Overview

1. Guidance is provided on how to examine a plan described in Internal Revenue Code § 403(b)(a) "403(b) plan").
    1. 13.1 defines a 403(b) plan and provides a technical overview and historical background of 403(b) plans.
    2. 13.2 discusses the types of employers eligible to maintain a 403(b) plan.
    3. 13.3 describes the various funding vehicles for 403(b) plans.
    4. 13.4 addresses the requirements of salary reduction contributions.
    5. 13.5 addresses the contribution limits applicable to 403(b) plans.
    6. 13.6 discusses the applicable nondiscrimination rules.
    7. 13.7-9 address distributions from a 403(b) plan.
    8. 13.10 provides a list of possible defects in a 403(b) plan or annuity contract and resulting tax consequences.
    9. 13.11 is a glossary of terms.
2. These guidelines address only employee plans issues and are intended to assist the employee plans specialist in examining a plan.
    1. Given the highly technical requirements of 403(b) plans, the agent may need to consult the Code and federal Income Tax Regulations for further development of a particular issue. Accordingly, cites are provided where appropriate.
    2. They are designed to help the examiner key in on the issues that should be raised in a particular plan. It is not expected that every issue raised in the guidelines will be relevant or should be raised in every examination.
    3. The techniques identified may be modified based on the actual examination issues encountered.
    4. Given the purpose of these guidelines, they cannot be, nor are they intended to be, a precedential or comprehensive statement of the legal position of the Service on the issues covered.
    5. They are not to be relied on or cited as authority by taxpayers.
    6. They are subject to change in accordance with future developments in the law.

Technical Overview

1. Historical background and regulatory framework of 403(b) plans.
    1. Section 403(b) was first added to the Code in 1958.
    2. In 1964, pre-ERISA regulations were issued detailing some of the basic statutory provisions of § 403(b). These regulations were later amended as new provisions were added to § 403(b).
    3. Final regulations were issued under § 415 in 1980.
    4. In addition, there are recently issued proposed regulations pertaining to the minimum distribution requirements and final regulations regarding **direct rollovers** . (**Bold** font indicates the term or phrase is defined in the Glossary). Currently, there are no nondiscrimination regulations under § 403(b).

General Requirements

1. Dating back to 1958, a 403(b) plan was less in the nature of a plan than an arrangement under which an employer purchased an individual **annuity contract** on behalf of an employee from an insurance company. With the enactment of the Tax Reform Act of 1986 ("TRA '86") and subsequent legislation, 403(b) plans became more like qualified retirement plans. For the first time, 403(b) plans or the **annuity contracts** thereunder must:
    1. Comply with certain nondiscrimination and coverage rules (including §§ 401(a)(4) , 401(m) and 410(b)),
    2. Ensure that **elective deferrals** do not exceed the § 402(g) limit,
    3. Conform to the minimum distribution rules of § 403(b)(10) , and
    4. Provide a participant with a meaningful opportunity to elect a **direct rollover** to another **eligible retirement plan** .

2. 403(b) plans take a wide variety of forms. Even where a 403(b) plan takes the form of an arrangement rather than a plan, it is nevertheless subject to all of the requirements of § 403(b).

    EXAMPLE 1: The employees of Public School District Y participate in a 403(b) plan ("Plan"). Employer's involvement in the Plan is strictly limited to providing a list of insurance carriers to employees and executing **salary reduction agreements** . The Plan is not described in a basic or summary plan description (SPD).

    EXAMPLE 2: Employer is an organization described in § 501(c)(3) and exempt from tax under § 501(a) . Employer maintains a 403(b) plan for its employees. The 403(b) plan consists of a lengthy plan document, and employees are informed of plan features through annual SPDs.
    (3) A 403(b) plan is always subject to Title II (relating to the Code) but may not be subject to Title I, the Labor Title of ERISA.

    Example 3: Assume the same facts as in Example 1. While the Plan may not be an "employee benefit plan" under Department of Labor (DOL) Reg. § 2510.3-2(f), the Plan is nevertheless subject to Code requirements.

General Characteristics

1. A 403(b) plan is a retirement plan under which a public school or an organization described under § 501(c)(3) and exempt from tax under § 501(a) purchases **annuity contracts** or contributes to **custodial accounts** for its employees. It also includes a **retirement income account** under which contributions are made by or on behalf of certain ministers. Section 403(b) plans are exempt from the requirements applicable to qualified annuity plans under § 403(a) and are governed by their own separate requirements under § 403(b) . Section 403(b) plans are also known as:
    - 403(b) arrangements
    - tax-sheltered annuities
    - tax-deferred annuities
    - **annuity contracts**

    NOTE:
    Throughout these Guidelines, the term "**annuity contracts**" encompasses **custodial accounts** and **retirement income accounts** unless otherwise specified.

2. Contributions to a 403(b) plan may consist of
    - **salary reduction,**
    - **non-salary reduction,**
    - after-tax employee contributions, or
    - some combination of the above.
3. In a salary reduction 403(b) plan, an employer gives participants a choice between receiving an amount in cash or having the employer contribute that amount to the 403(b) plan.
4. Contributions made to a 403(b) plan are generally not includible for income tax purposes in participants' gross income until distributed, even if participants had the ability to receive the contributions as taxable wages in the year of the contributions.
5. Earnings on contributions are also tax-deferred until distributed.
6. Distributions from a 403(b) plan are taxable under § 72, relating to annuities.
7. Generally, participants are required to pay FICA tax on **salary reduction contributions** at the time of contribution. Although there is no deduction for the employer because it is exempt from income tax, the employer is responsible for FICA, and income and FICA tax

withholding, if applicable. Keep in mind that certain governmental and church employers and employees may be exempt from FICA. See §§ 3121(b)(7) and (b)(8).

8. The following examples illustrate that 403(b) plans may involve both employer and individual tax matters.

> **EXAMPLE 4:** Hospital M maintains an annuity plan intended to be a 403(b) plan ("Plan"). The Plan provides for **non-salary reduction contributions** and is funded through **annuity contracts** . It is discovered on examination that the Plan is not a 403(b) plan, with the result that, for all open years under the statute: (i) the contributions made to the Plan are includible in the employees' gross income to the extent they are or become vested, (ii) the employees are responsible for FICA taxes, (iii) the employer may be responsible for income tax and FICA withholding, and (iv) Hospital M must pay FICA employment taxes.
>
> **EXAMPLE 5:** The same facts as in Example 4, except that the Plan is a 403(b) plan and it provides both **non-salary reduction** and **salary reduction contributions** . The **salary reduction contributions** are subject to FICA tax at the time of contribution. Hospital M is generally responsible for FICA withholding, and FICA employment taxes.

Exclusion Allowance

1. The **exclusion allowance** is integral to a 403(b) plan. The **exclusion allowance** permits contributions that would otherwise be includible in the employee's gross income to be made to a 403(b) plan on a pre-tax basis and, in addition, it establishes a maximum limit on such contributions.
    1. The **exclusion allowance** is an allowance because it only applies to employer contributions (including **elective deferrals**) made to a plan which satisfies the requirements of § 403(b).
    2. Because the **exclusion allowance** flows from the status of a plan as a 403(b) , it is available only if all the requirements and conditions of eligibility under § 403(b) are satisfied.
2. The **exclusion allowance** is a limit because only employer contributions (including **elective deferrals**) made to a 403(b) plan that are not in excess of the **exclusion allowance** (or the other contribution limits to the extent applicable) are excludable from gross income. See 13.5 for a detailed discussion of the **exclusion allowance** .

Aggregated Annuity Contracts

1. All **annuity contracts** (including **custodial accounts** and **retirement income accounts**) purchased by an employer on behalf of an employee are treated as a single **annuity contract** for purposes of applying the requirements of § 403(b) . See § 403(b)(5).

403(b) and Qualified Plans

1. Although there are many similarities, 403(b) plans differ from qualified plans in some important respects.
    1. Only certain types of tax-exempt employers, governments and ministers may contribute to a 403(b) plan.
    2. Suitable **funding vehicles** for a 403(b) plan are limited to **annuity contracts** and custodial accounts (and **retirement income accounts** for churches).
    3. The **exclusion allowance** is unique to 403(b) plans and is a further limit (in addition to modified §§ 415 and 402(g) limits) on contributions to a 403(b) plan.

    4. **Salary reduction contributions** to a 403(b) plan are subject to their own special nondiscriminacion rules and not the average deferral percentage (ADP) test under § 401(k)(3).
    5. There is no special averaging for lump sum distributions from 403(b) plans.
    6. A participant's interest in a 403(b) plan may not be rolled over to a qualified plan (except in limited instances with respect to an **annuity contract** purchased by an Indian tribal government, see 13.9).
2. Unlike qualified plans, 403(b) plans are not subject to the requirement of a definite written program (although Title I requires a written plan document for certain 403(b) plans). Accordingly, there is no Title II requirement that a 403(b) plan operate in accordance with is terms. However, certain Code requirements must be reflected in the underlying **annuity contracts** or **custodial account** agreements. These include the:
    1. nontransferability requirement for 403(b)(1) annuity contracts under § 401(g)
    2. direct rollover requirements under Reg. 1.403(b)-2, Q&A 4, (see 13.9)
    3. 402(g) limit (see 13.5).

Correction Programs

1. Three of the Service's correction programs apply to 403(b) plans. These include the:
    - Administrative Policy Regarding Self-Correction (APRSC)
    - Tax Sheltered Annuity Voluntary Correction (TVC) program
    - Audit CAP for 403(b) Plans.
2. These programs are set forth and described in the following revenue procedures (see also, IRM 7.9, Section 2, EPCRS):
    - Rev. Proc. 99-13, 1999-5 I.R.B. 52
    - Rev. Proc. 98-22, 1998-12 I.R.B. 11

APRSC

1. APRSC is designed to further the Service's voluntary compliance initiatives by providing a self-correction procedure that applies to 403(b) plans. In general, under APRSC, an employer (either directly or through the insurer or custodian) that has established compliance practices and procedures which are reasonably designed to facilitate overall plan compliance may correct Operational Failures (as defined in Section 3.05 of Rev. Proc. 99-13) in its 403(b) plan within two plan years following the plan year of the failure.
    1. Eligible employers may also correct insignificant Operational Failures at any time.
    2. APRSC permits correction of Operational Failures relating to contributions in excess of the limitation under § 415 or the maximum **exclusion allowance** limit under § 403(b)(2).
    3. In general, APRSC is not available to correct significant Operational Failures if either the plan or the employer is Under Examination (within the meaning of Section 5.06 of Rev. Proc. 98-22).
2. In examining a 403(b) plan, it is important to consider whether an employer has properly self-corrected an Operational Failure.

TVC

1. Rev. Proc. 99-13 extended TVC indefinitely and transferred administration of the TVC Program to the Key District Offices (KDOs) . The TVC Program generally allows an employer to correct any Operational, Demographic, or Eligibility Failure (as defined in Section 3 of Rev. Proc. 99-13) in its 403(b) plan that is within the jurisdiction of the EP/EO Division of the KDOs.
2. Through TVC, an employer enters into a closing agreement with the Service which specifies the types of failures, the agreed method of correction, the applicable fee, and the effect the agreement has on potential tax liability of participants and the employer.
3. TVC is not available if the plan or employer is Under Examination.

Audit CAP

1. Audit CAP for 403(b) Plans is available to correct Operational, Demographic, or Eligibility Failures other than a failure that has been corrected under APRSC or TVC or is eligible for correction under APRSC. Under Audit CAP, an employer and the Service enter into a closing agreement specifying the form of correction and the sanction amount.

Effect of Correction under EPCRS; Reliance

1. Although excise, FICA taxes, and FUTA taxes (and corresponding withholding) are not waived under the agreement, the Service will not pursue the income tax liability of participants or income tax withholding obligations of the employer due to the failures covered by the closing agreement under TVC or Audit CAP, or failures properly corrected under APRSC. However, correction of failures may result in income tax and withholding for income tax (e.g., a distribution of **excess deferrals**).
2. Excise taxes required to be filed on Form 5330, Return of Initial Excise Taxes Related to Pension and Profit-Sharing Plans, (other than those arising under § 4974) should not be resolved as part of the closing agreement document under TVC or Audit CAP for 403(b) Plans.
3. In general, excise tax issues should be resolved by securing a Form 5330 providing for 100% of the tax and interest outstanding (although recommendation to the Service Center to waive the failure to file and/or failure to pay penalty under § 6551 is at the discretion of the EP specialist).

403(b) Filing Requirements

1. With some exceptions, 403(b) plans are required to file the Form 5500, "Annual Return/Report of Employee Benefit Plan" . The following types of plan are exempt from filing (see instructions to Form 5500):
    - governmental plans
    - church plans and
    - 403(b) plans that are not "employee benefit plans" under Title I of ERISA
2. In general, a 403(b) plan that provides only **salary reduction contributions** and under which the employer is minimally involved in selecting the **funding vehicles** is not an employee benefit plan under Title I. See DOL Reg. 2510.3-2(f).

Examination Steps

1. Request all documents pertaining to the 403(b) plan, including, to the extent applicable:
    1. the determination of tax exemption,
    2. basic plan document and amendments thereto,
    3. SPDs,
    4. **annuity contracts,**
    5. **custodial account** agreements,
    6. **salary reduction agreements,**
    7. employment contracts and
    8. other communications with employees.

    NOTE:
    The plan may not have nor does the Code require it to have a basic plan document. However, faulty plan language may indicate operational defects.

2. Regarding APRSC, verify that the method of correction was appropriate and timely.
3. If the employer has a closing agreement through TVC:

    1. verify that the employer complied with the terms of the agreement and that correction was properly and timely completed. Because TVC does not cover the accuracy of specific numbers, verify their accuracy.
    2. check to see if there are any failures that fall outside of the scope of the agreement.

Eligibility

1. Unlike a qualified plan, only certain tax-exempt employers and certain ministers are eligible to maintain a 403(b) plan on behalf of eligible employees. The three key issues here are whether the:
    1. employer is eligible to maintain a 403(b) plan for participating employees,
    2. participants in a 403(b) plan perform services for the employer as employees, and
    3. minister is one described in § 414(e)(5)(A).

Eligible Employers

1. Not all non-profit or tax-exempt organizations are eligible to maintain a 403(b) plan. There are only four types of tax-exempt employers eligible to maintain a 403(b) plan:
    1. A State, a political subdivision of a State, or an agency or instrumentality of any one or more of these for employees who perform services for a public education organization described in § 170(b)(1)(A)(ii);
    2. A non-profit organization described in § 501(c)(3) and exempt from federal income tax under § 501(a) , or an organization treated as described in § 501(c)(3);
    3. A grandfathered Indian tribal government; and
    4. Beginning in years after December 31, 1996, a minister described in § 414(e)(5)(A).
2. A trade association described in § 501(c)(6) and exempt from tax under § 501(a) is not eligible to maintain a 403(b) plan.
    1. If an employer maintains an annuity plan and is not eligible, the plan is not a 403(b) plan and the exclusion allowance is inapplicable. For resulting tax consequences, see §§ 403(c) and 72.
    2. An ineligible employer may enter into a closing agreement with the Service pursuant to Rev. Proc. 99-13.
    3. Situations in which an employer's eligibility varies among taxable years are discussed in 13.5 (text V.C. below).

Public Education Organizations

1. A state or local government or any agency or instrumentality of one or more of these is an eligible employer only with respect to employees who perform services directly or indirectly for an educational organization.
2. To be an educational organization, the organization must normally maintain a regular faculty and curriculum, and normally have a regularly enrolled body of students in attendance at the place where it regularly carries on educational activities. Included in this category are:
    1. public schools
    2. state colleges
    3. universities
3. Both non-academic staff (e.g., a custodial employee) and faculty may be covered but elected or appointed officials holding positions in which persons who are not education professionals may serve are not eligible (e.g., a member of the school board, university regent or trustee may not be eligible).

> **EXAMPLE 6:** Public High School Y maintains a 403(b) plan ("Plan") for its employees. Employee A performs timekeeping and payroll services for High School Y. A may participate in the Plan because A performs services for a public educational organization. See Rev. Rul. 72-390, 1972-2 C.B. 227.

EXAMPLE 7: A, a state employee, provides "in-home" teaching services. A may be covered by a 403(b) plan maintained by A's employer because A performs services for a public educational organization.

Organizations Described in § 501(c)(3)

1. Another type of eligible employer is an organization described in § 501(c)(3) and exempt from federal income tax under § 501(a) ("501(c)(3) organization"). A 501(c)(3) organization is defined generally as one organized and operated exclusively for the following purposes:
    - religious
    - charitable
    - scientific
    - public safety testing
    - literary or educational
    - to encourage national or international amateur sports competition
    - for the prevention of cruelty to children or animals
2. These organizations include:
    1. charities,
    2. social welfare agencies,
    3. private hospitals and
    4. health care organizations,
    5. private schools,
    6. religious institutions and
    7. research facilities.
3. In order to be recognized as a 501(c)(3) organization, all organizations except church and related organizations, and other organizations excepted under § 508, must apply to the Service for a determination letter by filing Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" . See Publication 557, Tax-Exempt Status of Your Organization ; and also IRM 7.8.1, Exempt Organizations Examination Guidelines Handbook, Chapter 3.

Grandfathered Indian Tribe

1. An Indian tribal government is treated as a State for purposes of § 403(b) , so an educational organization or a 501(c)(3) organization associated with a tribal government is always eligible to maintain a 403(b).
2. In addition, an Indian tribal government, a subdivision, agency or instrumentality of an Indian tribal government, or a corporation chartered under federal, State, or tribal law which is owned in whole or in part by any of the foregoing is treated as an employer described in section 501(c)(3) with respect to any **annuity contract** purchased in a plan year beginning before January 1, 1995.

§ 414(e)(5)(A) Minister

1. A self-employed minister may deduct, within the limits of § 404(a)(10) , contributions to a **retirement income account** described in § 403(b)(9).
2. Similar deductions may be taken by a minister employed by a non-501(c)(3) organization with which the minister does not share common religious bonds.
3. Beginning January 1, 1998, contributions to a 403(b) plan are not includible in the gross income of a minister described in (2) above. See § 414(a)(5)(E).

Eligible Employees

1. A 403(b) plan can only cover the employees of an eligible employer (with the exception of ministers described in § 414(e)(5)(A).

2. Employee status under § 403(b) is generally determined by employee status for federal employment tax purposes under common law principles. Whether an individual is a common law employee or independent contractor is most likely to arise with professionals such as physicians. See the 20 steps for determining employee status in Rev. Rul. 87-41, 1987-1 C.B. 296.
3. Contributions made on behalf of an individual who is not an employee does not mean the plan is not a 403(b) , but the **exclusion allowance** is not available for the individual.

Examination Steps

1. Because the issue of the employer's eligibility is so basic it is easy to overlook. Check to see whether the employer:
    1. is a public educational organization,
    2. has § 501(c)(3) status, or
    3. has a closing agreement with the Service covering the employer's ineligibility.
2. Be sure to consider the employer's relationship to the participating employees. If the employer is not eligible, consider a closing agreement under Audit CAP for 403(b) Plans as provided in Rev. Proc. 99-13.
3. If the examination is conducted in connection with an Exempt Organizations audit, a loss of 501(c)(3) status will automatically cause the plan to fail the requirements of § 403(b) for any plan year during which the employer was not eligible. Again, consider a closing agreement under Rev. Proc. 99-13.
4. If the examination is not initiated by Exempt Organizations, you may want to request their assistance on the issue of employer eligibility.

Funding Vehicles

1. Amounts contributed to a 403(b) plan may be invested only in certain **funding vehicles** . **Funding vehicles** refer to the type of investment arrangement for the assets of a 403(b) plan.
2. The **funding vehicles** for 403(b) plans are generally limited to--
    1. **annuity contracts,**
    2. **custodial accounts** for regulated investment company stock,
    3. **retirement income accounts** for churches, or
    4. any combination of these.
3. **Custodial accounts** and **retirement income accounts** are treated as **annuity contracts** for purposes of the Code. Thus, **custodial accounts** and **retirement income accounts** are generally subject to the rules applicable to 403(b) **annuity contracts** (in addition to their own special requirements). **Custodial** and **retirement income accounts** must satisfy the--
    1. contribution limits (including §§ 415 and 402(g)),
    2. nondiscrimination (except those maintained by § 3121(w)(3) churches),
    3. minimum distribution, and
    4. **direct rollover** rules.

Annuity Contracts

1. The most common type of **funding vehicle** for a 403(b) plan is an **annuity contract** under § 403(b)(1).
    1. The **annuity contract** may be offered only by an insurance company.
    2. The contract may be owned by the individual, or, in the case of a group **annuity contract** , by the employer.
    3. The annuity may be either variable or guaranteed.
    4. An **annuity contract** may contain a vesting schedule for **non-salary reduction contributions** , but the vesting schedule must comply with Title I, the Labor Tide of ERISA, if applicable. However, the **exclusion allowance** is available only to **vested**

amounts contributed during a taxable year or any amounts which become vested in the taxable year. See 13.5.

2. Regulations extend the non-transferability requirement of § 401(g) to 403(b) **annuity contracts** . Thus, a 403(b) **annuity contract** must provide that it is nontransferable. This means that the contract cannot be sold, assigned, or pledged as security for collateral.
    1. However, loans may be made from an **annuity contract** and amounts held under the contract may be transferred or rolled over to another 403(b) plan under certain conditions.
    2. **Salary reduction contributions** to an **annuity contract** and their earnings are subject to certain early distribution restrictions to ensure that they are used for retirement purposes. See §§ 403(b)(7) and (b)(11).
    3. **Excess contributions** to an **annuity contract** are not subject to the excise tax under § 4973. See 13.5 and 13.8.
3. An **annuity contract** may provide life insurance protection as long as the death benefit is "merely incidental" to the primary purpose of providing retirement benefits. The rules for determining whether life insurance is incidental in qualified plans apply also to 403(b) plans.
    1. Life insurance is incidental if less than 50% of total employer contributions made on behalf of a participant are used to purchase an ordinary life insurance contract, or in the case of term or universal life insurance, no more than 25% of total contributions are used to purchase the life insurance contract.
    2. As in qualified plans, the portion of each year's premium representing the cost of life insurance protection (referred to as "P.S. 58 costs") is includible in gross income and counts toward the employee's basis in the **annuity contract** on distribution.
    3. In addition, a contract on a participant's life must be converted to cash or an annuity or distributed to the participant at retirement. See Rev. Rul. 60-84, 1960-1 C.B. 159; Rev. Rul. 66-143, 1966-1 C.B. 79; and Rev. Rul. 68-31, 1968-1 C.B. 151.
4. If a plan is structured so that contributions are placed in an employer's savings account to purchase **annuity contracts** for employees at retirement, the plan is not a 403(b) plan. See Rev. Rul. 68-87, 1968-2 C.B. 187, and Rev. Rul. 68-488, 1968-2 C.B. 188.

> **EXAMPLE 8:** Foundation, a 501(c)(3) organization, maintains an annuity plan intended to be a 403(b) plan ("Plan"). Foundation makes both **salary reduction** and **non-salary reduction contributions** to individual investment accounts (not mutual funds) for each of its employees. Foundation purchases **annuity contracts** for employees at their retirement. The arrangement is not a 403(b) plan.

> **EXAMPLE 9:** Employer is a public education organization maintaining a plan intended to be a 403(b) plan ("Plan"). All contributions under the Plan are invested in life insurance policies for its employees. Because life insurance must be incidental to the primary purpose of providing retirement benefits, the Plan is not a 403(b) plan.

Custodial Accounts

1. A **custodial account** under § 403(b)(7) is treated as an **annuity contract** and must satisfy the various requirements of § 403(b). In addition,
    1. the assets of a **custodial account** must be held by a bank or an approved non-bank trustee or custodian under § 401(f).
    2. the assets must be invested exclusively in regulated investment company stock (e.g., mutual funds) and consequently, a **custodial account** may not provide life insurance.
    3. a **custodial account** may permit loans to participants.
2. Both **salary** and **non-salary reduction contributions** to a **custodial account** are subject to certain early distribution restrictions.
3. Unlike contributions to **annuity contracts, excess contributions** to a **custodial account** are subject to the excise tax under § 4973. See 13.5.3.

Retirement Income Accounts

1. A **retirement income account** is defined under § 403(b)(9) as a defined contribution program established and maintained by a church or related organization.
2. A **retirement income account** may take the form of a defined benefit plan if it is grandfathered. A defined benefit plan which is established by a church or a convention or association of churches and is in effect on August 13, 1982, is not treated as failing to satisfy the requirements of § 403(b) merely because it is a defined benefit arrangement.
3. **Retirement income accounts** are generally subject to the rules and requirements for **annuity contracts** .
4. The **funding vehicles** for these accounts are varied, and include **annuity contracts** and **custodial accounts** .

Salary Reduction Contributions

1. 403(b) plans are very commonly funded in whole or in part through **salary reduction contributions** . The requirements for **salary reduction** and **non-salary reduction contributions** differ under § 403(b). This section focuses on requirements applicable only to **salary reduction contributions** .
2. **Salary reduction contributions** under a 403(b) plan are also subject to specific requirements such as annual contribution limits, nondiscrimination rules, and withdrawal restrictions. These requirements are discussed in text 13.5, 13.6, and 13.7.
3. **Salary reduction contributions** are defined as contributions made by an employer as a result of an agreement with an employee to take a reduction in salary or forego an increase in salary, bonuses or other wages. **Salary reduction contributions** are--
    1. often referred to as **elective deferrals** because they overlap with the definition of **elective deferrals** under § 402(g). See text 13.5.
    2. made pursuant to a **salary reduction agreement** .
4. **Salary reduction contributions** made to a 403(b) plan are similar to voluntary deferrals under a cash or deferred arrangement described in § 401(k)(a "qualified CODA"). Many of the same rules applicable to cash or deferred elections under § 401(k) apply to **salary reduction contributions** under a 403(b) plan, including the--
    1. frequency that an employee is permitted to enter into or modify a **salary reduction agreement** ,
    2. compensation to which an agreement may apply, and
    3. ability to revoke the agreement.
5. A 403(b) plan is neither required to permit, nor precluded from permitting, an employee to make multiple **salary reduction agreements** in a single taxable year. A 403(b) **salary reduction agreement** applies to compensation that is not currently available to the employee at the effective date of the agreement. The **salary reduction agreement** must be legally binding.

    > **Special Note:** Under prior law, employees were limited to one **salary reduction agreement** per taxable year and the agreement could only apply to amounts not yet earned at the effective date of the agreement.

6. To qualify for the **exclusion allowance** under § 403(b), the **salary reduction contributions** must be in the nature of compensation (rather than, for example, severance pay) paid by the employer to the employee.
7. **Salary reduction contributions** are generally treated as employer contributions (notably for purposes of §§ 403(b), 402(g) and 415) but are treated as employee contributions for other purposes, including FICA.

Examination Step

1. Check sample salary reduction election forms to determine whether the agreement applies to amounts not yet currently available to the employee at the time the agreement is effective.

Contribution Limits

1. There are three separate yet interrelated limitations on the amount of contributions to a 403(b) plan which are excludable from gross income. These limitations are found in:
   - § 402(g)
   - § 415
   - § 403(b)(2)
2. Section 402(g) imposes a limit on the annual dollar amount of **elective deferrals** made by a participant during the year. Section 402(g) limits the **elective deferrals** in a 403(b) plan to:
   1. $9,500 for years prior to 1998
   2. $10,000 for 1998.
3. All **elective deferrals** made by a participant to a SEP, CODA, 403(b) plan, 501(c)(18) plan, and simple retirement account are included in applying the limit. The limit is designed to restrict the total amount that may be deferred by a participant on a salary reduction basis.
4. Section 415 places an overall limit on the amount of **elective** and **non-elective contributions** that may be made annually on an employee's behalf to a 403(b) plan during a single **limitation year** . Section 415 imposes a limit of the lesser of $30,000 or 25% of compensation on the maximum amount that may be contributed to a 403(b) plan for the year.
5. The **exclusion allowance** under § 403(b)(2) is a cumulative limit which applies to both **elective** and **non-elective contributions** . Because employees of tax-exempt organizations typically have lower pay, especially early in their careers, the cumulative formula permits employees to make up retirement savings in later years. The limitations under §§ 402(g) and 415 are designed to coordinate with the cumulative formula of the **exclusion allowance** .
6. Under § 414(u) , contributions by an employer or employee pursuant to veterans' re-employment rights under the Uniform Services Employment and Reemployment Rights Act of 1994 (USERRA) , are not treated as contributions made in the year the contributions are made, but in the year to which they relate, for purposes of § 402(g), the **exclusion allowance** , and § 415.

§ 402(g) Limit on Elective Deferrals

1. For plan years beginning after December 31, 1987, **elective deferrals** under a 403(b) plan are subject to the limitation under § 402(g).
   1. In the absence of the special catch-up election discussed below, the maximum amount of **elective deferrals** that may be deferred under a 403(b) plan is $9,500 through 1997.
   2. Beginning in 1998, the maximum amount is the $7,000 limit under § 402(g)(1) as indexed for COLAs (indexed to $10,000 for 1998 and 1999).
2. For purposes of § 403(b), an **elective contribution** is any contribution that arises because of an employee's election between current cash compensation or deferral under the plan.
3. An **elective deferral** is any **elective contribution** by a participant made to the following types of plans:
   1. qualified CODA
   2. salary reduction simplified employee pension plan ("SARSEP")
   3. 501(c)(18) plan
   4. 403(b) plan
   5. simple retirement account.
4. **Elective deferrals** are subject to FICA.

5. **Elective deferrals** under a 403(b) plan are employer contributions which are used to purchase an **annuity contract** (or made to a **custodial account**) under a **salary reduction agreement** .
6. There are two limits restricting the amount of elective deferrals that may be made on behalf of a participant:
    1. a participant limit under § 402(g) and
    2. a contract limit under § 403(b)(1)(E) . The contract limit has two components, a form and an operational requirement.
7. The § 402(g) participant limit applies to all the **elective deferrals** made on behalf of a participant.

> **Example 10:** An employee participating in two salary reduction 403(b) plans with separate employers must count the **elective deferrals** made under both plans in applying the limit. If this employee also participated in a CODA under § 401(k), or a simple retirement account under § 408(p), these **elective deferrals** would also be counted. See § 402(g)(3).

8. The contract requirement under § 403(b)(1)(E) applies only to limit **elective deferrals** (as defined in (3) above made on behalf of employees by a single employer. See 13 .5.1.3.

NOTE:
Elective deferrals to a 403(b) plan reduce the $7,500 deferral amount under §§ 457(b) and 457(c)(2) (indexed to $8,000 for 1998 under § 457(e)(15)), and may reduce the amount that can be deferred under § 403(b).

9. The effect of § 457(c)(2) is that an individual who defers compensation in both an eligible section 457 plan ("457 plan") and in a 403(b) plan is limited to a total combined deferral of $8,000 annually (for 1998) if the individual is to enjoy tax deferral on the combined amounts.
    1. If the combined deferral exceeds this amount, the amounts are treated as excesses in the eligible 457 plan and are taxable currently under § 457.
    2. However, an individual who, although eligible, does not defer any compensation under the 457 plan in any given year is not subject to the $8,000 annual limit of § 457(c)(2). Such an individual can defer the full $10,000 under the 403(b) plan in 1998. The coordination limitation applies to plans of all employers rather than to each employer.

> **EXAMPLE 11:** X participates in both an eligible 457 plan and a 403(b) plan maintained by two separate employers, respectively. X defers the maximum amount of $8,000 under the 457 plan and $2,000 under the 403(b) plan in 1998, for a total of $10,000. X will have an **excess deferral** of $2,000 under the 457 plan because of § 457(c)(2). The $2,000 deferred under the 403(b) plan will be applied first against the $8,000 limit of § 457, and the amount deferred under the 457 plan, $8,000, will then be applied and will exceed the $8,000 limit by $2,000.

One-Time Irrevocable Election

1. **Elective deferrals** do not include **elective contributions** made pursuant to a one-time irrevocable election that is made at:
    1. initial eligibility to participate in the **salary reduction agreement** , or
    2. pursuant to certain other one-time irrevocable elections to be specified in regulations, or
    3. pre-tax contributions made as a condition of employment.
2. If a participant has the right or ability to terminate or modify an election, the contributions are **elective deferrals** even if the participant never exercises this right. The § 402(g) limit

affects only **elective deferrals** , it does not apply to other kinds of contributions. Consequently, it is critical to determine which (if any) contributions are **elective deferrals** .

> **EXAMPLE 12:** X participates in a 403(b) plan ("Plan"). In order to receive employer contributions under the Plan, X is required to elect to defer 3% of salary in the form of "Mandatory Contributions." X has the option of revoking this election at any time, although X never terminates his election. The Mandatory Contributions are **elective deferrals** because X's election is revocable. These contributions are therefore included in applying the § 402(g) limit. They are also subject to FICA (if applicable).
>
> **EXAMPLE 13:** Assume the same facts as in Example 12, except that the Plan further provides that an election to terminate participation in the Plan is irrevocable. Thus, an employee who terminates his election will be permanently excluded from participating in the Plan. Even so, since the election to participate is revocable, the Mandatory Contributions are **elective deferrals** under § 402(g) . The contributions are subject to FICA (if applicable).

NOTE:
Example 13 points out that if an employee may terminate his election to participate in a plan, the election is not considered to be irrevocable. "Irrevocability" relates to the election to participate rather than an election to terminate participation in a plan.

Catch-Up Election

1. Section 402(g)(8) provides a special election for certain long-term employees. Under the rule, they may "catch up" on the funding of their retirement benefit by increasing their **elective deferrals** over the $10,000 (for 1998) limit.
2. The election is available only to an employee who has completed at least 15 **years of service** (defined in § 403(b)) with an employer that is either a(n):
    1. educational organization
    2. hospital
    3. home health service agency
    4. health and welfare service agency
    5. church
    6. related organization.
3. Under the election, the annual limitation is increased by the smallest of:
    1. $3,000,
    2. $15,000 minus any **elective deferrals** made by the organization and previously excluded under the catch-up election, or
    3. $5,000 times the employee's **years of service** minus the **elective deferrals** made to plans of the organization in prior taxable years.
4. As can be seen from this election, there is a limit on increases under the election of $15,000, and the annual limit cannot exceed $13,000 for 1998. The catch-up applies to **elective deferrals** made by the **qualified organization** on behalf of the employee. In theory, an employee who has 15 **years of service** with another **qualified organization** could use the full amount of the catch up election with respect to the new organization.

Contract Limit

1. As indicated in text 13.5.1.2, § 402(g) limits all **elective deferrals** of a participant, even if the **elective deferrals** are made with respect to plans of separate employers. Section 403(b)(1)(E) imposes a contract requirement which limits the amount of **elective deferrals** under **annuity contracts** purchased by a single employer. A failure to satisfy this requirement results in the loss of 403(b) status of the **annuity contracts** .

Contract Terms

1. Under § 403(b)(1)(E) , a contract purchased by an employer must comply with the requirements of § 401(a)(30).
2. Section 401(a)(30) requires a qualified plan to provide that the amount of **elective deferrals** under plans of the employer not exceed the limit under § 402(g). Thus, in order to be a valid contract under § 403(b), the contract by its terms must preclude the making of **excess deferrals** .
3. Section 403(b) contracts must be amended to reflect the 402(g) limit no later than the first day of the first plan year beginning on or after January 1, 1998. See the Small Business Job Protection Act of 1996, Pub. L. 104-188, sec. 1450(c)(1), and sec. 1465; and Rev. Proc. 97-41.

Operational Requirement

1. **Excess deferrals** are **elective deferrals** in excess of the 402(g) limit. If 403(b) contracts purchased by a single employer accept **excess deferrals** , 403(b) status is lost unless the **excess deferrals** are timely corrected.
    1. Under Reg. 1.402(g)-1(e), a contract may avoid the loss of 403(b) status by distributing the **excess deferrals** plus the earnings thereon by April 15 of the following taxable year, if the contract so permits.
    2. The distribution may be made notwithstanding any other provision of law.
    3. The portion of the distribution attributable to **excess deferrals** is taxable in the year of contribution, while the earnings are taxable in the year of receipt. The issuer must file a Form 1099 indicating the distribution.
2. If a contract loses its status as a 403(b) because of 13.5.1.3.1 or paragraph (1) above, the **exclusion allowance** is not available with respect to the affected **annuity contracts** (or **custodial accounts**) beginning with the taxable year of the violation. Thus, all amounts contributed to the affected **annuity contract** or contracts beginning with the year of the violation are includible in gross income.
    1. The **excess deferrals** are taxable again on distribution.
    2. The employer is responsible for applicable employment taxes and income tax withholding.
3. If **excess deferrals** are made by the employee to contracts of two unrelated employers and they are not timely corrected, there is no loss of 403(b) status of the **annuity contracts** but the excess is taxed both in the year contributed and again on distribution.

> **EXAMPLE 14:** Association, a 501(c)(3) organization, maintains a 403(b) plan ("Plan") with a calendar plan year. In 1998, each of Association's highly compensated employees ("HCEs") elects to make contributions of $30,000 on the mistaken assumption that the contributions are not **elective deferrals** limited by § 402(g) . The **excess deferrals** of $20,000 ($30,000 - $10,000) are not timely corrected. All contributions made to the affected **annuity contracts** in 1998 are includible in the employees' gross income for taxable year 1998 and are subject to FICA. In addition, Association is responsible for employment taxes and withholding. The **excess deferrals** are taxable again on distribution.

> **EXAMPLE 15:** The same facts as Example 14, except that $15,000 of the $30,000 contributed to the Plan in 1998 consists of **non-elective contributions** . Even though only one-half of the contributions are elective, they are still in excess of the § 402(g) limit for the year, and thus all contributions made to the affected **annuity contracts** are includible in gross income for tax year 1998.

Examination Steps

1. The first step is to identify the **elective deferrals** under the plan(s) of the employer. Consider all contributions made to the plan(s).
2. In determining whether contributions are **elective deferrals** , examine the substance of the arrangement. Do not be misled by the labels an employer attaches to the contributions, such as "employer,""employee" or "mandatory" contributions.
3. In determining whether deferrals are elective or non-elective, you may want to consider the following, if applicable:
    1. The operation of the plan -- have any participants revoked their elections?
    2. Employment contracts -- is participation in the plan a condition of employment? If so, the contributions are not **elective deferrals** .
    3. All plan documents, including SPDs, **funding vehicles** , and any memoranda or other communications to employees, if any.
4. In certain cases, it may be appropriate to check for any inconsistencies in the various documents.
5. If there are **elective deferrals** under the plan, see if the underlying **annuity contracts** (including **custodial account agreements**) specifically limit **elective deferrals** . Also check for **excess deferrals** by requesting annual contributions records and/or salary reduction agreements.
6. If the employer has another plan covering the same employees (including a 403(b) plan with **elective deferrals** , a section 457 plan, or qualified CODA) , make sure that the combined amount of **elective deferrals** are within the 402(g) limit and the 457(c)(2) coordinated limit.
7. Check to see if the **elective deferrals** were reported on the Form W-2, and on Form 1099-R if distributed.
8. If a participant had **excess deferrals** , determine whether the excesses were timely and properly corrected.

Section 415 Limit

1. Section 415 limits on contributions (hereinafter referred to as 415 limits or 415 contribution limits) that apply to qualified plans also generally apply to 403(b) plans. A 403(b) plan is treated as a defined contribution plan for purposes of the 415 contribution limits. Consequently, in the absence of a special election, contributions to a 403(b) plan (including **salary reduction contributions** and after-tax employee contributions) may not exceed the lesser of 25% of **compensation** or $30,000 in the **limitation year** (although § 402(g) further limits **elective deferrals** to $10,000, as indexed for 1998).
    1. Unlike the **exclusion allowance** , the 415 limit applies to contributions made to a 403(b) plan with respect to the **limitation year** regardless of whether they are vested.
2. For **limitation years** beginning before January 1, 2000, the combined limit under § 415(e) also applies if the 403(b) plan is aggregated with a defined benefit plan of an employer.

    NOTE:
    For **limitation years** beginning after December 31, 1999, § 415(e) is repealed (but see 13.5.3, **Exclusion Allowance**).

Special "Catch-Up" Elections

1. Partly to reflect the cumulative nature of the **exclusion allowance** , there are also special "Catch-Up" elections under § 415(c)(4) that are unique to 403(b) plans. As with the special election under § 402(g)(8), only an employee of one of the following types of entities are eligible to make a special election (although the employee need not be long term):
    - education organization

- hospital
- home health service agency
- health and welfare service agency
- church or a related organization

2. A special election is made by filing the individual's income tax return in a manner consistent with the election.
3. Once made, the election is irrevocable. This means that no other special election may be made for any future year with the same employer (or an employer that is aggregated under § 415), although a participant may always rely on the general rule. See Reg. 1.415-6(e).

   NOTE:
   Even when a special election is made, contributions may never exceed $30,000 (as indexed under § 415(d)) with respect to a single **limitation year** .

4. Each catch-up election has its own limits. The respective limits under these elections are described under the following subsections.

(A) Election Limitation

1. The "(A) Election Limitation," under which an employee separating from service may use the full **exclusion allowance** up to a maximum of $30,000 in the year of separation without regard to the 25% limitation . For this purpose, the **exclusion allowance** must take into account only the 10 years of service (as defined in § 403(b)(2)) ending with the separation from service. See § 415(c)(4)(A).

(B) Election Limitation

1. The "(B) Election Limitation," under which an employee may defer the smallest of:
   1. $4,000 plus 25% of **includible compensation**),
   2. the amount of the **exclusion allowance** , or
   3. $15,000. This limit in effect replaces the 25% limit up to a maximum of $15,000. See § 415(c)(4)(B).

(C) Election Limitation

1. The "(C) Election Limitation," under which an employee may elect to use the 415 limit rather than the **exclusion allowance** . See § 415(c)(4)(C).

Alternative Limitations

1. There are also alternative limitations under § 415(c)(7) that are available in the case of employees of a church or related organization.
   1. Such employees may elect to substitute the § 415 limit with an annual limit of $10,000 (even if more than 25% of compensation) up to a total lifetime limit of $40,000.
   2. Alternatively, church employees may elect to use the minimum **exclusion allowance** under § 403(b)(2)(D).
2. Even if the limitation under §§ 403(b)(2) and 415 is $30,000, § 402(g) further limits **elective deferrals** to $10,000 as indexed for 1999 (or a maximum of $10,000 as indexed plus $3,000 if the catch-up limit applies). The § 402(g) limit must always be considered in examining a 403(b) plan with **elective deferrals** .
3. The following example illustrates that even where a special election is made under § 415, § 402(g) still limits the maximum amount of contributions that are elective deferrals.

   EXAMPLE 16: A public school district contributes $30,000 to a 403(b) plan on behalf of one of its teachers for the 1998 **limitation year** , the year of the

teacher's separation from service. The entire contribution is made pursuant to a valid revocable **salary reduction agreement** . The teacher has not previously made a special election under § 415 and properly elects the special "(A) Election Limitation." The entire $30,000 is within the **exclusion allowance** (which takes into account only the last 10 years) . Nevertheless, because the contributions are **elective deferrals** , the maximum amount that may be contributed on an excludable basis is $10,000 or, if the special election under § 402(g)(8) is made, $13,000.

Plan Aggregation

1. Under § 415, a participant generally is considered to exclusively control and maintain his own 403(b) plan. Consequently, contributions to a 403(b) plan are not combined or aggregated with contributions to a qualified plan except when a participant elects the "(C) Election Limitation" (to substitute the 415 limit for the **exclusion allowance**), or controls any employer. In these situations, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.
2. If a participant makes the "(C) election," any contributions made on the participant's behalf to a qualified plan by the employer contributing to the 403(b) plan or an affiliated employer must be aggregated with the contributions under the 403(b) plan for purposes of applying the limits under § 415(c)(1), and § 415(e) if applicable.
3. Similarly, where a participant controls any employer (this may be the employer contributing to the 403(b) plan or another employer) for a **limitation year** , the contributions to the 403(b) are combined with contributions to a qualified plan by the controlled employer or any affiliated employer under § 415. See Regs. §§ 1.415-7(h) and 1.415-8(d).
4. The following example illustrates that an employee who is covered by a pension plan of the employer may also participate in a 403(b) plan through the employer without having to aggregate the plans under § 415. Thus, the employer could contribute non-salary reduction contributions of up to $30,000 to the 403(b) even though the employee has contributions under the qualified plan which are at the § 415 maximum.

EXAMPLE 17: Employee A is employed by a hospital which is a 501(c)(3) organization. The hospital contributes to a 403(b) plan on behalf of A in the **limitation year** , and A is also a participant in the hospital's defined contribution plan. A does not elect the "(C) Election Limitation" and is not in control of the hospital. Because A and not the hospital is considered to have exclusive control of the contract, the plans are not aggregated.

EXAMPLE 18: The facts are the same as in Example 17, except that A makes the "(C) election" for the **limitation year** . The 403(b) and qualified defined contribution plans are aggregated for purposes of applying the limit under § 415(c).

EXAMPLE 19: The facts are the same as in Example 17, except that A is a physician maintaining a private practice in which he is more than a 50% owner. A is a participant in a defined contribution plan maintained by his private practice. The defined contribution plan of A's private practice must be combined with A's 403(b) plan for purposes of applying the limit under § 415(c) because A controls his private practice.

Limitation Year

1. The **limitation year** generally is the calendar year unless a participant elects another 12-month period.
2. If a participant is in control of an employer, the **limitation year** is the **limitation year** of the employer.

3. Control and affiliation for purposes of this section of the guidelines are defined under §§ 414(b) , 414(c) and 415(h).

Compensation

1. The definition of **compensation** under § 415 for 403(b) plans is similar to the definition for qualified plans.
2. **Compensation** under § 415 for 403(b) plans is also similar to **includible compensation** under § 403(b)(2) except that the period for computing § 415 **compensation** is the **limitation year** (rather than the most recent one-year period of service). See 13.5.3, **Exclusion Allowance** .
3. In addition, **includible compensation** is computed for each employer, whereas **compensation** from a controlled employer maintaining a qualified plan may be aggregated with **compensation** from the employer contributing to the 403(b) plan. See text 13.5.3.
4. For years beginning after December 31, 1997, **compensation** includes any **elective deferral** made to a qualified CODA, SARSEP, 501(c)(18) plan, 403(b) plan, or simple retirement account, or any amount contributed by the employer at the election of the employee and which is excludable from gross income under § 125 or 457.

Effect of Contributions in Excess of § 415 Limit

1. Contributions to a 403(b) plan in excess of the § 415 limit have two effects:
    1. the excess is includible in the employee's gross income for the tax year ending with or within the **limitation year** , and
    2. the excess reduces the available **exclusion allowance** in future years.
2. The latter (b.) is accomplished by treating the excess § 415 amounts ("415 amounts") as **amounts previously excludable** (see text 13.5.3) even though they were includible in gross income. Excess 415 amounts do not cause the plan or **annuity contract** to lose its 403(b) status. See § 415(a)(2).

> **EXAMPLE 20:** Foundation is a 501(c)(3) organization which maintains a 403(b) plan ("Plan") for its employees. The gross annual **compensation** of each of the HCEs equals $160,000. Contributions to the Plan on behalf of each of the HCEs equal $37,500 (all are **non-salary reduction**) in **limitation year** ending December 31, 1998, $7,500 above the allowable 415 limit. The $7,500 excess is includible in the HCEs' gross income for the 1998 taxable year. In addition, beginning in 1999, the $7,500 excess reduces the HCEs' available **exclusion allowances** by increasing **amounts previously excludable** .

NOTE:
Compensation in Example 20 is limited to $160,000, the § 401(a)(17) cap on annual **compensation** (as indexed for 1998) that may be considered for contributions to a plan and for nondiscrimination testing. See text 13.6.

> **EXAMPLE 21:** Employee A participates in a 403(b) plan ("Plan") . A's compensation is $45,000. A has two full years of service with Charity as of December 31, 1998, the end of the **limitation year** . In 1997, Charity started making **non-salary reduction contributions** on A's behalf to the Plan. Charity contributed $12,000 in 1997 and $12,000 in 1998 on A's behalf. A's 415 limit for 1997 (and 1998) equals 25% x **compensation** or .25 x $45,000, which equals $11,250. The excess 415 amounts are $750 in 1997 and $750 in 1998. A's **exclusion allowance** in 1997 and 1998 is computed as follows:

1. A's **exclusion allowance** for 1997 is $9,000, calculated as follows:
   20% x includible **compensation x years of service** ,
   minus **amounts previously excludable**
   (.2 x $45,000 x 1) - 0 = $9,000
2. A's **exclusion allowance** for 1998 is $8,250, calculated as follows:
   (.2 x $40,000 x 2) - ($9,000 + $750)
   $18,000 - 9,750 = $8,250.

Of the $12,000 contributed in 1997, only $9,000 is excludable. The other $3,000 is includible in gross income in 1997. $750 of the $3,000 is in excess of the 415 limit. Because of the 1997 excess 415 amounts, A's 1998 **exclusion allowance** is reduced from $9,000 to $8,250. $3,750 of the $12,000 contribution is therefore includible in A's gross income for 1998.

NOTE:
The excess amounts in 1997 and 1998 are not added to **includible compensation** even though they are in fact includible in gross income.

Correction

1. Like qualified plans, excess 415 amounts in 403(b) plans may be corrected under Reg. 1.415-6(b)(6) to the extent the excess amounts are due to one of the following:
   1. the allocation of forfeitures,
   2. a reasonable error in estimating a participant's compensation,
   3. a reasonable error in determining total **elective deferrals** , or
   4. in certain other limited facts and circumstances as determined by the Commissioner. See Rev. Proc. 92-93, 1992-2 C.B. 505.
2. In the absence of such correction, excess 415 amounts are currently includible in gross income and reduce the participant's future **exclusion allowances** .

EXAMPLE 22: Employer maintains a 403(b) plan ("Plan") under which it contributes excess 415 amounts to a **custodial account** on Participant A's behalf in **limitation year** 1998. To the extent the excess amounts are not properly corrected, the excess amounts are includible in A's gross income in 1998 and reduce Participant A's **exclusion allowance** in future years (by treating these amounts as **amounts previously excludable**) . See also 13.5.4, regarding the § 4973 excise tax.

Examination Steps

1. Check the annual contributions to the 403(b) plan. If the amount deferred for any employee exceeds $30,000, there may be excess 415 amounts.
2. Determine whether a participant in the 403(b) has his or her own practice (such as a medical clinic or consulting firm) which maintains a Keogh plan. Contributions under the qualified plan may have to be aggregated with 403(b) contributions.
3. Check plan documents, including the basic plan document and SPDs, as well as the **funding vehicles** , to determine whether contributions are properly limited by § 415. Plan language is not required, however, faulty plan language may indicate an operational defect.
4. If the employer has more than one 403(b) plan, see how the plans interrelate. If the employer also has a qualified plan, check to see if combined contributions are within the 415 limit for participants who elected the "C Election Limitation."
5. For further details on the contribution limits, see Publication 571 Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.

Exclusion Allowance

1. The **exclusion allowance** is an amount that may be contributed to a 403(b) plan on a pre-tax basis under § 403(b)(2).
    1. Unlike § 402(g) , the **exclusion allowance** applies to both non-elective and **elective contributions** . The exclusion allowance applies strictly to **vested amounts** contributed during a taxable year or any amounts which become vested in the taxable year. **See Example 26** .
    2. The **exclusion allowance** is designed to work with § 415, so the formulas and definitions of these terms under §§ 403(b)(2) and 415 frequently overlap. Contributions in excess of the **exclusion allowance** for the year are currently includible in the employee's gross income in that year. Unlike **excess deferrals** , contributions in excess of the **exclusion allowance** do not result in the contract's loss of 403(b) status.

NOTE:
Contributions to an annuity plan are not covered by the **exclusion allowance** if the employer was never eligible to sponsor a 403(b) plan. If the ineligible plan cannot satisfy the requirements of some other tax-favored plan (such as a qualified plan) , no exclusion is available and all amounts contributed to the plan are includible in the employees' gross income in the taxable year they are or become vested.

Formula

1. An employee's **exclusion allowance** for a taxable year is calculated as follows:
    - Exclusion Allowance = 20% x **includible compensation** x **years of service** - **amounts previously excludable** from the employee's gross income.

NOTE:
Each element of the formula is discussed in greater detail below, followed by examples.

2. Although contributions are tested on an annual basis, the **exclusion allowance** is a cumulative formula.

EXAMPLE:
An employer who contributes less than the available **exclusion allowance** in Year 1 to purchase an annuity for an employee may contribute the "unused" amounts in Year 2. Thus, the limit may be greater than 20% of compensation in any given year (but not more than the 402(g) or 415 limit).

Special NOTE: Remember that the **exclusion allowance** is calculated with respect to the taxable years of an employee.

3. Separate exclusion allowances are generally calculated separately with respect to separate employers. Contributions to 403(b) plans of the same employer are combined in calculating the **exclusion allowance** . The amount of contributions, **years of service** , and **includible compensation** are all calculated for each employer.

EXCEPTION:
All **years of service** as an employee of a church or a related organization are considered **years of service** for the same employer (both for purposes of the **exclusion allowance** and § 415(c)(4)). Contributions by church organizations are also considered to be made by the same employer.

Employer

1. The "employer" is generally the common law employer for purposes of applying the **exclusion allowance** .

   NOTE:
   The "same desk" rule applies in determining whether there has been a change in the employer. Cf. Rev. Rul. 79-336.
   EXAMPLE:
   Hospital A maintains a 403(b) plan for its employees and merges with Hospital B, which also has a 403(b) plan, to form Hospital C. Employees of Hospitals A and B work at the same location and perform substantially the same services as they did prior to the merger. Under the "same desk" rule, employees of Hospital C may determine **years of service, includible compensation** , and **amounts previously excludable** with respect to service performed for Hospitals A and H, respectively, and Hospital C. Employees of Hospitals A and B have not separated from service for purposes of the distribution restrictions. RRP

Special Elections

1. An employee on whose behalf a **qualified organization** purchases a 403(b) **annuity contract** may elect to calculate his or her **exclusion allowance** under § 415(c)(4).
2. If this election is made, the limit under § 415 is substituted for the **exclusion allowance** .
3. There is also a special minimum **exclusion allowance** equal to the lesser of $3,000 or **includible compensation** for employees of a church or a related organization who have an adjusted gross income of $17,000 or less.