The 403(b) Examination Guidelines: A Road Map

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This "road map" to the newly released IRS Examination Guidelines for tax-sheltered annuity programs highlights the ambiguities and potentially controversial areas in the Guidelines and how the IRS suggests employers comply with them.

The long-awaited IRS proposed Examination Guidelines for 403(b) programs (also known as tax-sheltered annuities or TSAs) were finally released in May 1995. [IRS Ann 95-33, 1995-19 IRB (5/8/95)] At the same time, the IRS announced its latest voluntary compliance program—the Tax-sheltered Voluntary Compliance (TVC) program—directed specifically at tax-sheltered annuity programs. [Rev Proc 95-24, 1995-18 IRB] Taken together, the proposed Examination Guidelines and the TVC program formalize the recent change in the IRS's attitude toward these plans. In the past, TSA programs operated in a virtually audit-free environment. Recent IRS audits of nonprofit organizations, however, have shown that many if not most of these plans are not in compliance with basic rules under Code Section 403(b). In recent speeches, Bob Architect of the IRS's headquarters in Washington, DC—generally recognized as the IRS's principal spokesperson on Section 403(b)—has stated that every exempt organization audit will now include a review of any 403(b) arrangement. Through this aggressive audit initiative, coupled with the TVC program, the IRS is working to encourage employers to comply with the law.

The IRS has billed the Examination Guidelines as a consolidation and reiteration of rules that have been outstanding for a long time. However, many practitioners disagree with that characterization. In fact, several sections of the proposed Guidelines are new, surprising, and controversial.

We view very favorably the IRS's decision to provide Examination Guidelines to the public and to accept and evaluate public comment. The Guidelines give practitioners and employers a unique opportunity to see into the "mind" of the IRS and to know what to expect in the event of an audit. However, there are problem areas in 403(b) programs generally, and portions of the Guidelines are particularly troublesome.

STRUCTURE OF THE GUIDELINES

The IRS has organized the TSA-related issues into nine categories:

- Eligibility issues (concentrating on both employees and employers)
- Funding vehicles
- Salary reduction agreements and contributions
- Contribution limitations (including the Code Section 402(g) limitation, the exclusion allowance, and the Code Section 415 limitations)

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This article was originally published in the Journal of Pension Benefits and is reprinted with permission of Aspen Publishers.

- Nondiscrimination and coverage issues
- Minimum distribution rules
- Loan rules
- Early distribution restrictions
- Transfers and rollovers

Within this framework of legal requirements, the Guidelines examine the ramifications of violating these rules. Some violations will result in taxation of the individual participant only (contract defects), and others will cause the loss of 403(b) status to the entire program (plan defects).

The Guidelines note that, if a contract or a plan loses its 403(b) status, the employee is subject to income taxation on contributions. In addition, the employer may owe FICA taxes on the amount it contributed on behalf of the employees (salary deferral contributions are always subject to FICA tax, even if the program is covered under Section 403(b)), and FUTA taxes on all contributions to the program. The employee may also owe FICA taxes on the employer contributions that are now taxed as compensation. [Guidelines § I(B)]

It is important to remember that 403(b) programs are not Code Section 401(a) qualified plans. This has several important implications, not the least of which is that many 403(b) arrangements are not required, for tax purposes, to have a plan document. (However, if the TSA program is subject to Title I, then a plan document is required for Department of Labor (DOL) compliance. [Reish and Ferenczy, "403(b) Plans: The Overlooked Pension Dilemma," 2 *J Pension Benefits*, 4 (Summer 1995) 82] Therefore, when an IRS reviewer examines a TSA, he or she is often looking at an amalgam of documentation such as employment contracts, annuity contracts, custodial agreements, summary plan descriptions, salary deferral elections, and other employee communications materials. The Guidelines state that there are several situations in which a plan is required to have a certain provision. It is hard to know what that means for a program that has more informal documentation, or—perhaps more importantly—what occurs if the various types of informal documentation are contradictory.

Example. A hospital's employee communications materials indicate that participants will receive a maximum matching contribution equal to 1 percent of pay per year of service, up to a maximum of 6 percent. The hospital hires a new CEO and its letter of intent outlining the terms of the CEO's employment contains a statement that the CEO will receive matching contributions of up to 6 percent of his or her pay without any reference to years of service. Which document controls? Does it make any difference if the CEO never makes contributions and never receives the more favorable matching contribution?

This example illustrates the amorphous nature of a 403(b) program, as well as the difficulties experienced by sponsors in trying to maintain compliance with the law.

ELIGIBLE EMPLOYEES AND EMPLOYERS

In order to sponsor a 403(b) plan, an employer must be either a public school or an organization that is tax exempt under Code Section 501(c)(3)—generally, a religious, charitable, educational, scientific, literary, or public-safety-related organization. There is a narrow exception to these rules that allows cooperative health services under Code Section 501(e), private foundations under Code Section 509(a), and private operating foundations under Code Section 4942(j)(3) to sponsor a 403(b) program. No other type of organization, even if tax exempt, may sponsor a TSA.

Despite this rule, it is not unusual for an ineligible tax-exempt entity to mistakenly adopt a 403(b) program. The IRS acknowledges this problem, indicating in the Guidelines that this is a plan defect—that is, the entire program loses its 403(b) status, resulting in immediate taxes and penalties for all employees and the employer. These include:

- Income taxes due from the employer on the entire 403(b) account
- FICA taxes due from both the employer and the employee on employer contributions to the plan
- Other employment taxes (such as FUTA) taxes on all contributions made to the plan

Ineligible employer problems are specifically excluded from voluntary resolution through the TVC program. Therefore, an ineligible sponsor currently has no mechanism through which to avoid the draconian results of the loss of 403(b) status in the event the plan is audited and the defect discovered. IRS officials have indicated in speeches that they are working on a means of resolving this problem.

The Guidelines instruct the reviewer to confirm

the employer's tax-exempt status under Code Section 501(c)(3) (assuming the employer is not a public school). 501(c)(3) organizations apply to the IRS for tax exemption on Form 1023 and receive in return a determination letter that confirms the tax-exempt status. The Guidelines instruct the reviewer not merely to check that a determination letter exists, but to verify the assertions made in the Form 1023 application. [Guidelines § II(A)] This seems excessive if the IRS has already issued the exemption letter.

A participant in a 403(b) program (assuming that the employer can validly maintain a TSA) must be an employee and not an independent contractor. It appears that this requirement is directed at physicians who work in hospitals, since they may or may not be bona fide employees. The Guidelines point to Revenue Ruling 87-41, which outlines the 20 factors for examining this issue. In essence, the question is whether the tax-exempt entity truly has the right to control the actions of the purported employee, or if the individual actually is a master of his or her own destiny. If the worker is an independent contractor and has been treated as an employee (or vice versa), the tax ramifications are significant. In addition to affecting whether the individual may participate in a 403(b) program, there may be substantial employment taxes or self-employment taxes in arrears. The Guidelines do not address the impact, if any, the employer's contributions to a 403(b) program on behalf of an ineligible employee have on the program's tax-sheltered status. It is possible that the entire program could lose its 403(b) status as a result of this compliance defect.

FUNDING VEHICLES

The Guidelines remind employers that only two funding vehicles are permitted in 403(b) programs: annuity contracts sold by insurance companies and custodial accounts containing only mutual funds. (There is an exception to this rule for churches, which may invest in broader retirement income accounts.) While the annuity contracts may contain a life insurance element (so long as it is incidental), custodial accounts may not. If a program allows investments in both annuity contracts and custodial accounts (so-called wrap plans), IRS representatives have indicated that insurance may be purchased in the annuity contract portion. Annuities must be nontransferable, except Revenue Ruling 90-24 transfers under from one 403(b) arrangement to another, discussed below. Custodial accounts must be held by a bank or approved nonbank custodian under Code Section 401(f). Participant loans can be made from either vehicle.

Failure to use a proper funding vehicle results in the immediate taxation of all participants using the bad vehicle. The Guidelines provide the following example of improper funding: the employer holds the 403(b) program funds as part of its general assets until the employee retires, and then purchases an annuity.

The Guidelines do not address when contributions must actually be deposited to the 403(b) vehicle. This is particularly important when salary deferrals are involved. Analogous rules exist for 401(k) plans of for-profit organizations, promulgated by the DOL (as soon as they can be reasonably segregated, but not more than 90 days). However, experience shows how easy it is for the employers to hold on to those funds for general operation expenses for a time that exceeds the DOL period. Incidentally, if the 403(b) program is subject to Title I—for example, the employer contributes to the program—then the DOL regulations apply, and it will be a fiduciary breach to fail to deposit deferrals on a timely basis. A salary-reduction-only 403(b) program typically is not subject to the protections of ERISA Title I's fiduciary rules.

However, when does failure to deposit contributions also threaten the program's tax-sheltered status? And is it a proper remedy to punish the employees when the culprit is their employer?

SALARY REDUCTION

Although 403(b) programs are not required to have salary reduction contributions, most do. Salary reduction features are generally the cornerstone of these plans, since tax-exempt entities may not sponsor 401(k) plans.

The Guidelines concentrate on three rules for salary reduction elections in 403(b) programs:

1. They must be in writing, legally binding, and irrevocable with respect to amounts earned while the agreement is in effect.
2. They must apply to amounts earned after the deferral election is made.
3. There may be only one election per year.

The phrase "legally binding" appears in the Guidelines several times, but it is not clear exactly what this means or what the reviewer is to analyze to determine whether the salary deferral election is

"legal" or "binding."

The Guidelines contain an odd example relating to the requirement that the deferral election relate to amounts not yet earned. The Guidelines state that "salary is 'earned' when the services that give rise to the employee's entitlement to pay are performed." The Guidelines then indicate that sick pay, for example, is considered "earned" when the right to the pay is accrued, and not when it is actually paid. So, if an employee accrues sick pay in 1993 when he or she had no salary deferral election in effect, it is considered to be "earned" in 1993. Therefore, no deferral of the sick pay is permitted in 1994 when the employee actually falls ill and receives the income. This seems to be a difficult enough process when the sick pay was earned when no salary deferral election is in effect. However, it is even more arduous and impractical to handle this issue if the sick pay was earned during periods of varying salary deferral elections.

Imagine, for example, a healthy employee who accrues some sick pay in 1993 (when no deferral election was in effect), in 1994 (when a deferral election of 5 percent of pay was in effect), and in 1995 (when a deferral election of 10 percent of pay was in effect). When the employer compensates the employee in 1996 with sick pay, is it expected to somehow apportion that sick pay among the various accrual periods? If so, how?

This area of confusion, which is a breeding ground for inadvertent violations, can be avoided if the final version of the Guidelines provides that pay is earned when the final condition for payment is satisfied. For example, sick pay is earned not when it is accrued but when the employee falls ill and doesn't show up for work (or terminates employment with distributable sick pay).

The Guidelines also remind the practitioner that only one salary deferral election may be made during a calendar year, although the election may be terminated at any time. The Guidelines also clarify that the continuation of a prior year's election is not an affirmative election by the participant. Therefore, an election to change the rate of deferrals later in the year is allowed.

The Guidelines indicate that, if a second election is made during a calendar year, "all amounts deferred under the second election are taxable." However, it is not clear whether this means that all deferrals after the date of the second election are per se taxable, or only the increase in contribution under the second election. It seems reasonable that the former would be true; if not, there would be no negative ramifications if the employee's second election represented a decrease in the rate of deferral.

CONTRIBUTION LIMITS

There are three separate limitations on contributions: the Code Section 402(g) limit on salary deferrals (currently $9,500 in most circumstances); the exclusion allowance; and the Code Section 415 limitations on annual additions.

Code Section 402(g) limitation on salary deferrals. The Guidelines provide that, "a 403(b) *by its terms* must preclude the making of excess deferrals to plans of the employer." [Emphasis added] This again raises the specter of plan documentation: what if there is none? Is this rule violated? What if the employer has complied in practice with this rule since the program's inception?

The Guidelines indicate that the entire program loses its 403(b) status if it accepts deferrals in excess of the Code Section 402(g) limitations (assuming that the excess is not distributed by April 15 of the following year), since it is a violation of Code Section 401(a)(30) as incorporated by Code Section 403(b). [Guidelines §§ V(A)(2)(b), XI(B)(6)] While this treatment parallels 401(k) plans, it is interesting that the Guidelines take such an extreme stance in this instance, but not in regard to all 401-type violations. For example, a failure to make distributions to participants at age 70½ produces a plan defect only if that failure is part of a continuing pattern. [See Guidelines §§ XI(A)(5), (17)]

The Guidelines note that the 401(k) "one-time irrevocable election" rules apply also to 403(b) programs. Therefore, a TSA may allow an employee to permanently elect not to participate (or to participate at a reduced level) in the employer's contribution, without this constituting a salary reduction election. For example, a TSA that provides for an employer contribution of 10 percent of pay may allow new employees to permanently opt out of the plan in exchange for an increase in pay. This does not convert all employer contributions into salary deferrals by the employees who do not choose to opt out of the plan. The flip side of this is, of course, that a program that allows an employee to make such an election at a later time runs the risk of having the employer contributions considered by the IRS to be salary deferrals, subject to the $9,500 limit.

Exclusion Allowance. One of the most significant observations of the Guidelines in relation to the exclusion allowance is the deceptively simple treatment given to this most confusing area of the law.

For example, there is no discussion of the complexities of determining an employee's years of service. The law provides that partial years of service (determined based on the "customary" service of the employer's employees—whatever that is) are given partial credit. Since many teachers work for the same school district for their entire careers, periods of reduced service (during times such as parental leave or illness) are likely. We suggest that the final version of the Guidelines assist the reviewer (and practitioners) in discerning the proper treatment of these odd periods of employment and unemployment. We also suggest that the Guidelines discuss the exclusion allowance in all its intricacy and give reviewers examples that would better parallel actual uneven employment, compensation, and salary reductions.

Code Section 415 limitations. The Section 415 limitations on annual additions is an area of law with which qualified plan practitioners are very familiar. As with the exclusion allowance, the Guidelines belie the complexity of this area. The most striking omission in the Guidelines relates to the aggregation of plans for Code Section 415 purposes, particularly due to control of the tax-exempt employer. The brief treatment is probably because of the lack of prior guidance on this issue. Who controls a nonprofit organization, which is not "owned" by anyone? This omission may also reflect the IRS's own uncertainty in this area; the IRS recently requested practitioner comments and suggestions on this topic. [Ann 95-48, 1995-23 IRB 13]

This may be an area in which the IRS will exercise little scrutiny, unless the 403(b) participant also controls another company. [See Guidelines § V(C)(2), Example (4)] The greatest impact will be on professionals who have their own businesses or practices and also teach at a university or practice at a hospital that sponsors a 403(b) program.

In general, this section of the Guidelines provides a reasonably concise description of the various alternative elections a 403(b) participant can make under Code Section 415. The Guidelines also remind the reviewer that nothing is needed to make one of these elections other than for the participant to calculate the amount excluded from taxable income in a manner consistent with the election. What is interesting about this passive method of election-making is that an employee could, at least theoretically, calculate his or her allowable 403(b) contribution incorrectly in a given year. Under a normal definition of the exclusion allowance, such an employee may find that he or she could not contribute as much as he or she did under the deferral election. Further investigation may uncover that the full contribution is excludable from income, but only if one of the Section 415 elections were made. This election is deemed to have been made if the employee's taxes were calculated consistent with the election having been made—that is, if the election is required in order to exclude the TSA contribution from income. Thus, the employee may have "made an election" without really intending to do so. This could have negative ramifications for later years, since the elections are irrevocable.

Correction. The Code and regulations provide means of correcting contributions in excess of these three limitations. These correction methods are generally available only for limited periods of time. Fortunately, the TVC program allows employers to correct overcontributions made to a plan which are no longer eligible for the normal "fixes." [See Rev Proc 95-24, 1995-18 IRB, § 7]

Excise tax on contributions in excess of Code Section 415 limits or the exclusion allowance. The Guidelines note that there is an 6 percent excise tax on excess contributions made to custodial accounts only. This tax is payable by the employee, not the sponsor.

The Guidelines do not discuss how this tax is determined if the employee contributes to both a custodial account and an annuity contract. For example, suppose an employee's exclusion allowance enables the employee to contribute $7,000 to a 403(b) program. The employee erroneously contributes $9,500—$5,000 to the annuity contract and $4,500 to the custodial account. There is $2,500 of excess contribution in this situation, but is it in the annuity contract (which means that no 6 percent penalty applies), or in the custodial account (where it does apply), or in some combination of the two?

Nondiscrimination Rules

Since TRA '86, employer contributions to 403(b) programs are required to comply with Code Sections 401(a)(4) (nondiscrimination in contributions, benefits, or other plan rights and features), 401(a)(5) (permitted disparity), 401(a)(17) (limitation on compensation to $150,000), 401(a)(26) (minimum participation rules), 401(m) (nondiscrimination in matching and employee contributions), and 410(b) (minimum coverage rules).

The most significant part of this section of the Guidelines is the recognition by the IRS that we are (and have been since January 1, 1987) in a period of "good faith, reasonable interpretation" of the law.

> Because this is a period of transitional compliance and presumably the reasonable/good faith interpretation standard allows some room for error, nondiscrimination issues should be pursued only in cases involving clear, egregious violations. [Guidelines § VI]

What are clear, egregious violations? The Guidelines take a particularly dim view of an employer's disregarding Code Section 403(b)(12)(ii), which requires essentially universal eligibility of employees to make salary reduction contributions. Other than that, they are very vague. Wisely, the Guidelines remind the reviewer that the safe harbors contained in IRS Notice 89-23, 199-1 C.B. 654, are *one* way (not the only way) to show nondiscrimination in the nonsalary reduction contributions.

By failing to define what represents a clear, egregious violation, the IRS is reserving the right to penalize people engaged in practices that reach or border on abusive. It is unlikely that it intends to challenge simple compliance errors. This also provides some flexibility for practitioners to defend against IRS charges of discrimination by contending that the purported violation is not egregious.

Nondiscrimination errors are plan defects, resulting in the loss of tax-deferred status for the entire program. (This is interesting from the viewpoint of participants who were allowed to be in the program, since they are taxed because a fellow employee was improperly excluded.) However, it is even more significant that violations of Code Section 403(b)(12) nondiscrimination rules (including the "egregious" failure to allow all employees to defer salary into the program) may be corrected through TVC. Therefore, an employer that was unaware of or disregarded the post-TRA '86 nondiscrimination rules can reestablish compliance relatively easily.

It is interesting (although not surprising in light of the lack of prior guidance on this issue) that the Guidelines fail to address one of the main questions practitioners have had with regard to the nonsalary deferral contributions: What employees may be excluded? The Guidelines acknowledge that excludable employees may be left out of nondiscrimination testing, and that this term includes the statutory exclusions of Code Section 403(b)(12) (nonresident aliens, students teaching at their school and employees who normally work less than 20 hours per week. In addition, the Guidelines provide that, "Excludable employees are those employees who . . . have not satisfied any *permissible* age and service requirements of the plan." [Guidelines, § VI(B) (emphasis added)] However, it is not clear if the "permissible" age and service requirements parallel Section 410(a) rules—that is, can the nondiscrimination testing for employer contributions exclude individuals who have not completed one year of service and attained age 21?

Similarly, Guidelines specify that all nonexcludable employees of the controlled or affiliated service group must be considered in the nondiscrimination testing. However, this is a very murky area of the law. What constitutes "control" or "ownership" of a nonprofit organization has been an area of confusion for years, and IRS guidance on this issue is very sparse.

The Guidelines offer no enlightenment on an important issue facing many colleges and universities. It is not unusual for a college or university to provide employer contributions for faculty in a 403(b) program and for nonfaculty staff in a qualified plan. The Conference Committee Report to the Tax Reform Act of 1986 indicates that 403(b) programs can be aggregated with qualified plans (although the qualified plans must meet nondiscrimination testing on their own) for purposes of nondiscrimination testing. However, the qualified plan benefits must be "comparable" (within the meaning of Revenue Ruling 81-202) to the 403(b) benefits for aggregation to be permissible.

Distribution Rules

It is clear from both the Code and the Guidelines that the IRS is concerned that distributions be made from 403(b) plans when they are required—and not before they are allowed. 403(b) program distribution rules look very much like those for 401(k) plans, with a few exceptions that the Guidelines do a good job of highlighting.

The basic rules are the following:

1. Begin distributions by the age of 70½, and make sure the pattern follows the rules of Section 401(a)(9). Special rules allow a participant to begin distributions at age 75 for his or her pre-1987 403(b) amounts, if they have been kept segregated from the post-1986 amounts;
2. Do not make distributions of salary reduction funds before age 59½, termination of employment, death, disability, or retirement. Plans may allow hardship distribution for any funds from an annuity contract, or salary reduction funds from a custodial account. Transfers under Reve-

nue Ruling 90-24, 1990-1 C.B. 97 do not constitute distributions; and

3. Make sure to allow people taking a distribution to make a direct rollover to an IRA or another 403(b) program.

As mentioned, the failure to provided minimum distributions may only produce excise taxes for the participant if it is not part of a pattern of abuse of these rules. Once it is deemed to be a consistent pattern, the program may lose its 403(b) status for all participants. Similar rules appear to apply to a failure to follow the distribution restrictions.

What constitutes a pattern of abuse is not at all clear. A plan could erroneously allow distributions in a given year to anyone who asks, and this could constitute one violation (to the one person who asked) or several (because everyone requested a distribution). Similarly, a custodian's failure to understand the minimum distribution requirements could mean that one employee or a significant percentage of employees is affected.

A few special distribution rules mentioned in the Guidelines deserve attention. First, special minimum distribution rules apply to churches and pre-1987 funds, if they were properly segregated. Second, the limitation on distributions applies only to the salary reduction portion of an annuity contract. Amounts contributed by the employer are distributable at any time, assuming the program allows for it (remember that plans with employer contributions are subject to Title I of ERISA and are required to have some plan documentation). All funds in a custodial account are subject to the distribution restrictions, regardless of their source. (This is particularly interesting, because anecdotal experience indicates that custodians are much less aware of the restrictions on 403(b) program distributions and are much more likely to violate these rules than are insurance companies providing annuities.)

Because the participants generally exercise much more control over their 403(b) monies than do qualified plan participants, it is not surprising that the law provides them with the ability to move from one 403(b) product to another. This ability—and the rules relating to it—are outlined in Revenue Ruling 90-24, 1990-1 C.B. 97, and therefore these transactions are called 90-24 transfers. Transfers may be made between annuity contracts, between custodial accounts, or mixed between the two. However, distribution limitations present before the 90-24 transfer must continue to apply to those funds after the transfer. This may produce some logistical difficulties for an annuity contract that accepts such a transfer from a custodial account. The law currently does not require any contract to permit incoming or outgoing 90-24 transfers.

The Guidelines do not outline what "financial hardship" means (nor, for that matter, do the Code and regulations). IRS representatives have indicated that 401(k) rules provide a reasonable analogy. [See also, General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation (*Blue Book*), p. 715]

The direct rollover rules of Code Section 401(a)(31) apply to 403(b) programs, and employees must be allowed to make a direct rollover if they so choose. These rules also include the requirement that the sponsor provide an employee with notice of these rollover rights. Note that TSA funds may be rolled over only to other 403(b) programs and individual retirement accounts. [IRC § 403(b)(8); Treas Reg § 1.403(b)-2T, Q&A-1]

Violation of the direct rollover rules causes a loss of 403(b) status for the contract involved, and a pattern of noncompliance may result in the loss of 403(b) status for the entire program. This is an odd effect, if it is examined in the context of a fact situation.

Assume that an employee requests distribution of a portion of his or her 403(b) account. No notice of rollover is provided and the employee was not given the opportunity to make a direct rollover. This had no practical effect, because the employee had current plans for the use of the distributed funds. The IRS audits the plan and discovers the defect. The penalty is that the affected employee loses tax-sheltered status for his or her remaining 403(b) funds. Assuming that the reason for requiring that notice to be provided to the employee is that Congress and the IRS believe the employee should—and likely does not—know of this available option, it seems inequitable to punish this same employee for the contract-holder's failure to effectively provide that option. Fortunately, this defect may also be corrected through the TVC program if it is discovered before IRS audit.

One item not mentioned in the Guidelines is of particular note. The Guidelines should have reminded the reviewer and employers that, contrary to the rules for qualified plans, 403(b) plan termination does not constitute a distributable event. An employee may not receive his or her 403(b) account until a distributable event occurs. However, a terminating plan may provide (or be amended before

termination to provide) that a 90-24 transfer may be made upon plan termination.

PLAN DEFECTS AND CONTRACT DEFECTS

It is important to keep in mind which defects are contract defects, which affect only the relevant participant, and which are plan defects, which could destroy the tax benefits for the entire arrangement.

The Guidelines consider the following to be contract defects that affect the erring participant only:

Contract Defect	Penalty
Contributions in excess of the exclusion allowance	Income taxation on the excess, plus a 6% excise tax under Code Section 4973 if the deposit was to a custodial account
Contributions in excess of the Code Section 415 limitations	Income taxation on the excess, 6% Code Section 4973 excise tax if deposited to a custodial account, and reduction of future exclusion allowance amounts
Excess deferrals that do not cause a loss of 403(b) status—that is, if made to plans of more than one employer	Taxation of the excess in both the year contributed and the year distributed
Loans in excess of the Code Section 72(p) limitations	Taxable deemed distribution of the amount of the loan in excess of the limitation
Isolated failure to make minimum distributions	50% excise tax to the employee on the amount not distributed under Code Section 4974
Violation of the one-deferral-election-per-year rule	Gray area, but probably taxation of all amounts deferred after the second election was made
Application of deferral election to prior earnings	Income taxation of the amounts earned prior to the effective date of the deferral election

The next set of defects are still contract defects, but they can invalidate the employee's entire contract (not just that year's contributions). In addition, if egregious, these can turn into plan defects under certain circumstances:

- Inadequate (not legally binding) salary reduction agreement(s)
- Annuity contracts not purchased from an insurance company
- Custodial accounts not maintained by a bank or approved nonbank custodian
- Failure of a custodial account to invest solely in mutual funds
- Violation of the incidental death benefit rules (that is, too much life insurance)
- Participation by an ineligible employee
- Failure of an annuity contract to be nontransferable in either form or operation
- Impermissible distributions
- Failure to provide direct rollovers
- Pattern of violating the minimum distribution rules

Finally, the following defects are always plan defects, which invalidate the 403(b) program entirely:

- Ineligible employers
- Failure to purchase annuity contract until participants reach normal retirement age
- Discrimination
- Failure to satisfy minimum participation rules
- Inadequate coverage
- Excess deferrals allowed by the plan

CONCLUSION

We generally applaud the issuance of the 403(b) Examination Guidelines as part of both the IRS's continuing program of providing practitioners with a "preview" of what is to be examined during an audit and its practice of issuing continuing guidance in the area of tax-sheltered annuity programs. An employer whose employees participate in a 403(b) program would be well advised to review these Guidelines in great detail, with an eye to correcting existing defects before the IRS initiates an audit.

However, it is important for both the IRS and practitioners to understand two things about these programs. First, the IRS has contributed to the atmosphere of noncompliance through its inattention to these plans and the paucity of guidance in the gray areas. Second, in setting up and maintaining these programs, tax-exempt employers customarily have relied upon advice from the vendors of investment vehicles. Therefore, violations in this area tend to be

inadvertent and not the result of bad intent.

It is also important to note that many 403(b) program sponsors are relatively small charitable organizations, that are not in the position to pay sizable penalties and sanctions to the IRS.

These factors make the audit initiative and the heavy penalties for noncompliance, particularly troublesome. We hope the IRS will take them into account as it audits plans and applies tax penalties in these situations.