to COLAs in $5,000 increments),
- a five percent owner of the company, or
- a one percent owner of the company with annual compensation exceeding $150,000 (not subject to COLAs).

Annual Testing

Except for the first plan year, the determination of whether a plan is top-heavy for the current plan year is made as of the last day of the prior plan year. For the first plan year, the top-heavy determination date is the last day of the first plan year.

401(k) Distributions

Plan participants may take 401(k) plan distributions following certain distribution triggering events.

Triggering Events

A "triggering event" generally must occur before a participant is entitled to take a distribution from a 401(k) plan. These events can differ between plans and are defined in the plan document.

Allowable Distribution Triggers for Employer Nonelective and Matching Contributions	Allowable Distribution Triggers for Elective Deferrals (Includes QNECs and QMACs)
• Severance from employment • Attainment of a specified age or normal retirement age (NRA) • Death • Disability • Plan termination • In-service distributions • Qualified domestic relations orders (QDROs)	• Attainment of age 59½ • Severance from employment • Death • Disability • Qualified reservists distribution • Plan termination • Financial hardship • Qualified domestic relations orders (QDROs)

In-Service Distributions of Employer Contributions

In addition to the previously described standard triggering events, profit sharing plans (including 401(k) plans) may allow plan participants to take in-service distributions. An in-service distribution provision allows 401(k) plan participants to withdraw employer contributions from the plan (not elective deferrals) before the participant incurs a traditional triggering event.

The maximum amount that a participant may take as an in-service distribution under any circumstances is the participant's vested portion of employer contributions. The amount that a participant is eligible to withdraw as an in-service distribution may be further limited depending on the length of time the employee has been a participant in the plan and depending on whether the in-service distribution is taken on account of financial hardship. (Additional limits apply to hardship distributions of employee salary deferrals in 401(k) plans.)

In-Service Distributions for Hardship Purposes

If a participant requests an in-service distribution from a 401(k) plan because of hardship, the employer will frequently limit the amount of the in-service distribution to the lesser of

- the participant's vested balance in her individual account, or
- the amount of the participant's immediate and heavy financial need.

Plan administrators must refer to the specific plan language for a concise definition of what circumstances constitute a hardship. Hardship distributions are not eligible to be rolled over.

Hardship Distributions of Elective Deferrals

Elective deferrals under a 401(k) plan are subject to more restrictive distribution provisions than profit sharing dollars. Elective deferrals generally may not be distributed before the occurrence of a triggering event. But if the plan document allows, employers may permit participants to receive distributions of their elective deferrals because of financial hardship. (In some grandfathered cases, hardship distributions may include earnings on deferrals, but generally only earnings that were accrued on or before the last day of a plan's 1988 plan year.)

Effective for plan years after December 31, 2018, the Bipartisan Budget Act of 2018 and subsequent proposed Treasury regulations allow participants to receive hardship distributions of qualified nonelective contributions, qualified matching contributions, and their earnings. Earnings on 401(k) elective deferrals are also eligible for hardship distribution.

Hardship distributions of elective deferrals must be limited to situations in which a participant can demonstrate an immediate and heavy financial need and that a hardship distribution of elective deferrals is necessary to satisfy such financial need (Treasury Regulation (Treas. Reg.) 1.401(k)-1(d)(3)). To meet these criteria, many 401(k) plan documents contain the following deemed hardship reasons. PPA expands certain hardship reasons to include hardship events that occur with respect to a participant's primary beneficiaries. Employers may choose whether to allow distributions on account of beneficiary hardship.

- Safe Harbor

  Employers maintaining prototype plans always must use the safe harbor rules under Treas. Reg. 1.401(k)-1(d)(3)(iii)(B). Under the safe harbor rules, a distribution is deemed to be on account of an immediate and heavy financial need if the distribution is for one of the following reasons.

  - Unreimbursed medical care expenses for the participant, a spouse, a dependent, or a beneficiary
  - Direct costs of purchasing the participant's principal residence
  - Payments necessary to prevent eviction from or foreclosure on the participant's principal residence

- Funeral or burial expenses for the participant's parent, spouse, children, dependents, or a beneficiary
- Tuition and related post-secondary educational fees for up to the next 12 months for the participant, a spouse, a dependent, or a beneficiary
- FEMA declared disaster area

NOTE: *In the past, any participant could take a distribution to pay for repairs to their principle residence if the repairs qualified for the casualty deduction. But the Tax Cuts and Jobs Act of 2017 no longer allows a deduction for casualty losses unless the taxpayer suffering the casualty loss is located in a presidentially-declared disaster area. Unless existing Treasury regulations are rewritten, casualty loss experienced by certain participants no longer meet the safe harbor condition. (Effective for losses incurred in taxable years beginning after December 31, 2017, and before January 1, 2026.)*

- Requirements for Satisfying Financial Need

  Under the "general rule" described in Treas. Reg. 1.401(k)-1(d)(3)(iii)(A), an employer must consider all of a participant's financial resources to determine whether a hardship distribution of elective deferrals is needed to satisfy an immediate and heavy financial need. Consideration of the participant's financial resources is based on facts and circumstances. If the financial need can be alleviated by other resources—including those outside the plan—the employer should not approve the hardship distribution. To make the determination, the employer may rely on a participant's written certification that states why the need cannot be relieved by other resources (Treas. Reg. 1.401(k)-1(d)(3)(iv)(C)).

Hardship Distribution

Murray designates his niece, Alexa, as his primary beneficiary. During her second year of college, Alexa cannot afford her college tuition. Because Murray has designated Alexa as his primary beneficiary and Murray's plan allows for hardship distributions to a participant's beneficiary, he can request a hardship distribution to assist with her tuition expenses.

- **Financial Resources Safe Harbor**

  If the following conditions are met under the safe harbor rules, a hardship distribution of elective deferrals will be *deemed* necessary, thereby alleviating the need for the employer to consider all of a participant's financial resources. Prototype plans must always use this safe harbor method.

  - The participant must receive any other distributions (including in-service distributions) or loans* available under all of the employer's plans.
  - Although the distribution may not exceed financial need, the amount may include any amounts necessary to pay federal, state, and local income taxes (and any penalties) that the participant is likely to incur because of the distribution.
  - The participant cannot make any elective deferrals (or employee after-tax contributions) under all plans of the employer for a period of six months following the hardship distribution of elective deferrals.* (This does not prohibit a participant from making deferrals under an IRC Sec. 125 cafeteria plan).

  *Effective for 2019 and later plan years, the Bipartisan Budget Act of 2018 and proposed Treasury regulations will not require participants to suspend deferrals for six months following a hardship distribution or to take a plan loan before receiving a safe harbor hardship distribution.

- **Cost of Taking a Hardship Distribution**

  Participants looking to take a hardship distribution should consider the potential costs.

  - The distributed pretax amounts are included as ordinary income and are taxable.
  - The distribution is subject to the 10 percent penalty tax, unless a penalty tax exception applies.
  - Hardship distributions are ineligible for rollover; once they have been distributed, there is no way to put the money back into a tax-deferred account.

Early Distribution Penalty Tax

If an individual takes a taxable 401(k) or 403(b) plan distribution before attaining age 59½, he generally must pay a 10 percent early distribution penalty tax. The 10 percent penalty tax is assessed at the time the individual submits her individual income tax return. IRC Sec. 72(t)(2) provides several early distribution penalty tax exceptions, which apply to 403(b) plans as well as to QRPs.

- Death
- Disability
- Substantially equal periodic payments
- Separation from service after age 55
- Dividends from ESOP plans
- Distributions to alternate payees (such as a former spouse) made pursuant to a qualified domestic relations order
- Unreimbursed medical care expenses that are more than 10 percent of the participant's adjusted gross income for the year
- IRS levies
- Qualified reservist distributions

Required Minimum Distributions

401(k) and 403(b) plan participants must begin RMDs by their required beginning date (RBD). The RBD is the later of April 1 of the calendar year 1) following the calendar year in which the participant attains age 70½, or 2) following the calendar year in which the participant retires from the employer maintaining the plan. The extended RBD is applicable only if allowed under the employer's plan document. For a 403(b) plan, the extended RBD also must be included in the underlying individual annuity contract for the provision to be allowable.

The plan does not need participant consent to distribute RMDs. As an IRC Sec. 401(a)(9) qualification condition, a plan must begin RMDs to participants no later than the participant's RBD. RMDs are not eligible for rollover.

An RMD generally is calculated by dividing the account balance by the applicable distribution period. Subsequent-year distributions must be taken by December 31 of the year for which the distribution is required. An IRS 50 percent excess accumulation penalty tax may apply if the RMD is not distributed timely.

Participants may aggregate all of their 403(b) accounts or contracts in order to take RMDs (this is different from 401(a) plan operations). But 403(b) plan assets cannot be aggregated with IRAs when determining RMDs.

Annuity payments from an IRC Sec. 403(b)(9) retirement income account will satisfy the distribution requirements of Treas. Reg. 1.401(a)(9)-6, even though the payments are not made under an annuity contract purchased from an insurance company, provided that the relationship between the annuity payments and the retirement income accounts is consistent with any rules prescribed by the IRS.

For 403(b) plan assets, the RMD rules apply only to the post-1986 account balance, plus earnings thereon, provided that such amounts have been separately tracked. This includes earnings accumulated after December 31, 1986, that are attributable to both pre-1987 and post-1986 contributions (Treas. Reg. 1.403(b)-6(e)(6)). The pre-1987 account balance must be distributed under the incidental benefit requirements of Treas. Reg. 1.401-1(b)(1)(i). If separate records do not exist for the pre-1987 and post-1986 amounts, the entire balance will be subject to the general RMD rules. Amounts that are distributed from the pre-1987 balance and rolled over will be treated as part of the post-1986 balance. Amounts that are transferred, however, will retain their pre-1987 character if separate records are maintained. IRS Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*, indicates that distributions of pre-1987 balances must begin by the later of

- the end of the calendar year in which the participant reaches age 75, or
- April 1 of the calendar year following retirement.

401(k) Plan Design Features

ADP, ACP Safe Harbor Plans

An employer sponsoring a traditional 401(k) plan may avoid ADP and ACP testing by adopting certain safe harbor provisions.

- These safe harbor provisions have been available since January 1, 1999, and provide relief from complex ADP and ACP testing requirements.
- For 2002 and later plan years, safe harbor plans generally are deemed to satisfy the top-heavy rules. Contributions used to satisfy the ADP safe harbor must be immediately 100 percent vested.

ADP Safe Harbors

Employers are not required to conduct or satisfy ADP testing requirements if the plan meets the terms of one of the following safe harbors.

- ADP Safe Harbor #1

  The employer must make a matching contribution for each non-HCE equal to

  - 100 percent of the employee's elective deferrals that do not exceed 3 percent of the employee's compensation, plus
  - 50 percent of the employee's elective deferrals between 3 and 5 percent of compensation.

  No matching contribution for an HCE may be greater than that for a non-HCE at the same level of deferral.

- Alternative to ADP Safe Harbor #1

  There is an alternative to satisfying the ADP safe harbor described above. To meet the requirements of this alternative,

  - the level of employer match may not increase as an employee's elective deferrals increase, and
  - matching at levels that are not equal to the formula prescribed above will not be considered a failure, provided the aggregate amount of matching contributions (for a given rate of elective contribution) is at least equal to that which would have been provided under the matching formula described above.

  This means that the formula may be different, but the outcome in total matching dollars must be the same or greater than under the first alternative formula. The most common formula that meets this safe harbor is a dollar-for-dollar match on an employee's deferrals that do not exceed four percent of compensation.

- ADP Safe Harbor #2

  An employer can satisfy this safe harbor by making a nonelective contribution of at least three percent of each eligible non-HCE's compensation, regardless of whether the employee elects to defer.

ACP Safe Harbor

Employers are not required to conduct or satisfy ACP testing if they satisfy one of the ADP safe harbors described above, and if they meet the following conditions.

- No employee contributions or elective deferrals in excess of six percent of compensation are matched.
- The level of the employer's matching contributions does not increase as an employee's contributions or elective deferrals increase.
- The match for any HCE does not exceed the match for a non-HCE at the same level of employee contribution.

"Maybe Notice"

An employer can amend a 401(k) plan to a safe harbor plan during the year by satisfying the regular safe harbor notice requirements at least 30 days and not more than 90 days before the beginning of the plan year and by providing each eligible employee with a notice that gives detailed information on eligibility, definition of compensation, deferral elections, and distribution and vesting requirements, as well as the following contingent notice information.

- Instead of stating the safe harbor nonelective contribution amount, the initial notice must state that the employer may amend the plan during the year to provide a three percent safe harbor nonelective contribution.
- The initial notice also must state that, if the plan is amended during the plan year, eligible employees can expect to receive a supplemental (or follow-up) notice regarding the amendment from the employer 30 days before the last day of the plan year.

Follow-Up Notice

If the employer amends the plan for the safe harbor provisions, it must provide the follow-up notice no later than 30 days before the last day of the plan year. The follow-up notice must state that the employer will make a three percent safe harbor nonelective contribution for the year.

Example:

Employer B maintains a calendar-year 401(k) plan, and tests the plan using the current-year ADP/ACP testing method. Employer B is unsure whether to add the 401(k) safe harbor nonelective contribution provisions to the plan, but wants to have the flexibility to do so before 2020, without committing to the decision in 2019. He can keep his options open by providing the initial safe harbor notice, as modified above, within a reasonable time (i.e., at least 30 days and not more than 90 days) before January 1, 2020. If he decides to adopt the 401(k) safe harbor provisions in 2020, he must amend the plan and distribute the supplemental notice described above to all eligible employees by December 1, 2020.

Qualified Automatic Contribution Arrangement

Effective for plan years starting on or after January 1, 2008, a QACA is an automatic contribution arrangement (ACA) that may be exempt from ADP and ACP testing if it meets certain minimum levels of employee and employer contributions and if it meets the automatic contribution notice requirements. For this reason, this plan design is often called a safe harbor plan. If the only contributions made to the plan are QACA contributions, the plan also is exempt from top-heavy testing.

The final regulations clarify that a QACA may exclude only those eligible employees that have affirmatively elected not to participate. But a plan can provide that an employee's affirmative election can expire, and can require such employees to make new affirmative elections before once again automatically enrolling them in the QACA.

A QACA notice must be provided to eligible participants 30 to 90 days before the start of the plan year.

- Employee Deferrals

  QACAs must have a specified schedule of minimum default percentages for salary deferrals—starting at 3 percent and gradually increasing to 6 percent. The default percentages can be higher than 6 percent, but cannot exceed 10 percent. The default percentage must be applied uniformly to all employees, that is all participants enrolled during the initial year will be enrolled at the same percent and increases will apply to all participants in the same manner. Exceptions cannot be made for groups of employees (unless the employee makes elective deferral elections).

	Minimum	Maximum
Year 1	3%	10%
Year 2	4%	10%
Year 3	5%	10%
Years 4+	6%	10%

- Employer Contributions

  The employer generally must make either a

  - nonelective contribution of at least 3 percent of compensation to all participants, including those who choose not to make any elective contributions; or
  - matching contribution of 100 percent of an employee's elective contributions up to 1 percent of compensation, and a 50 percent match for all elective contributions above 1 percent and up to 6 percent of compensation.

  Employer QACA contributions require an accelerated vesting schedule. The longest vesting schedule available is a two-year cliff schedule (100 percent vesting after two years).

Federal Preemption

Before PPA, federal legislation did not preempt state laws that required an employee to provide consent before an employer could withhold amounts from the employee's pay (other than by court order, etc.). Effective August 17, 2006, ERISA (as amended by PPA) preempts state law to the extent state laws would interfere with automatic enrollment programs.

Permissible Withdrawals

A plan with an eligible automatic contribution arrangement (EACA) feature (or a QACA feature designed to satisfy the EACA requirements) may permit an employee to withdraw amounts that were automatically deferred if certain conditions are met.

- An employee must elect a permissible withdrawal no later than 90 days after the date the first automatic deferral contribution would have been paid to the employee (IRC Sec. 414(w)(2)).
- The permissible withdrawal period may be shorter than 90 days, but must be at least 30 days.
- Permissible withdrawal requests must be effective by the earlier of the pay date for the second payroll period beginning after the election is made, and the first pay date that is at least 30 days after the election is made.
- A permissible withdrawal must include the automatic deferrals, plus any earnings attributable to the withdrawn deferrals.
- A permissible withdrawal request must be processed as timely as any other distribution request, and distribution fees for permissible withdrawals may be no higher than other distribution fees.

If a plan allows an employee to elect to make permissible withdrawals,

- the distribution will be taxable in the year of distribution,
- an early distribution penalty tax will not be assessed,
- such distributions will not violate a plan's normal distribution restrictions (triggers), and
- any employer match made on the withdrawn deferrals will be forfeited.

Additionally, automatic deferrals will continue after a permissible withdrawal unless the employee elects to stop or change the deferrals.

Additional ACA Guidance

In September 2009, the IRS released additional ACA guidance. Revenue Ruling 2009-30 addresses uniformity issues for automatic increases of deferral amounts under ACAs, EACAs, and QACAs. The IRS also released Notice 2009-65, which contains two sample amendments (one for ACAs and one for EACAs). These are basic, simplified amendments with limited provisions.

The ACA amendment explains who is a covered employee, allows employers to set default percentages, and provides the effective date of the ACA provision.

The EACA amendment provides a 90-day permissible withdrawal of defaulted deferrals, explains who is a covered employee, allows employers to set default percentages, defines the uniformity requirements, and provides the effective date of the EACA provision.

NOTE: *A detailed discussion of EACAs and QACAs is beyond the scope of this course.*

Compare: 401(k) Safe Harbor and QACA Safe Harbor Plans

401(k) Safe Harbor vs	QACA Safe Harbor Plans
3% nonelective contribution or Match up to 4%	3% nonelective contribution or Match up to 3.5% (tiered matching formula) **NOTE:** *Lower maximum match, but plan may have more deferrals because of auto enrollment*
Requires 100% immediate vesting on ADP safe harbor contributions	Two-year cliff vesting
ADP/ACP safe harbor available	ADP/ACP safe harbor available
Top-heavy exemption available	Top-heavy exemption available

What is a 403(b) Plan?

Internal Revenue Code section (IRC Sec.) 403(b) plans—often called "tax-sheltered annuities"—have been available since 1958. A 403(b) plan allows employees to set aside a portion of their compensation for retirement purposes. Only certain types of employers may offer 403(b) plans.

Employers may establish 403(b) plans that allow employee salary deferrals and allow employers to make matching or other contributions. When employer contributions are made to a 403(b) plan, the plan becomes subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA), unless the plan is maintained by a governmental employer or church group.

In many respects, 403(b) arrangements are similar to 401(k) plans. The employer withholds salary deferrals on a per-pay-period basis and forwards them to the investment provider. Unlike 401(k) plans, there generally is no trust established by the employer to hold the plan assets. Each employee establishes her own annuity contract or custodial account to hold the 403(b) plan assets.

403(b) Employer Eligibility

Types of Employers That May Offer a 403(b) Plan

Many types of organizations are eligible to file for tax-exempt status, but only certain organizations fall within the definition of IRC Sec. 501(c)(3). Employers that do are eligible to maintain 403(b) plans. A 501(c)(3) tax-exempt organization is one that qualifies an individual to claim a deduction on his federal income tax return for contributions to the organization.

IRC Sec. 501(c)(3) employers (all of which may offer 403(b) plans) include corporations, funds, or foundations that are organized exclusively for the following reasons.

- Religious purposes
- Charitable purposes
- Scientific purposes
- Public safety
- Literary purposes
- Educational purposes
- Fostering national and international amateur sports competition
- Prevention of cruelty to children or animals

NOTE: *No part of the net earnings of a 501(c)(3) organization can benefit any private shareholder or individual. Also, no substantial part of the organization's activities can be spent carrying on propaganda or otherwise attempting to influence legislation.*

Taxable Subsidiaries Are Not Eligible 403(b) Employers

If an eligible 403(b) employer owns and operates a for-profit subsidiary, the taxable subsidiary may not maintain a 403(b) plan for its employees.

501(c)(3) Tax-Exempt Organizations

The following are examples of organizations that could file for federal tax-exempt status under IRC Sec. 501(c)(3), provided they properly operate as tax-exempt entities.

- Churches or church-controlled organizations
- Hospitals
- Private colleges
- Museums
- Symphony orchestras
- Nursing homes
- Humane societies
- Zoos
- Health clinics
- Scientific foundations

Educational Organizations

- **Public Educational Organizations**

  Public educational organizations (described in IRC Sec. 170(b)(1)(A)(ii)) run by a state or state agency also may offer 403(b) plans to eligible employees. Public educational organizations include elementary schools, high schools, prep schools, colleges, and universities. State-sponsored charter schools also are eligible to establish 403(b) plans.

  Certain governmental organizations that are established as separate entities from the government and that have no enforcement or regulatory powers are eligible to establish 403(b) plans if such organization provides educational or charitable services that are similar to services that would be provided by a 501(c)(3) organization.

- **Tribal Government School Systems**

  Public school systems organized by Native American tribal governments can establish 403(b) plans for their school system employees. Native American tribal governments are not eligible to establish a 403(b) plan for any employees working for a for-profit business, such as a casino.

Certain Ministers

Ministers are eligible employees for whom a 403(b) plan can be established if they are

- employed by an IRC Sec. 501(c)(3) organization,
- a self-employed minister treated as employed by a tax-exempt organization that is a qualified 403(b) employer, or
- a minister or chaplain who is employed by an organization that is not an IRC Sec. 501(c)(3) organization and who functions as a minister in day-to-day professional responsibilities with the employer.

Certain Ministers

Elizabeth, a minister employed as a chaplain by a state-run prison, and Gary, a chaplain in the United States Armed Forces, are eligible employees because their employers are not IRC Sec. 501(c)(3) organizations and they are employed as ministers.

NOTE: *According to IRS Publication 571,* Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations*, a self-employed minister may not establish a 403(b) account for his own benefit. Only the organization (denomination) with which the minister is associated can establish the account.*

Cooperative Hospital Service Organizations

Charitable service organizations defined under IRC Sec. 501(e) may maintain 403(b) plans.

Civilian Faculty and Staff of the Uniformed Services University of the Health Sciences

Federal organizations authorized to train medical students for the Uniformed Services may maintain 403(b) plans.

Tax-Exempt Organizations That Cannot Maintain 403(b) Plans

As mentioned previously, many types of organizations are exempt from tax under IRC Sec. 501(c), but only those described in IRC Sec. 501(c)(3) can maintain 403(b) plans.

The following are examples of tax-exempt organizations that cannot maintain 403(b) plans.

- Country clubs (IRC Sec. 501(c)(7))
- Credit unions (IRC Sec. 501(c)(14))
- Civic leagues (IRC Sec. 501(c)(4))
- Fraternal lodges (IRC Sec. 501(c)(10))
- Labor, agricultural, or horticultural organizations (IRC Sec. 501(c)(5))
- Trade or professional organizations (IRC Sec. 501(c)(6))
- Nonprofit recreational clubs (IRC Sec. 501(c)(7))
- Nonprofit cemetery companies (IRC Sec. 501(c)(13))
- Nonprofit military veterans organizations (IRC Sec. 501(c)(19))

Establishing a 403(b) Plan

Written Plan Document Requirement

One of the most noticeable ways that the IRS made 403(b) plans more like 401(k) plans is one of the most significant changes resulting from the final regulations. Treas. Reg. 1.403(b)-3(b)(3) requires all 403(b) contracts to be issued according to a written employer-level plan document. While there have been written employer-level 403(b) plan documents in the past, only employers with ERISA plans were required to operate under a written employer-level plan document before these regulations became effective.

Under the final 403(b) regulations, all 403(b) plans, with the exception of church plans, were to be established and maintained under a written employer-level plan document by January 1, 2009.

NOTE: *Under the final regulations, a 403(b) plan maintained by a church group may, but generally is not required to, operate under a written employer-level plan document. But if a church plan elects to operate as a retirement income account, it must operate under an employer-level plan document.*

Most 403(b) plans are established as follows.

Board Resolution

The employer's governing body (e.g., a foundation's board of directors) must pass a resolution authorizing the 403(b) arrangement. The governing body must authorize or select the investment providers, and identify one or more individuals to prescribe basic operational and investment rules or guidelines.

Request For Proposal

The employer sends a request for proposals (RFPs) to insurance or fund companies to find investment providers for the plan.

Select Investment Providers

The employer must select investment providers for the 403(b) plan.

Third-Party Administrators

To comply with the requirements under the final regulations, many 403(b) employers contract with an outside third-party administrator (TPA) firm to assist with keeping their plans in compliance. According to Field Assistance Bulletin (FAB) 2010-01, if the employer contracts with an outside TPA to make any "discretionary determinations" under the plan, it will subject the plan to ERISA. (Remember that governmental and church plans are exempt from ERISA.)

Notification and Investment Selection

Employees must be formally notified of the 403(b) arrangement. In the past, this notification process was sometimes conducted informally. Informal notification is no longer allowed under the final 403(b) regulations.

Employees must select among the various investment providers and sign a 403(b) annuity contract or custodial agreement with one of or more of the allowable investment providers. If a plan is set up as an individual account plan, the assets will be held under individual annuity contracts or individual custodial agreements.

Providers Publicize Investment Products

Some 403(b) employers, especially for non-ERISA plans and plans with a large number of allowable investment providers, allow the investment providers to come on site to speak to employees regarding the benefits of participating in a 403(b) plan and their particular investment alternatives.

Execute Plan Document

The employer must execute a written employer-level 403(b) plan document.

Payroll Capabilities

The employer must review payroll processing capabilities to ensure that the deduction and remittance process can be handled.

Deferral Election

Participants must notify their employer of their deferral amounts and the investment providers that they selected with an election form. The employer deducts the amounts from their paychecks and remits them to the selected investment providers.

Individual Arrangements

Each 403(b) plan participant must execute a custodial agreement (or annuity contract) with each mutual fund (or insurance) organization that the participant selects.

These annuity contract or custodial account agreements typically contain standard contract provisions, plus the requirements of IRC Sec. 403(b).

Conflicting Language Between Employer Plan Document and Vendor Agreements

The provisions and language in the employer-level document and the vendor agreement ideally would be consistent, but often is not possible. If there is a conflict between the terms of the two documents, the employer-level document will control. The vendor level agreements may be more restrictive than the plan document, but never more liberal.

Conflicting Language

If the employer plan document does not allow for plan loans, participants may not take plan loans even if their underlying annuity contract or custodial account allows for loans. But if the employer plan document allows for plan loans, participants may take loans as long as their underlying annuity contract or custodial account also allows for loans.

Employer plan documents often have language similar to this: "Plan loans will be available if allowed for under the underlying custodial account agreements or annuity contracts."

403(b) Plan Investments

Eligible 403(b) plan participants are somewhat limited in their investment options compared to their 401(k) plan counterparts. Depending on the 403(b) plan, the following are allowable investment choices.

Annuity Contracts

The annuity contract has been the traditional 403(b) plan investment arrangement. The contract can be either a fixed or variable annuity contract and must contain anti-alienation, nonassignability, and transferability provisions (unless the contract was purchased before 1963).

Custodial Accounts (Mutual Funds)

In 1974, custodial accounts were added as allowable 403(b) plan investments. When a custodial account is established to receive and hold 403(b) plan investments, such accounts may be invested only in registered mutual funds. A mutual fund 403(b) plan is sometimes referred to as a "403(b)(7) plan." The custodian must be a bank or other entity approved by the IRS to serve as custodian. A mutual fund is a professionally managed investment that sells shares to investors and pools the capital it raises to purchase stocks, bonds, or money market securities, depending on the investment objectives of the fund. Closed-end mutual funds also are allowable investments.

Group custodial arrangements also are allowed and they will become more common as a result of the new requirement imposed on employers to track 403(b) plan assets.

Retirement Income Accounts

In 1982, a special investment rule became available for churches and church-related organizations. Under IRC Sec. 403(b)(9)(B), these organizations can invest in investment options other than annuities and mutual funds through an arrangement called a retirement income account. Under a retirement income account, the allowable investment options are identical to the investment options allowed under a 401(k) plan. For a church group 403(b) plan to operate as a retirement income account, the plan must operate under an employer-level written plan document and make an election in writing that it is operating as a retirement income account. Possible investments may include stocks, bonds, governmental securities, and bank certificates of deposit.

NOTE: *A self-employed minister is considered both an employee and an employer and can contribute to a retirement income account established on his behalf for his own benefit.*

Life Insurance Contracts

With the exception of retirement income accounts, life insurance is no longer an allowable 403(b) investment for contracts issued after September 23, 2007. For 403(b) contracts issued on or before September 23, 2007, holding life insurance in the contract is grandfathered. Other incidental benefits, such as enhanced death or disability benefits, are still permissible as long as the incidental benefit rules are followed. These are the same incidental benefit rules that apply to QRPs. Such enhanced benefits generally would increase the cost of the underlying annuity contract(s).

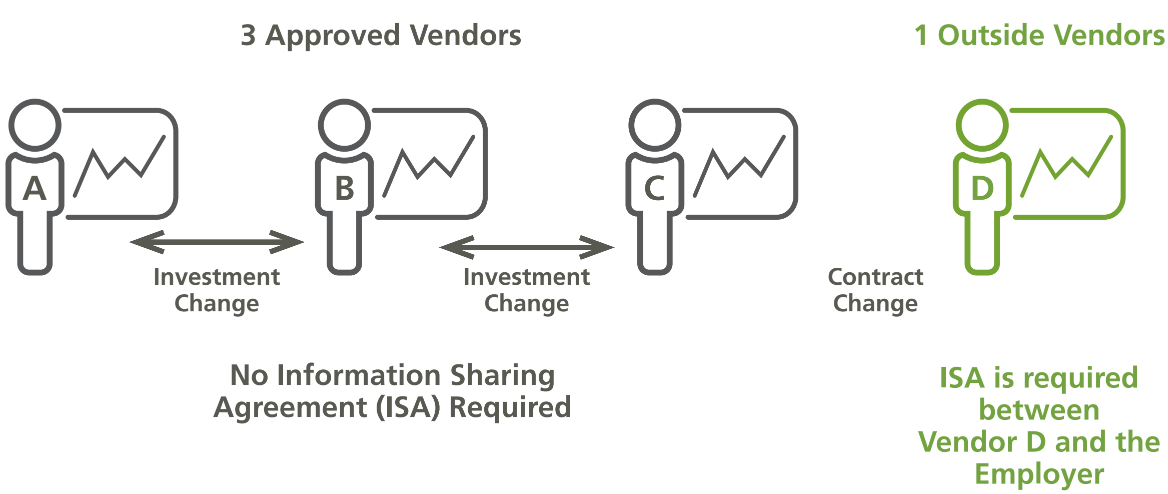
Contract Exchanges

A contract exchange is a movement of assets under the same employer 403(b) plan from an employer-approved investment provider (i.e., one that is currently receiving contributions under the plan) to an investment provider that does not have a current relationship with the employer (i.e., an unapproved or outside investment provider). Participants may conduct contract exchanges if

- the plan allows for such exchanges,
- benefits are not diminished (i.e., a fee may not be charged for the actual exchange),
- distribution restrictions under the original contract are maintained in the successor contract, and
- the employer and investment provider enter into an information-sharing agreement (ISA) (Treas. Reg. 1.403(b)-10(b)(2)).

NOTE: *Although the investment provider can charge a reasonable surrender fee or load fee, it cannot charge a fee for making the exchange.*

A formal ISA is not required when moving assets between approved vendors. In this case, an ISA is not required as long as the employer and investment provider have some type of contractual arrangement that includes an exchange of the data necessary for the proper administration of the plan.



Information Sharing Agreements

The ISA is one of the most important aspects of the exchange procedure. It is an ongoing agreement between the employer and the investment provider to share employee and plan information necessary for proper plan administration, including information pertaining to distribution and plan loan issues. The IRS has not released a model agreement, perhaps thinking that the information in the agreement differs in each situation. The IRS notes in Revenue Procedure (Rev. Proc.) 2007-71 the type of information that must be shared. The ISA must contain enough information for the contract (or custodial account) to satisfy IRC Sec. 403(b). Examples of the information that employers must share to ensure proper plan administration include the following.

- The employer should provide information on whether the participant's employment is continuing or whether there is a severance from employment for distribution purposes.
- The investment provider should notify the employer of any hardship distribution if that distribution results in a six-month suspension of deferrals.
- The investment provider should notify the employer or other investment providers of the amount of employee benefits available for plan loans, or of any rollover accounts available to satisfy the financial need requirement for a hardship distribution.

Employers also must share information necessary for a contract (or custodial account) containing employer contributions to satisfy other tax requirements. This includes

- the amount of any outstanding plan loan balance so an investment provider or TPA can determine whether an additional plan loan satisfies the loan limitations (and avoid an additional loan that would create a deemed distribution), and
- the amount of a participant's or beneficiary's after-tax employee contributions so that an investment provider TPA can determine how much of a distribution is includible in gross income.

Non-ERISA 403(b) Plans

ERISA was a sweeping piece of legislation that still affects the operation of many types of retirement plans. ERISA consists of four titles. Title I of ERISA deals with the protection of employee benefit rights. Some 403(b) plans are subject to Title I of ERISA, while others are not. Most plans that are funded exclusively with employee elective deferrals are referred to as non-ERISA plans because Department of Labor Regulation (DOL Reg.) 2510.3-2(f)(4) provides an exemption from Title I of ERISA for these plans. (These plans would otherwise be "employee benefit plans" subject to ERISA because they provide retirement income to employees or allow employees to defer compensation into a plan.)

Although more and more plans are becoming ERISA plans as a result of the final 403(b) regulations, the majority of 403(b) plans are still non-ERISA plans. The employer's advantage in maintaining a non-ERISA 403(b) plan is that the plan is not subject to the requirements of ERISA. For example, a non-ERISA 403(b) plan does not have to conduct most nondiscrimination testing.

Governmental and church plans are always exempt from the requirements of ERISA. Church plans may elect to have ERISA apply, but it is extremely rare. Other eligible 403(b) plan employers are exempt from ERISA only if they maintain a non-ERISA 403(b) plan. A 403(b) plan is not subject to ERISA if it satisfies certain requirements. This differs from the QRP rules. With QRPs, when one common-law employee participates in the plan, the plan generally becomes subject to ERISA.

A 403(b) plan is exempt from ERISA if the plan meets certain requirements centered on the employer having only limited involvement with the plan (DOL Reg. 2510.3-2(f)). For this reason many non-ERISA plans are deferral-only plans. For nongovernmental and non-church employers, the plan generally is not subject to ERISA if the plan meets all the following "safe harbor" conditions.

- Participation is voluntary for employees.
- All rights under the annuity contract or custodial account are enforceable solely by the employee or his beneficiary.
- The sole involvement of the employer is limited to any of the following permitted employer activities.
  - Permitting agents and brokers to publicize their products to employees
  - Requesting information concerning investment products
  - Summarizing or otherwise compiling the information about investment products to facilitate review and analysis
  - Collecting payroll deduction amounts, remitting those amounts to the investment providers, and maintaining records of those payments

- Holding in the employer's name one or more group annuity contracts covering its employees
- Limiting the available investment products to a number and selection that is designed to afford employees a reasonable choice in light of all relevant facts and circumstances, including
  - the number of employees affected,
  - the number of investment providers who have indicated interest in approaching employees,
  - the variety of available products,
  - the terms of the available arrangements,
  - the administrative burdens and costs to the employers,
  - the possible interference with employee performance resulting from direct solicitation by agents and brokers, and
  - the employer receives no direct or indirect consideration or compensation (cash or otherwise) other than reasonable compensation to cover expenses properly and actually incurred in performing the employer's duties under the salary deferral agreements.

If a 403(b) plan is not subject to ERISA, the plan is not subject to the nondiscrimination rules under IRC Sec. 401(a)(4) and (5) with respect to nonelective employer contributions. A non-ERISA 403(b) plan also is not subject to the minimum participation and minimum coverage requirements of IRC Sec. 410(b), the minimum vesting standards of IRC Sec. 411, the minimum funding requirements of IRC Sec. 412, and the qualified joint and survivor annuity requirements of IRC Sec. 417. In addition, a non-ERISA 403(b) plan is not subject to the ERISA reporting and disclosure requirements (e.g., summary plan description or Form 5500 requirements) or the ERISA fiduciary requirements.

Governmental 403(b) Plans	Church 403(b) Plans	501(c)(3) Safe Harbor Plans
• Always non-ERISA plans • Nothing employer could do would make plan subject to ERISA, including making employer contributions	• Always non-ERISA plans • Church plans may elect to be ERISA plan (rare)	• Non-ERISA plans if safe harbor rules are followed • Limited employer involvement—cannot make employer contributions or various plan determinations

ERISA 403(b) Plans

When a 403(b) plan becomes an ERISA 403(b) plan (or an "ERISA plan"), it becomes subject to the DOL's jurisdiction, similar to QRPs. In general, a 403(b) plan established by a 501(c)(3) organization that allows for employer contributions in addition to employee elective deferrals is an ERISA plan because DOL regulations do not provide an exemption from ERISA for 403(b) plans that permit employer contributions. In an ERISA 403(b) plan, the employer is not limited in the amount of control that it exercises over the plan. The employer may make nonelective and matching contributions to an ERISA 403(b) plan in addition to depositing salary deferral contributions.

Remaining Non-ERISA After Final 403(b) Regulations

Before the final 403(b) regulations, only a 403(b) plan that was subject to ERISA was required to maintain a written employer-level 403(b) plan document. A 403(b) plan that is subject to Title I of ERISA must meet ERISA's requirements for eligibility, vesting, disclosure, reporting, and fiduciary standards. Determining whether a 403(b) plan is subject to ERISA is important so that employers know their plan responsibilities. The written plan requirement initially caused concern that salary deferral-only 403(b) plans would become ERISA plans. But the DOL quickly reassured employers that a salary deferral-only 403(b) plan could still be a non-ERISA plan under the new regulations. FAB 2007-02 clarified that adopting a written plan, as required under the final regulations, would not in itself subject a salary deferral-only 403(b) plan to ERISA. (Governmental plans and church plans are exempt from ERISA.) DOL Reg. 2510.3-2(f) also offers guidance to ensure that a plan remains non-ERISA.

The FAB reiterates the DOL's position that whether a 403(b) is subject to ERISA will be determined based on the employer's actual involvement in making certain discretionary decisions and on the other facts and circumstances surrounding the 403(b) plan. An employer's development and adoption of a single document to facilitate administration and address general tax matters will not violate the safe harbor conditions (previously discussed).

DOL Safe Harbor Requirements

The safe harbor requirements did not change under the new regulations. Under DOL Reg. 2510.3-2(f), a 403(b) plan is not subject to ERISA if the employer meets the previously listed safe harbor conditions. The FAB states, as an example, that an employer who receives some type of inappropriate "consideration" from an annuity provider will lose any safe harbor protection.

Permitted Employer Activities

Despite the restrictions of the non-ERISA plan safe harbor, the employer can still perform the necessary functions to keep the 403(b) plan in operation. According to FAB 2007-02—and consistent with previous guidance under DOL Reg. 2510.3-2(f)—the safe harbor rules allow the employer to

- adopt and maintain a written plan document;
- permit annuity contractors (including agents or brokers who offer annuity contracts or make available custodial accounts) to publicize their products by providing participant information to the plan vendors;
- request information concerning proposed funding media, products, or annuity contractors and to compile such information to facilitate review and analysis by the employees;
- enter into salary reduction agreements and collect annuity or custodial account payments required by the agreements, to remit such payments to annuity contractors, and to maintain records of such payments;
- hold one or more group annuity contracts in the employer's name covering its employees, and exercise rights as representative of its employees under the contract, at least with respect to amendments of the contract; and
- limit funding media or products available to employees, or annuity contractors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.

FAB 2007-02 also notes that past advisory opinions and guidance have addressed specific administrative functions that an employer can perform to ensure that a plan remains tax compliant with IRC Sec. 403(b)—without violating the safe harbor. FAB 2007-02 confirms that an employer still may

- conduct administrative reviews of the program structure and operation,
- conduct discrimination testing and review for compliance with contribution limits,
- fashion and propose corrective actions,
- develop improvements to prevent recurrence of tax defects,
- obtain cooperation of independent entities as needed to correct tax defects,
- keep records of activities, and
- terminate the plan when necessary.

Finally, according to the DOL, a program still can meet the safe harbor requirements and "include terms that require employers to certify to an annuity provider a statement of facts within the employer's knowledge as employer, such as employee addresses, attendance records, or compensation levels. The employer also may transmit to the annuity provider another party's certification as to other facts, such as a doctor's certification of the employee's physical condition."

Activities Not Permitted

There are specific discretionary actions that will cause an employer to fail to meet the safe harbor requirements. FAB 2007-02 confirms that under a 501(c)(3) non-ERISA plan, employers cannot make employer contributions, authorize plan-to-plan transfers or distributions, satisfy applicable qualified joint and survivor annuity requirements, or make determinations regarding hardship distributions, qualified domestic relations orders (QDROs), or eligibility for or enforcement of loans. If an employer accepts the responsibility for making these determinations, the 403(b) plan will be considered an ERISA plan subject to certain testing and nondiscrimination rules. An employer may, however, periodically review the documents making up the plan in order to identify conflicting provisions and to ensure compliance with the Internal Revenue Code and Treasury regulations. But an employer may not negotiate with annuity providers or account custodians to change the terms of their products, such as setting conditions for hardship withdrawals. If employers delegate responsibility for performing certain functions of the plan, the DOL notes that documents should "describe the employer's limited role and allocate discretionary determinations to the annuity provider or participant or other third party selected by the investment provider or participant."

NOTE: *Governmental plans and church plans are not subject to Title I of ERISA, even if the employer makes employer contributions or exercises control over the plan.*

ERISA Bonding Requirement

Purpose

At the time a plan is established, the employer typically must purchase a fidelity (surety) bond. The purpose of the bond is to protect employee benefit plans from acts of fraud or dishonesty by individuals handling the plan assets. In the event of loss to the plan on account of fraud or dishonesty, the bond is used to restore the plan assets. Most federally and state-chartered financial organizations are exempt from this requirement.

Bond Amount

As a general rule, any ERISA plan fiduciary, administrator, officer, or employee who handles plan assets must be bonded for at least 10 percent of the amount of the plan assets the individual handles. The plan administrator must be bonded for 10 percent of the full dollar value of the plan. The minimum amount of the bond is $1,000. The maximum amount generally is $500,000, but is capped at $1 million for plans that hold employer securities (which does not apply to 403(b) plans).

Summary Plan Description

The employer of an ERISA 403(b) plan must provide a summary plan description (SPD) to participants. An SPD must explain the key plan features in nontechnical language. A summary of material modifications (SMM) must be given to employees when the plan is amended.

Form 5500 Filing

As with QRPs, ERISA 403(b) plans must file Form 5500, *Annual Return/Report of Employee Benefit Plan*, by the last day of the seventh month following the end of each plan year. For taxable years before 2009, 403(b) plans that were subject to the Form 5500 filing requirement had only limited reporting requirements and were exempt from the requirement that an independent qualified public accountant's opinion be attached to the plan's annual return (for plans with more than 100 participants).

In 2007, the DOL and IRS together issued final regulations regarding Form 5500 reporting, which eliminated the limited reporting exemption for ERISA 403(b) plans beginning for the 2009 plan year. Employers maintaining ERISA 403(b) plans are required to report on the same basis as QRPs, including the requirement for an independent accountant's opinion.

Summary Annual Report

The employer of an ERISA 403(b) plan must provide a summary annual report (SAR) to each participant and beneficiary who is receiving benefits under the plan.

Prohibited Transactions

The prohibited transaction rules under ERISA Secs. 406 and 408 apply to ERISA 403(b) plans.

Anti-Assignment and Alienation Rules

ERISA 403(b) plans must comply with the rules under ERISA Sec. 206(d)(1) that prohibit the assignment or alienation of benefits under the plan. But an ERISA 403(b) plan that allows an assignment or distribution of benefits under a qualified domestic relations order (QDRO) will not be in violation of the anti-assignment or alienation rules.

Fiduciary Responsibility

Fiduciaries of ERISA plans must meet the fiduciary responsibility requirements that are contained in ERISA Sec. 404(a). A fiduciary generally is a party that has discretionary control over the plan's management or assets. The employer and plan administrator (among others) usually are ERISA fiduciaries.

ERISA fiduciaries must discharge their duties with respect to the plan for the exclusive purpose of providing benefits to the participants and their beneficiaries "… with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" (ERISA Sec. 404(a)(1)(B)).

403(b) Contributions

403(b) plans are similar to 401(a) plans in that they may allow both employee and employer contributions. Employee contributions generally consist of pretax deferrals, Roth deferrals, and catch-up contributions. Employer contributions may include nonelective or matching contributions that may be either discretionary or mandatory.

Employee Contribution Types

Elective Deferrals

Elective deferrals are contributions made under a salary reduction agreement. As with 401(k) plan salary reduction agreements, this agreement allows the employer to withhold money from an employee's paycheck and contribute those amounts directly into a 403(b) contract or account for the employee's benefit. The employee does not pay income tax on these contributions until they are withdrawn.

Universal Availability Rule for Elective Deferrals

With some important exceptions, 403(b) plans must be nondiscriminatory. According to IRC Sec. 403(b)(12), the meaning of nondiscrimination depends on the type of contribution: elective deferrals or employer contributions. The elective deferral portion of the plan generally is considered nondiscriminatory if all employees of the organization are eligible to participate.

Employees must have an effective opportunity to defer. This is known as the "universal availability rule." Both ERISA and non-ERISA 403(b) plans generally must comply with the nondiscrimination requirements that apply to elective deferrals. A 403(b) plan cannot exclude employees for elective deferral purposes based on age or years of service.

The universal availability rule is unique to 403(b) plans. By contrast, 401(k) plans must use the more complicated actual deferral percentage (ADP) test to determine whether the elective deferral portion of the plan is nondiscriminatory.

NOTE: *Church plans are exempt from the nondiscrimination requirements that apply to elective deferrals.*

Effective Opportunity to Defer

Employers cannot merely make a 403(b) plan available—they must ensure that employees have an effective opportunity to defer. This includes making sure that employees are aware that the plan is in place and know how to participate. Employers can meet this requirement by providing an employee notice that describes the availability of the deferral election, the period of time during which the election can be made, and any conditions of the election.

Recent guidance on the 403(b) prototype program indicates that a deferral notice provided no later than 30 days after commencement of employment will not fail to meet this requirement. The employer also must provide the opportunity to change deferral elections at least annually.

NOTE: *Failure to comply with the universal availability rule is a type of 403(b) compliance failure that could result in the disqualification of the entire 403(b) arrangement.*

Allowable Exclusions

The universal availability rule limits class exclusions to employees who

- are students working at an educational organization,
- are eligible to defer under another plan of the employer (such as a 401(k) or governmental 457(b) plan),
- are nonresident aliens with no U.S. income from the employer as described under IRC Sec. 410(b)(3)(C),
- normally work less than 20 hours per week, or
- elect to defer less than $200 per year.

The IRS includes a "bright line" test for determining who actually works less than 20 hours per week based on actual hours worked. The IRS provides a two-step process. First, on the date of hire, the employer must determine if it reasonably expects that the employee will work less than 1,000 hours for the coming 12-month period. If so, the employer can exclude the employee during the first year. Second, in subsequent 12-month periods, the plan must determine if the employee actually worked less than 1,000 hours in the preceding 12-month period to exclude the employee (Treas. Reg. 1.403(b)-5(b)(4)(iii)).

Once a participant is eligible to defer, she cannot become ineligible because of the part-time exclusion, even if she worked less than 1,000 hours in the preceding 12-month period. This is referred to as the "once in always in" condition.

Notice 2018-95 provides relief from this requirement for taxable years beginning after December 31, 2008 and ending on the last day of the exclusion year that ends before December 31, 2019.

If a 403(b) plan is subject to ERISA, the plan is subject to the more stringent 1,000 hours-of-service rule that applies to QRPs.

The regulations also state that if a plan permits designated Roth contributions, this option, like the pretax deferral option, also must be universally available (Treas. Reg. 1.403(b)-5(b)(1)).

Applies to Each Separate Entity

Universal availability generally applies separately to each common-law entity such as

- multiple 501(c)(3) organizations covered under the same 403(b) plan,
- multiple state entities covered under the same 403(b) plan if not part of a common payroll, and
- geographic units historically treated separately on a day-to-day basis for employee benefit purposes.

Qualified Roth Contribution Program (Roth Elective Deferral)

Created by EGTRRA and effective for taxable years beginning on or after January 1, 2006, employers may incorporate a Roth contribution program into their 403(b) plans. In a plan that contains a qualified Roth contribution provision, a participant may elect to treat elective deferrals made to a 403(b) plan as Roth contributions (i.e., after-tax contributions). This provision operates just like a Roth 401(k) provision. The elective deferrals are made on an after-tax basis, but the Roth deferrals and earnings on the Roth deferrals are distributed tax-free if the distribution meets the requirements of a qualified Roth distribution.

As with Roth 401(k) contributions, Roth 403(b) contributions must be

- specifically designated as Roth contributions,
- made to separate accounts within the plan,
- separately tracked,
- made on an after-tax basis, and
- limited such that the combined total of pretax deferrals and Roth deferrals does not exceed the IRC Sec. 402(g) limit or other potential deferral limits.

Pretax Deferrals	Roth Deferrals
• Reduce current taxable income • Limit is \$19,000 for 2019 (applies to pretax and Roth deferrals in aggregate)	• Does not reduce current taxable income • Deferrals (and deferral earnings) are distributed tax-free if the participant has met the 5-year clock and attained age 59½, is deceased, or is disabled • Limit is \$19,000 for 2019 (applies to pretax and Roth deferrals in aggregate)

Roth Elective Deferrals

In 2019, Phyllis receives $90,000 in W-2 income for the year and elects to defer $15,000 to her 403(b) plan. $10,000 is deferred on a pretax basis and $5,000 is contributed to a Roth account. Phyllis has taxable wages for the year of $80,000 even though she has contributed $15,000 of her wages into the 403(b) plan.

Special 403(b) Increase for Certain Long-Tenured Employees

The special 15-years-of-service catch-up rule is unique to 403(b) plans. Under IRC Sec. 402(g)(7), employees with 15 years of service with a public school system, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches (or associated organization) may increase their IRC Sec. 402(g) limits ($19,000, or $25,000 if 50 or older, for 2019) for a year by the lesser of

- $3,000,
- $15,000 reduced by all previous years' increases under this option, or
- $5,000 multiplied by the participant's years of service and then reduced by all previous years' elective deferrals.

NOTE: *An eligible 403(b) participant may use both the age 50 catch-up rule and the special 15-years-of-service catch-up rule in the same year for a possible maximum salary deferral amount for 2019 of $28,000 (see example below). Under the formula above, the maximum additional elective deferral that an eligible employee may make in any one year is $3,000.*

Under the formula, the maximum amount of additional elective deferrals that may be made on behalf of an eligible employee is $15,000 (in aggregate). An employee who has averaged $5,000 or more in annual salary deferrals would not be eligible to use this special catch-up rule.

Special 403(b) Increase for Certain Long-Tenured Employees

Rhoda is age 50 and has worked for the same public school for 18 years. In 2019, she has compensation of $75,000. Rhoda has not previously used the special catch-up rule. In the past 18 years she has deferred $60,000 into her 403(b) plan. How much can Rhoda defer from her salary in 2019?

$19,000	(Maximum 2019 402(g) limit)
+$6,000	(Maximum 2019 age 50 catch-up contribution)
+$3,000	(Amount available under the special catch-up rules)
$28,000	

Special catch-up:	lesser of
$3,000	A. $3,000
$15,000	B. $15,000 reduced by all prior years' deferrals under this option, or
$30,000	C. ($5,000 X years of service) reduced by all prior years' 403(b) deferrals)

NOTE: *Special catch-up must be used, if eligible, before the age 50 catch-up.*

Automatic Enrollment Under a 403(b) Plan

Similar to QRPs, a 403(b) plan may include an automatic enrollment (negative election) provision.

PPA amended Sec. 514 of ERISA to allow ERISA 403(b) and QRP employers to more easily offer an automatic contribution arrangement feature under their plans. PPA amended ERISA to supersede state anti-wage garnishment laws that generally prohibit deductions from an employee's pay without the employee's actual consent.

Approximately half of all states have such laws. Without the ERISA exemption, if a plan offered an automatic contribution arrangement provision, it may have been in violation of such state law. As a result of this change, among others made by PPA, plans subject to ERISA may now more easily offer automatic contribution arrangements.

CAUTION: The ERISA exemption created by PPA did not cover non-ERISA 403(b) plans. As a result, automatic contribution arrangements remain problematic in some states for 403(b) plans, except for church 403(b) plans as a result of the PATH Act. In addition, a non-ERISA 403(b) plan does not receive the protection of the Department of Labor (DOL) safe harbor for a qualified default investment alternative. And, for a 403(b) plan that is otherwise not subject to ERISA, this type of "employer involvement" under the plan could cause the plan to become subject to ERISA. (Remember that governmental and church 403(b) plans are exempt from ERISA.)

The PATH Act, effective December 18, 2015, now preempts state law to the contrary and allows automatic enrollment in 403(b) church plans even if the plan is not a plan that is subject to ERISA.

As with 401(k) plans, a 403(b) plan could operate with an eligible automatic contribution arrangement provision or a qualified automatic contribution arrangement provision. A 403(b) plan that meets the additional requirements of a qualified automatic contribution arrangement under IRC Sec. 401(k)(13) is automatically deemed to satisfy the 401(m) automatic contribution percentage (ACP) test.

Types of Employer Contributions

The types of contributions that employers can make to a 403(b) arrangement can be similar to the contribution types seen in qualified retirement plans. With respect to employer contributions made to a 403(b) plan, the employer may impose eligibility and vesting requirements similar to the rules that govern qualified retirement plans (IRC Sec. 401(a) plans).

The employer contribution formula must be specified in the written plan document. Examples include the following.

Matching Contributions

The employer may make a contribution that is dependent on the amount that the employee contributes to the 403(b) plan. For example, a matching formula may state that the employer will contribute 50 percent of the amount the employee contributes, up to six percent of the employee's compensation.

Discretionary Contributions

The employer may contribute amounts to the plan each year at its discretion in the same way that a for-profit company contributes to its profit sharing plan. In a typical discretionary contribution plan design, the employer is not obligated to make a contribution in any year. Contributions are usually allocated to eligible employees on the basis of their compensation, though it is possible to give additional weight to an employee's age, length of service, or job classification.

Mandatory Contributions

A 403(b) plan can be designed to call for required contributions each year from the employer, usually as a fixed percentage of each eligible employee's compensation. Other contribution formulas can be designed and written into 403(b) plans.

Eligibility

Exclusions Based on Age

An employer may specify that the employees must attain a certain age before they are eligible to receive a plan contribution. Generally, this age cannot exceed 21. But certain educational institutions may require up to age 26 for participations. If an employer would like to take advantage of this later age, they must require one year or less of service and there is immediate 100 percent vesting.

Governmental and nonelecting church plans do not have a limit on their age requirement.

Exclusions Based on Years of Service

Employers may require employees to complete up to two years of service before they are eligible to participate in the plan. If more than one year of service is required for eligibility, employees must be 100 percent vested when they enter the plan.

Governmental and church plans do not have a limit on their service requirement.

Exclusions of Certain Other Employees

A plan may exclude any classification of employees (except for part-time and seasonal employees) from receiving plan contributions. But excluding any employees other than union, nonresident aliens with no U.S. income, or new employees that are attained through a merger or acquisition may lead to issues with 410(b) coverage testing.

A non-ERISA plan is not subject to 410(b) coverage testing.

IRC Sec. 401(a)(5) Integration Rules

The plan can make use of Social Security integration or permitted disparity rules. The permitted disparity rules allow allocations of employer contributions to be increased for higher paid employees, within certain limits. IRC Sec. 401(a)(5) describes some of these limits.

IRC Sec. 401(a)(17) Compensation Cap

For purposes of allocating employer contributions and testing for discrimination, the amount of any employee's compensation that can be taken into account is limited to the IRC Sec. 401(a)(17) compensation cap, which is $280,000 for 2019.

IRC Sec. 415 Limit

General Limit

For qualified plans, the maximum contribution amount allowed per year, per participant, may not exceed the lesser of 100 percent of the participant's compensation or $56,000 for 2019.

- This limit is called the IRC Sec. 415 "annual additions" limit and includes all employer contributions, employee contributions, and forfeitures made to any one participant's account. (While the "100 percent limit" applies for all annual additions, the dollar limit—$56,000—does not have to include catch-up contributions.)
- The annual additions limit applies separately to each plan participant and to each "unrelated employer."
- The annual additions limit applies for a "limitation year," which is a 12-month period (usually the plan year) defined in the plan document.

The definition of compensation for annual additions testing for 403(b) plans is found in IRC Sec. 403(b)(3). This definition of compensation generally incorporates all of a participant's wages, salaries, fees, and other amounts received for personal services rendered, paid by the employer and includible in gross income. Compensation includes elective deferrals.

Alternative Limit for Church Employees

An alternative limitation applies to amounts that would not be permissible except for this special limitation. Church employees can choose to use $10,000 per year as their limit, even if the annual additions limit figured under the general rule is less (in other words, the $10,000 maximum annual contribution, may exceed 100 percent of compensation).The total lifetime contributions under this rule can't exceed $40,000.

The $40,000 aggregate limit under this rule applies only to the contribution amounts that would have exceeded the allowable IRC Sec. 415 limitation for the year if not for the application of this special rule.

Example

A minister received compensation of only $5,000 in 2019. His congregation decides to make a $6,000 contribution on his behalf into his 403(b) plan. Because the contribution exceeds 100% of his income by $1,000, the minister has used up $1,000 of his $40,000 lifetime limit under this special rule.

ERISA 403(b) Contribution Testing

In an ERISA 403(b) plan, the employer is not limited in the amount of control that it exercises over the plan. The employer may make nonelective and matching contributions to an ERISA 403(b) plan in addition to depositing salary deferral contributions.

ACP Test

Unlike 401(k) plans, 403(b) plans are not subject to the ADP test. Look at the universal availability rule to determine whether elective deferrals are nondiscriminatory in a 403(b) plan. If a 403(b) plan allows for matching contributions or nondeductible voluntary employee (after-tax) contributions, it must comply with the ACP test of IRC Sec. 401(m). This is the same ACP test that applies to 401(k) plans. Under IRC Sec. 401(m), matching and nondeductible voluntary contributions made on behalf of HCEs are limited based upon the level of matching contributions made for non-HCEs.

If an eligible employer maintains both a 403(b) and a 401(k) plan and the plans are permissively aggregated for IRC Sec. 410(b) coverage, the plans could be permissively aggregated when performing the 403(b) ACP test. The 401(k) plan ACP test must be performed separately.

NOTE: *Governmental and church plans are exempt from ACP testing.*

403(b) Distributions and Transfers

Distributions of Elective Deferrals

Legislative changes have made annuity distributions of employee deferrals subject to the same restrictions as custodial account distributions, thus limiting when distributions of elective deferrals are permitted from a 403(b) annuity contract. Employee deferrals, whether in a 403(b) annuity or 403(b)(7) account, may be distributed (plan permitting) only upon the following.

- Severance from employment
- Death
- Disability as defined under IRC. Sec. 72(m)(7)
- Attainment of age 59½
- Attainment of qualified reservist status
- A proper QDRO submission
- Hardship (generally limited to actual deferrals, with no earnings)
- Plan termination

NOTE: *If an employee's pre-1989 deferral balance in a 403(b) annuity has been tracked separately, the employee may take advantage of a special grandfather rule. The grandfather rule allows pre-1989 403(b) annuity deferral balances to be distributed at any time without regard to a triggering event. Except for this special 403(b) grandfather rule, the allowable distribution triggers for elective deferrals under a 403(b) are the same as the allowable distribution triggers for elective deferrals under a 401(k) plan.*

Hardship Distributions

Effective for plan years before January 1, 2019, participants could receive distributions of their elective deferrals (including designated Roth contributions if permitted) for financial hardship reasons without having to meet a triggering event.

For plan years beginning after December 31, 2018, the Bipartisan Budget Act of 2018 and subsequent proposed regulations allow participants to also receive distributions of qualified nonelective contributions and qualified matching contributions (if applicable) and their earnings from 403(b) annuity contracts. Although earnings on 401(k) deferrals are now eligible for hardship distribution, at the time of this writing, the legislation and proposed regulations did not allow earnings on 403(b) deferrals to be distributed.

NOTE: *A plan may allow an employee to take a hardship distribution from the earnings portion on any pre-1989 salary deferral contributions. Employees with 403(b) custodial accounts may not take a hardship distribution from any amounts attributable to employer contributions.*

According to the final 403(b) regulations, allowable hardship distributions from 403(b) plans will be determined under the same rules that apply to 401(k) plan hardship distributions, including applying the same safe harbors. (See *Hardship Distributions of Elective Deferrals*, for more information.)

Distributions of Employer Contributions

The final regulations attempt to synchronize the timing of allowable distributions of employer contributions from 403(b) annuity contracts and from custodial accounts, but the requirements for contracts and accounts still are not quite the same.

Distributions From Custodial Accounts

Distributions of employer contributions from custodial accounts are limited to the occurrence of one of the following triggering events: severance from employment, death, disability, attainment of age 59½, QDROs, or plan termination. One of the primary changes under the final regulations is the required application of triggering events to distributions of employer contributions from 403(b) annuities. The final regulations allow employers and annuity investment providers latitude to design their own distribution triggers rather than the statutory triggers that apply to custodial accounts.

Distributions From Annuity Contracts

Before the final regulations, there were no statutory restrictions on distributing such amounts. Beginning with annuity contracts issued on or after January 1, 2009, however, distributions of employer contributions may be made no earlier than a participant's

- attainment of a stated age,
- attainment of a fixed number of years, or
- after the occurrence of a stated event (e.g., severance from employment, death, or disability).

This rule change still affords 403(b) plan employers and annuity providers flexibility in designing their distribution triggers for employer contributions under their contracts. While future contracts must specifically list the chosen distribution triggers, the final regulations do not require any statutory minimum age (such as age 59½) or any significant minimum years of service. It does appear that the regulations require 403(b) annuity contracts to follow at least the "minimum deferral period rules" that apply to QRPs before allowing an in-service distribution of balances that are attributable to employer contributions.

Employers may take a number of different approaches to specifying allowable distribution triggers under the plan. For example, an employer's written document may specifically list the distribution triggers allowed under the plan. If so, all individual contracts under that plan would have to allow distributions under those same triggers, and no others. Alternatively, an employer's written document may indicate that the distribution triggers for each individual contract are those that are specified in each individual contract. Yet another option for employers is to design a combination of these approaches and require, for example, that if an individual contract allows for distributions after a stated age, that age must be at least age 55. Thus, there is a critical need for information sharing between employers and investment providers to ensure compliance of each individual contract under the employer's written plan.

For distribution restriction purposes, retirement income accounts for church organizations are treated similarly to annuity contracts.

NOTE: *After-tax assets (and attributable earnings) are not subject to the distribution timing restrictions and may be distributed at any time, plan permitting.*

Transfers After the Final Regulations

Under the final 403(b) regulations, a transfer means moving assets from one employer's 403(b) plan to another employer's 403(b) plan or to a governmental defined benefit plan to purchase service credits or to repay a previous distribution.

Transfers between 403(b) Plans

Transfers between 403(b) plans are allowed under the final 403(b) regulations if

- both the transferring plan and receiving plan permit transfers;
- the participant is an employee, former employee, or beneficiary of a former employee of the receiving plan;
- benefits are not diminished (i.e., a fee may not be charged for the transfer); and
- distribution restrictions under the original contract are maintained in the successor contract (Treas. Reg. 1.403(b)-10(b)(3)).

Transfers to Governmental Defined Benefit Plans

A participant may make a trustee-to-trustee transfer from a 403(b) arrangement to a state governmental defined benefit plan (IRC Sec. 403(b)(13)), assuming that the defined benefit plan allows for such transfers. The transfer amount is not included in income if it is made to purchase permissive service credits or to repay contributions and earnings that were previously refunded under a forfeiture of service credit under the plan or under another plan maintained by a state or local government employer within the same state (Treas. Reg. 1.403(b)-10(b)(4)).

If such a transfer is allowed under the defined benefit plan, the defined benefit plan must calculate and inform the participant as to the maximum amount allowed to be transferred into the defined benefit plan.

Transfers and Mergers After The Protecting Americans from Tax Hikes (PATH) Act

Effective December 18, 2015, under rules to be prescribed by the secretary mergers and transfers between qualified church plans and 403(b) church plans are allowed.

Certain requirements must be met in order for such a merger or transfer to be allowable, including the requirement that participants must be fully vested after the merger or transfer regardless of whether or not they were fully vested beforehand.