Internal Revenue Service

Tax Exempt and
Government Entities

Employee Plans Division

403(b) Tax-Sheltered Annuity Plan for Sponsor

Be Aware of Common Mistakes

As a 403(b) plan sponsor/employer, you need to pay attention to the operation of your 403(b) tax-sheltered annuity plan so that you can:

- be compliant with the law,
- maximize your employees' retirement benefits, and
- avoid additional taxes and penalties.

403(b) Tax-Sheltered Annuity Plan for Sponsor

A 403(b) tax-sheltered annuity (TSA) plan is a retirement plan offered by public schools and certain tax-exempt organizations. An individual's 403(b) annuity can be obtained only under an employer's TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and nonelective employer contributions.

Read on to learn about specific 403(b) topics where mistakes are common, and learn about Internal Revenue Service (IRS) products, services, and assistance to help you keep your 403(b) tax-sheltered annuity plan healthy.

Note: Underlined topics identify electronic links for detailed information on that topic. For those reading a print version of this product, you can access an electronic version on-line at www.irs.gov/ep to link to your topic of interest.

403(b) Tax-Sheltered Annuity

It is important to know the tax rules applicable to a 403(b) plan to: 1) help you comply with the tax law; and 2) help you ensure that your employees get the maximum benefit out of your 403(b) plans.

In a national sample of audited 403(b) plans, the IRS found recurring mistakes in the following areas:

Failure to be a Qualified Employer. Only employers established as public schools and certain tax-exempt charitable organizations classified under IRC section 501(c)(3) may sponsor a 403(b) plan.

Failure to Properly Apply Universal Availability. This failure arises when employers exclude eligible employees from participation. These employers often misapply eligibility and coverage conditions to improperly exclude employees who are otherwise eligible to make elective deferrals under section 403(b)(12). Under this failure, eligible employees, often part-time employees who would otherwise be eligible to participate, are not given the right to make salary reduction contributions.

Plan—COMMON MISTAKES

Failure to Limit Employee Elective Deferrals. The general limit on employee elective deferrals is $14,000 in 2005, $15,000 in 2006, and indexed thereafter. Additional catch-up contributions are permitted if certain criteria are met. Failure to limit deferrals to these amounts can result in additional taxes and penalties that may affect both the employee and the employer.

Failure to Timely Return Excess Elective Deferrals and Earnings. Excess elective deferrals plus earnings must be distributed to the employee no later than April 15th of the following year to avoid additional taxes and penalties for both employee and employer. Excess deferrals, distributed timely, are included as income for the year contributed with the applicable earnings being reported as income for the year distributed. Report corrective distributions of excess deferrals (including earnings) on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts, etc.*

Failure to Properly Withhold and Report Withholdings on Form 941, *Employer's Quarterly Federal Tax Return.* If you allow excess deferrals to be contributed into a 403(b) annuity, then taxable wages are under-reported on your quarterly employment tax return–Form 941. If you withheld less than the right amount of income, social security, or Medicare taxes from an employee's wages and fail to correct this prior to the last day of the applicable calendar year, the employer is responsible for the underpayment and penalties.

Stay informed. Subscribe today to the *Retirement News for Employers* at www.irs.gov/ep. See NEWSLETTERS.

Failure to Identify and Report Defaulted Loans. Loans that fail to comply with the provisions of section 72(p) may be deemed a taxable distribution that is reported to the employee as income. For example: Loan defaults often occur when required payments are missed or aggregate loans exceed the $50,000 maximum limit, often as a result of loans from multiple vendors.

Failure to Satisfy Hardship Distribution Requirements. "Hardship distributions" are considered premature distributions when:

- adequate documentation of the financial hardship is not obtained,
- other available financial means were not previously exhausted, or
- distributions from multiple vendors, in aggregate, exceed the amount needed to relieve the hardship.

If you find mistakes in your 403(b) plan, take steps to bring it into compliance so that your employees can continue to benefit on a tax-favored basis. As an employer, mistakes on your retirement plan need to be corrected timely to avoid additional taxes and penalties that may affect both you and your employees. You may want to contact a tax professional for help.

Most 403(b) plan mistakes can be corrected through the Employee Plans Compliance Resolution System (EPCRS). Information on EPCRS is available through www.irs.gov/ep. See CORRECTION.

Customer Assistance

The following publications cover 403(b) tax-sheltered annuity plans, other retirement plans, and correction programs:

- Publication 15, *Circular E, Employer's Tax Guide*
- Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations*
- Publication 590, *Individual Retirement Arrangements (IRAs)*
- Publication 3998, *Choosing a Retirement Solution for Your Small Business*
- Publication 4050, *Retirement Plan Correction Programs* CD-ROM
- Publication 4224, *Retirement Plan Correction Programs* pamphlet
- Publication 4406, *403(b) and 457 Retirement Plans with plan feature comparison chart*

Download these publications at www.irs.gov/ep, or order a free copy through the IRS by dialing (800) 829-3676.

For assistance or information on retirement plan tax-related issues:

www.irs.gov/ep

Visit this site for on-line resources covering specific retirement plans (including 403(b) plans). Site has tools such as a checklist for maintaining your plan, source documents, and worksheets.

(877) 829-5500
Tax Exempt and Government Entities
Customer Account Services

IRS Department of the Treasury Internal Revenue Service
Publication 4483 (10-05)
Catalog Number 47243V

Public Schools/Certain Tax Exempt Organizations:

In Part from Publication 571 (for complete Pub 571 click here):

An employee cannot set up his or her own 403(b) account. Only employers can set up 403(b) accounts. A self-employed minister cannot set up a 403(b) account for his or her benefit. If you are a self-employed minister, only the organization (denomination) with which you are associated can set up an account for your benefit.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.2 (03-01-2005)

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:

a. employer is eligible to maintain a 403(b) plan for participating employees,
b. participants in a 403(b) plan perform services for the employer as employees, and
c. self-employed and certain other ministers are described in *IRC section 414(e)(5)(A*).

Employee status under *IRC section 403(b)* is generally determined by employee status for federal employment tax purposes under common law principles. See the 20 steps for determining employee status in *Rev. Rul. 87-41, 1987-1 C.B. 296*.

4.72.13.6.1 (03-01-2005)

Universal Availability Requirements for Salary Reduction Contributions
(1) Salary reduction contributions are tested separately from non-salary reduction contributions for nondiscrimination. (*IRC section 403(b)(12)(A)(ii))*.

a. The nondiscrimination requirement for salary reduction contributions is satisfied only if the plan in operation allows each employee to elect to defer more than $200 annually. Unlike a qualified CODA, nondiscrimination with respect to salary reduction contributions is not satisfied through compliance with the ADP test.
b. The test for salary reduction contributions focuses on eligibility and generally requires universal eligibility. However, there is no requirement that the opportunity to make salary reduction contributions be available; but **once that opportunity is available to any employee, it must be available to all nonexcludable employees to satisfy nondiscrimination**.
c. Until future guidance is issued, both public education institutions and 501(c)(3) organizations MUST currently operate their 403(b) plans in accordance with a good faith/reasonable interpretation of the nondiscrimination requirement for salary reduction contributions. No plan provisions are currently required, but faulty plan language may indicate an operational violation.
d. Additional catch-up contributions under IRC section 414(v) must be universally available to employees if these are made available to any employee.

(2) Excludable employees may be disregarded in applying the nondiscrimination test for salary reduction contributions. These include:

a. nonresident aliens with no U.S. source income,
b. employees who normally work less than 20 hours per week,
c. collectively-bargained employees,
d. students performing certain services,
e. employees whose maximum salary reduction contributions under the plan would be no greater than $200, and
f. participants in an eligible 457 plan, a qualified CODA, or other salary reduction 403(b) plan.

Note: Unlike a qualified plan, a 403(b) plan is not permitted to have any minimum age and service exclusion for salary reduction contributions.

(3) Like elective deferrals under *IRC section 402(g)*, salary reduction contributions for nondiscrimination testing consist of employer contributions made pursuant to a salary reduction agreement.

(4) Under Notice 89-23, employer means the common law employer (and not the controlled group) for purposes of testing salary reduction contributions for nondiscrimination. A good faith, reasonable interpretation as to the identity of the employer is sufficient for this purpose.

Salary reduction contributions made pursuant to a one-time irrevocable election at initial eligibility to participate in the salary reduction agreement, or pursuant to certain other one-time irrevocable elections specified in the regulations, and pre-tax contributions made as a condition of employment are treated for limitation purposes and tested for nondiscrimination purposes as non-salary reduction contributions. See text 4.72.13.5 for a discussion of a similar definition for elective deferrals under *IRC section 402(g).*

(5) The following examples illustrate that salary reduction contributions are tested separately from other contributions for nondiscrimination and that these contributions must be offered universally to non-excludable employees. The effect of violating nondiscrimination is the loss of 403(b) status. Contributions to the Plans are therefore subject to income tax, employment tax and withholding.

Example: Employer is a large public university located in City Y. Employer maintains an annuity plan (Plan) intended to be a 403(b) plan. Both non-elective, non-matching contributions and salary reduction contributions are provided under the Plan. Under the Plan, only senior administrative staff and faculty are eligible to elect to defer a portion of their salary pursuant to salary reduction agreements with Employer. Employer also maintains a defined benefit plan for remaining employees. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory. The Plan does not satisfy the requirements of *IRC section 403(b)*.

Example: Same as above example, except that all full-time employees are eligible to participate in the Plan. There are 40 part-time clerical employees who are not students and who normally work 29 hours per week (or 1,508 hours per year). Since the part-time employees in this example are not excludable, the salary reduction contributions are discriminatory. The Plan is not a 403(b) plan.

Example: Employer is a small private school which maintains an annuity plan intended to be a 403(b) plan. All eligible employees may elect to defer at least 4% of compensation. An eligible employee, A, has compensation of $25,000 for 2005 and elects prior to 2005 to defer 1.5% of compensation. The plan administrator declines to process the election and informs A that the minimum deferral is 4% of compensation. The salary reduction contributions are discriminatory, and the Plan fails to satisfy 403(b).

Example: Employer is a private hospital maintaining an annuity plan (Plan) intended to be a 403(b) plan. The Plan provides only a salary reduction arrangement. Under the Plan, all medical doctors and senior administrative staff are eligible to participate in the Plan immediately upon hire. Remaining employees, including nurses and other support staff, are eligible only after two years of service and attainment of age 21. Employer maintains no other plans of deferred compensation. The salary reduction contributions are discriminatory, and the Plan loses its status as a 403(b).

4.72.13.6 (03-01-2005)

Nondiscrimination and Coverage

(1) TRA '86 imposed nondiscrimination and coverage rules on 403(b) plans under *IRC section 403(b)(12)*.

a. These rules generally must be satisfied for plan years beginning after December 31, 1988.
b. These rules do not apply to churches, including qualified church-controlled organizations, as defined by *IRC section 3121(w)(3).*

(2) Nondiscrimination and coverage requirements (except *IRC section 401(a)(17))* with respect to non-salary reduction contributions do not apply to governmental 403(b) plans. A governmental plan (within the meaning of *IRC section 414(d))* is one maintained by a State or local government or political subdivision, agency or instrumentality thereof.

(3) Currently there are no nondiscrimination regulations under *IRC section 403(b)(12)*. Pending the issuance of regulations or other guidance, Notice 89-23, *1989-1 C.B. 654* (extended by Notice 96-64, *1996-2 C.B. 229*), provides guidance for complying with the nondiscrimination rules.

a. Notice 89-23 deems a 403(b) plan to satisfy nondiscrimination if the employer operates the plan in accordance with a good faith, reasonable interpretation of *IRC section 403(b)(12)*. One means of satisfying this test is through the safe harbors set forth in Notice 89-23.
b. Under the notice, salary reduction and non-salary reduction contributions are tested separately for nondiscrimination. Only non-salary reduction contributions (both matching and non-elective) are subject to the coverage requirements of *IRC section 410(b)*.

(4) Under *IRC section 414(u)*, a 403(b) plan is not treated as failing nondiscrimination or coverage requirements by reason of the making of employer or employee contributions (or the right to make such contributions) made pursuant to veterans' reemployment rights under USERRA.

4.72.13.2.1 (03-01-2005)

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:

a. 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 *IRC section 170(b)(1)(A)(ii)*;**
b. A non-profit organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 501(a),* or an organization treated as described in *IRC section 501(c)(3)*;
c. A grandfathered Indian tribal government; and
d. Beginning in years after December 31, 1996, a minister described in *IRC section 414(e)(5)(A).*

(2) A trade association described in *IRC section 501(c)(6)* and exempt from tax under *IRC section 501(a)* is **not eligible** to maintain a 403(b) plan.

a. If an employer maintains an annuity plan and is not eligible, the plan is not a 403(b) plan. For resulting tax consequences, see *IRC sections 403(c)* and *72*.
b. An ineligible employer may enter into a closing agreement with the Service under the Employee Plans Compliance Resolution System.

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IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.2.1.1 (03-01-2005)

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:

a. public schools
b. state colleges
c. 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: 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. *Rev. Rul. 72-390, 1972-2 C.B. 227*.

Example: 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.

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Certain Tax-Exempt Organizations:

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.2.1.2 (03-01-2005)

Organizations Described in *IRC section 501(c)(3)*

(1) Another type of eligible employer is an organization described in *IRC section 501(c)(3)* and exempt from federal income tax under *IRC section 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:

a. charities,
b. social welfare agencies,
c. private hospitals and
d. health care organizations,
e. private schools,
f. religious institutions, and
g. 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 section 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.

4.72.13.2.1.3 (03-01-2005)

Grandfathered Indian Tribe

(1) A designated Indian Tribal Government is treated as a State for purposes of *IRC section 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.

4.72.13.2.1.4 (03-01-2005)

IRC section 414(e)(5)(A)
Minister

(1) A self-employed minister may deduct, within the limits of *IRC section 404(a)(10)*, contributions to a retirement income account described in *IRC section 403(b)(9)*.

(2) Similar deductions may be taken by a minister employed by a non-501(c)(3) organization, and one 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. *IRC section 414(a)(5)(E).*

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Salary reduction agreements;

In Part from Publication 571 (for complete Pub 571 click here):

S***alary reductions (referred to as Elective Deferrals)*** are contributions made under a salary reduction agreement. This agreement allows an employer to withhold money from an employee's paycheck to be contributed directly into a 403(b) account for the employee's benefit. The employee does not pay tax on these contributions until they are withdrawn from the account. An employee can enter into more than one salary reduction agreement during a year.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.4 (03-01-2005)

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 *IRC section 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.

(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 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 *IRC section 401(k)* (CODA). Many of the same rules applicable to cash or deferred elections under *IRC section 401(k)* apply to salary reduction contributions under a 403(b) plan, including the –

a. frequency that an employee is permitted to enter into or modify a salary reduction agreement,
b. compensation to which an agreement may apply, and
c. 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 yet paid or currently available to the employee at the effective date of the agreement. The salary reduction agreement must be legally binding.

(6) An automatic reduction of an employee's salary by a certain amount may be treated as a salary reduction agreement if the employee has an effective opportunity to elect to receive the amounts in cash. (Rev. Rul. 2000-35)

(7) The salary reduction contributions must be in the nature of compensation.

(8) Salary reduction contributions are generally treated as employer contributions (notably for purposes of *IRC sections 403(b)*, *402(g)* and *415*) but are treated as employee contributions for other purposes, including FICA.

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Non-elective employer contributions:

In Part from Publication 571 (for complete Pub 571 click here):

Nonelective contributions are employer contributions that are not made under a salary reduction agreement. Nonelective contributions include matching contributions, discretionary contributions, and mandatory contributions from the employer. The employee does not pay tax on these contributions until they are withdrawn from the account.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.6.2 (03-01-2005)

Non-Salary Reduction Contributions

(1) Non-salary reduction contributions are:

a. all contributions that are not salary reduction contributions
b. basically all non-elective and matching contributions
c. tested separately from salary reduction contributions for nondiscrimination.

(2) Nonelective (non-matching) contributions, and matching and after-tax employee contributions, are also tested separately for nondiscrimination. *IRC section 403(b)(12)(A)(i)* requires compliance with the following provisions:

a. *IRC section 401(a)(4)* (nondiscrimination)
b. *IRC section 401(a)(5)* (permitted disparity)
c. *IRC section 401(a)(17)* (the $220,000 ceiling on compensation for 2006, indexed thereafter)
d. *IRC section 401(a)(26)* (minimum participation)
e. *IRC section 401(m)* (matching and after-tax employee contributions)
f. *IRC section 410(b)* (minimum coverage) for non-salary reduction contributions

(3) Non-salary reduction contributions of 403(b) plans maintained by **public education institutions, or governmental entities which qualify as 501(c)(3) organizations**, are **not subject to the nondiscrimination or coverage requirements** (other than *IRC section 401(a)(17)*) beginning in tax years on or after August 5, 1997 (prior to that date, governmental plans are deemed to satisfy these requirements, except *IRC section 401(a)(17)*).

(4) For 501(c)(3) organizations, under Notice 89-23, nondiscrimination requirements for non-salary reduction contributions are deemed satisfied if the employer operates the plan in accordance with a good faith reasonable interpretation of the above Code sections. The safe harbors in the notice are one means of satisfying the good faith/reasonable interpretation test.

(5) Excludable employees are those employees who have not satisfied any permissible age and service requirements of the plan, in addition to those listed in 4.72.13.6.1 (2).

(6) Employer is generally defined for purposes of nondiscrimination with respect to non-salary reduction contributions under the following provisions of *IRC section 414*:

- (b) (controlled groups)
- (c) (groups under common control)
- (m) (affiliated service groups)
- (o) (other organizations or arrangements described by regulations).

Note: Until further guidance is issued, a good faith, reasonable interpretation applies in defining the employer for this purpose. See Notice 89-23 for more detail.

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Failure to Limit Employee Elective Deferrals

Employee elective deferrals:

In Part from Publication 571 (for complete Pub 571 click here):

General Limit

Under the general limit on elective deferrals, the most that can be contributed to an employee's 403(b) account through a salary reduction agreement is the least of:

a. the employee's includible compensation for the employee's most recent year of service or
b. the 402(g) Limit ($14,000 in 2005, $15,000 in 2006, indexed thereafter).

This limit applies without regard to community property laws.

See Exceptions to these limits under Catch-up Contributions.

More than one 403(b) account. If, for any year, elective deferrals are contributed to more than one 403(b) account for the employee (whether or not with the same employer), the employee must combine all the elective deferrals to determine whether the total is more than the limit for that year.

403(b) plan and another retirement plan. If, during the year, contributions in the form of elective deferrals are made to other retirement plans on an employee's behalf, the employee must combine all of the elective deferrals to determine if they are more than the employee's limit on elective deferrals. The limit on elective deferrals applies to amounts contributed to:

- 401(k) plans, to the extent excluded from income,
- Section 501(c)(18) plans, to the extent excluded from income,
- SIMPLE plans,
- Salary reduction simplified employee pension (SARSEP) plans, and
- All 403(b) plans.

Excess elective deferrals. If the amount contributed is more than the allowable limit, the employee must include the excess in the employee's gross income for the year contributed. This is explained under Interest and Penalties.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.1.1.3 (03-01-2005)

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 *IRC section 403(b)*.

4.72.13.5 (03-01-2005)

Contribution Limits
(1) For years beginning on or after January 1, 2002, there are two separate limitations on the amount of contributions to a 403(b) plan which are excludable from gross income. These limitations are found in:

- *IRC section 402(g),* and
- *IRC section 415*

(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.

(3) All elective deferrals made by a participant to a SARSEP, 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) Under *IRC section 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 *IRC section 402(g) and IRC section 415.*

4.72.13.5.1.1 (03-01-2005)

One-Time Irrevocable Election
(1) Elective deferrals for income tax purposes do not include elective contributions made pursuant to a one-time irrevocable election that is made at:

a. initial eligibility to participate in the salary reduction agreement, or
b. 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 *IRC section 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: 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 *IRC section 402(g)* limit. They are also subject to FICA (if applicable).

Example: Assume the same facts as in the above *example*, 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 *IRC section 402(g)*. The contributions are subject to FICA (if applicable).

Note: The above *example* 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.

4.72.13.5.2 (03-01-2005)

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, contributions to a 403(b) plan (including salary reduction contributions and after-tax employee contributions) may not exceed the lesser of 100% of includible compensation or $42,000 (2005) ($44,000 (2006), indexed thereafter) in the limitation year (although *IRC section 402(g)* further limits elective deferrals to $14,000 (2005), $15,000 (2006), indexed thereafter).

(2) The 415 limit applies to contributions made to a 403(b) plan with respect to the limitation year regardless of whether they are vested.

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Plan Aggregation

In Part from Publication 571 (for complete Pub 571 click here):

Participation in a qualified plan. If an employee participates in a 403(b) plan and a qualified plan, the employee must combine contributions made to his or her 403(b) account with contributions to a qualified plan and simplified employee pensions of all corporations, partnerships, and sole proprietorships in which the employee has more than 50% control.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.5.2.2 (03-01-2005)

(1) Under *IRC section 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 controls any employer. In this situation, the 403(b) plan is treated as a defined contribution plan maintained by both the employer and the participant.

(2) Thus, 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) plan are combined with contributions to a qualified plan by the controlled employer or any affiliated employer under *IRC section 415.*

(3) 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 *IRC section 415.* Thus, the employer could contribute non-salary reduction contributions of up to $42,000 to the 403(b) plan even though the employee has contributions under the qualified plan which are at the *IRC section 415* maximum.

Example: 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. Employee A is not required to aggregate contributions under the qualified defined contribution plan with those made under the 403(b) plan for purposes of testing under IRC section 415.

Example: The facts are the same as in the above example, except that A is also 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 A's 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 *IRC section 415(c)* because A controls his private practice.

4.72.13.5.2.3 (03-01-2005)

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 IRC sections 414(b), 414(c) and 415(h).

Return to Publication

Includible Compensation:

In Part from Publication 571 (for complete Pub 571 click here):

Includible Compensation for the Employee's Most Recent Year of Service

Definition. Generally, "includible compensation for the employee's most recent year of service" is the amount of taxable wages and benefits the employee received from the employer that maintained a 403(b) account for the employee's benefit during the employee's most recent year of service.

When figuring the employee's includible compensation for the employee's most recent year of service, keep in mind that the employee's most recent year of service may not be the same as the employer's most recent annual work period. This can happen if the employee's tax year is not the same as the employer's annual work period.

When figuring includible compensation for the employee's most recent year of service, do not mix compensation or service of one employer with compensation or service of another employer.

Most Recent Year of Service

The employee's "most recent year of service" is the employee's last full year of service, ending on the last day of the employee's tax year that he or she worked for the employer that maintains a 403(b) account on the employee's behalf.

Tax year different from employer's annual work period. If the employee's tax year is not the same as the employer's annual work period, the employee's most recent year of service is made up of parts of at least two of the employer's annual work periods.

Example: A professor who reports her income on a calendar-year basis is employed on a full-time basis by a university that operates on an academic year (October through May). For purposes of figuring her includible compensation for her most recent year of service for 2005, the professor's most recent year of service consists of her service performed during January through May of 2005 and her service performed during October through December of 2005.

Figuring an Employee's Most Recent Year of Service

To figure an employee's most recent year of service, begin by determining what constitutes a full year of service for his or her position. A "full year of service" is equal to full-time employment for the employer's annual work period.

After identifying a full year of service, begin counting the service the employee has provided for the employer starting with the service provided in the current year.

Part-time or employed only part of year. If the employee is a part-time employee, or a full-time employee who is employed for only part of the year, the employee's most recent year of service consists of the employee's service this year and his or her service for as many previous years as is necessary to total one full year of service. You add up the employee's most recent periods of service to determine the employee's most recent year of service. First, take into account the employee's service during the year for which you are figuring the limit on annual additions. Then add the employee's service during his or her next preceding tax year, and years before that, until either the total service equals 1 year of service or you have taken into account all of the employee's service with the employer.

Example: Employee A was employed on a full-time basis during the months July through December 2003 (1/2 year of service), July through December 2004 (1/2 year of service), and October through December 2005 (1/4 year of service). A's most recent year of service for purposes of computing A's limit

on annual additions for 2005 is the total of A's service during 2005 (1/4 year of service), A's service during 2004 (1/2 year of service), and A's service during the months October through December 2003 (1/4 year of service).

Not yet employed for 1 year. If, at the close of the year, the employee has not yet worked for the employer for 1 year (including time the employee worked for the same employer in all earlier years), use the period of time the employee has worked for the employer as his or her most recent year of service.

Includible Compensation

After identifying the employee's most recent year of service, the next step is to identify the includible compensation associated with that full year of service.

Includible compensation is not the same as income included on the employee's tax return. "Compensation" is a combination of income and benefits received in exchange for services provided to the employer.

Generally, "includible compensation" is the amount of income and benefits:

- Received from the employer who maintains your 403(b) account, and
- Must be included in the employee's income.

The amount the employee must include in income is determined without taking into account the foreign earned income exclusion.

Includible compensation does include the following amounts:

- Elective deferrals (employer's contributions made on the employee's behalf under a salary reduction agreement).
- Amounts contributed or deferred by the employer under a section 125 cafeteria plan.
- Amounts contributed or deferred, at the election of the employee, under an eligible section 457 nonqualified deferred compensation plan (state or local government or tax-exempt organization plan).
- Wages, salaries, and fees for personal services earned with the employer maintaining the 403(b) account.
- Income otherwise excluded under the foreign earned income exclusion.
- The value of qualified transportation fringe benefits (including transit passes, certain parking, and transportation in a commuter highway vehicle between the employee's home and work).

Includible compensation does not include the following items:

1. The employer's contributions to the employee's 403(b) account
2. Compensation earned while the employer was not an eligible employer.
3. The employer's contributions to a qualified plan that:
    a. Are on the employee's behalf, and
    b. Are excludable from income.
4. The cost of incidental life insurance.

Contributions after retirement. Nonelective contributions may be made for an employee for up to five years after retirement. These contributions would be based on includible compensation for the last year of service before retirement.

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Catch-Up Contributions:

Age 50 Catch-Up Contributions/Year-of-Service Catch-Up

In Part from Publication 571 (for complete Pub 571 click here):

The most that can be contributed to an employee's 403(b) account by salary reduction is the lesser of the employee's limit on annual additions or his or her limit on elective deferrals.

If the employee will be age 50 or older by the end of the year, the employee may also be able to make additional catch-up contributions. These additional contributions cannot be made with after-tax employee contributions.

The employee is eligible to make catch-up contributions if:

- The employee will have reached age 50 by the end of the year, and
- The maximum amount of elective deferrals that can be made to the employee's 403(b) account have been made for the plan year.

The maximum amount of catch-up contributions is the least of:

- $4,000 for 2005 ($5,000 for 2006, indexed thereafter), or
- The employee's includible compensation minus his or her other elective deferrals for the year.

Figuring catch-up contributions. When figuring allowable catch-up contributions, combine all catch-up contributions made by the employer on the employee's behalf to the following plans.

- Qualified retirement plans. (To determine if the plan is a qualified plan. ask the plan administrator.)
- 403(b) plans.
- Salary reduction simplified employee pension (SARSEP) plans.
- SIMPLE plans.

TIP *Catch-up contributions do not affect the employee's maximum contribution limit. Therefore, the maximum amount that an employee is allowed to have contributed to his or her 403(b) account is the employee's MAC plus the allowable catch-up contribution.*

Worksheet C in chapter 9 of Publication 571 can be used to figure an employee's limit on catch-up contributions.

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Years-of-Service Catch-up and Certain Employers:

15-Year Rule

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.5.1.2 (03-01-2005)

Catch-Up Election
(1) Section 402(g)(7) 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 $14,000 for 2005 ($15,000 for 2006, indexed thereafter) limit.

(2) **The election is available only to** an employee who has completed at least 15 years of service (defined in *IRC section 403(b)*) with an employer that is either a(n):

a. educational organization
b. hospital
c. home health service agency
d. health and welfare service agency
e. church
f. related church organization.

(3) With the exception of churches, years with different employers cannot be added together for purposes of satisfying the 15-year requirement.

(4) Under the election, the annual limitation is increased by the smallest of:

a. $3,000,
b. $15,000 minus any elective deferrals made by the organization and previously excluded under the catch-up election, or
c. $5,000 times the employee's years of service minus the elective deferrals made to plans of the organization in prior taxable years.

(5) As can be seen from this election, there is an aggregate limit on increases under the election of $15,000, and the annual limit cannot exceed $17,000 for 2005 ($14,000 + $3,000). The catch-up applies to elective deferrals made by the qualified organization on behalf of the employee. The catch-up election is per employer and not per employee.

(6) For an individual who attains age 50 prior to the end of the year, there is an additional catch-up of $4,000 in 2005 and $5,000 in 2006 (indexed thereafter).

Employee with 15 Years of Service:

In Part from Publication 571 (for complete Pub 571 click here):

Years of Service

To determine if an employee is eligible for the increased limit on elective deferrals you will first need to figure the employee's "years of service." How years of service if figured depends on whether the employee was a full-time or a part-time employee, whether the employee worked for the full year or only part of the year, and whether the employee worked for the employer for an entire year.

Years of service must be figured for each year during which the employee worked for the employer who is maintaining the 403(b) account.

If more than one employer maintains a 403(b) account for the employee in the same year, years of service must be figured separately for each employer.

Definition
"Years of service" are the total number of years the employee has worked for the employer maintaining the 403(b) account as of the end of the year.

Figuring Years of Service
Take the following rules into account when figuring years of service.

Status of employer. Years of service include only periods during which the employer was a qualified employer. The plan administrator can tell you whether or not the employer was qualified during all the employee's periods of service.

Service with one employer. Generally, the employee cannot count service for any employer other than the one who maintains the 403(b) account.

Church employee. If the employee is a church employee, treat all of the employee's years of service with related church organizations as years of service with the same employer.

Self-employed ministers. If the employee is a self-employed minister, his or her years of service include full and part years in which the employee has been treated as employed by a tax-exempt organization that is a qualified employer.

Less than one year of total service. Years of service cannot be less than one year. If at the end of the employee's tax year, the employee has less than one year of service (including service in any previous years), figure his or her limit on annual additions as if the employee has one year.

Total years of service. When figuring years of service, figure each year individually and then add the individual years of service to determine the employee's total years of service, ending with the year for which the limit on annual additions is being calculated. The total years of service will be used when figuring the employee's limit on annual additions.

Example: The annual work period for full-time teachers employed by ABC Public Schools is September through December and February through May. Marsha began working with ABC schools in September 2001. She has always worked full time for each annual work period. At the end of 2005, Marsha had 4.5 years of service with ABC Public Schools, as shown below:.

Note. *This table shows how Marsha figures her years of service, as explained in the previous example.*

Marsha's Years of Service

Year	Period Worked	Portion of Work Period	Years of Service
2001	Sept.-Dec.	.5 year	.5 year
2002	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2003	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2004	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
2005	Feb.-May	.5 year	1 year
	Sept.-Dec.	.5 year	
Total years of service			4.5 years

Full time or part time. To figure an employee's years of service, you must analyze each year individually and determine whether the employee worked full time for the full year or something other than full time. When determining whether the employee worked full time or something other than full time, use the employer's annual work period as the standard.

Employer's annual work period. "Employer's annual work period" is the usual amount of time an individual working full time in a specific position is required to work. Generally, this period of time is expressed in days, weeks, months, or semesters and can span two calendar years.

Example: All full-time teachers at ABC Public Schools are required to work both the September through December semester and the February through May semester. Therefore, the annual work period for full-time teachers employed by ABC Public Schools is September through December and February through May. Teachers at ABC Public Schools who work both semesters in the same calendar year are considered working a full year of service in that calendar year.

Full-Time Employee for the Full Year

Count each full year during which the employee was employed full time as one year of service. In determining whether the employee was employed full time, compare the amount of work the employee was required to perform with the amount of work normally required of others who held the same position with the same employer and who generally received most of their pay from the position.

How to compare. Any method that reasonably and accurately reflects the amount of work required can be used. For example, if the employee is a teacher, you can use the number of hours of classroom instruction as a measure of the amount of work required.

In determining whether positions with the same employer are the same, consider all of the facts and circumstances concerning the positions, including the work performed, the methods by which pay is determined, and the descriptions (or titles) of the positions.

Example: An assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he or she is required to perform is the same as the amount of work normally required of assistant professors of English at that university who get most of their pay from that position.

If no one else works for the employer in the same position, compare the employee's work with the work normally required of others who held the same position with similar employers or similar positions with the employer.

Full year of service. A full year of service for a particular position means the usual annual work period of anyone employed full time in that general type of work at that place of employment.

Example: If a doctor works for a hospital 12 months of a year except for a one-month vacation, the doctor will be considered as employed for a full year if the other doctors at that hospital also work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches these semesters will be considered as working a full year.

Other than Full Time for the Full Year

If, during any year, the employee was employed full time for only part of the employer's annual work period, part time for the entire annual work period, or part time for only part of the work period, the employee's year of service for that year is a fraction of the employer's annual work period.

Full time for part of the year. If, during a year, the employee was employed full time for only part of the employer's annual work period, figure the fraction for that year as follows:

- The numerator (top number) is the number of weeks, months, or semesters the employee was a full-time employee.
- The denominator (bottom number) is the number of weeks, months, or semesters considered the normal annual work period for the position.

Example: Jason was employed as a full-time instructor by a local college for the 4 months of the 2004 spring semester (February 2004 through May 2004). The annual work period for the college is 8 months (February through May and July through October). Given these facts, Jason was employed full time for part of the annual work period and provided 1/2 of a year of service.

Part time for the full year. If, during a year, the employee was employed part time for the employer's entire annual work period, figure the fraction for that year as follows:

- The numerator (top number) is the number of hours or days you worked.
- The denominator (bottom number) is the number of hours or days required of someone holding the same position who works full time.

Example: Vance teaches one course at a local medical school. He teaches 3 hours per week for two semesters. Other faculty members at the same school teach 9 hours per week for two semesters. The annual work period of the medical school is two semesters. An instructor teaching 9 hours a week for two semesters is considered a full-time employee. Given these facts, Vance has worked part time for a full annual work period. Vance has completed 1/3 of a year of service.

Part time for part of the year. If, during any year, the employee was employed part time for only part of the employer's annual work period, figure the fraction for that year by multiplying two fractions.

Figure the first fraction as though the employee had worked full time for part of the annual work period. The fraction is as follows:

- The numerator (top number) is the number of weeks, months, or semesters the employee was a full-time employee.
- The denominator (bottom number) is the number of weeks, months, or semesters considered the normal annual work period for the position.

Figure the second fraction as though the employee had worked part time for the entire annual work period. The fraction is as follows:

- The numerator (top number) is the number of hours or days the employee worked.
- The denominator (bottom number) is the number of hours or days required of someone holding the same position who works full time.

Once these two fractions have been figured, multiply them together to determine the fraction representing the employee's partial year of service for the year.

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Failure to Timely Return Excess Elective Deferrals and Earnings

Additional taxes and penalties: Distributed timely: Corrective distributions:

Additional Taxes and Penalties:

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.5.1.3.2 (03-01-2005)

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 for affected contracts unless the excess deferrals are timely corrected.

a. 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.
b. The distribution may be made notwithstanding any other provision of law.
c. 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.
d. The issuer must file a Form 1099-R indicating the distribution.

(2) If a contract loses its status as a 403(b) because of paragraph (1) above, the affected annuity contract (or custodial account) loses its status under section 403(b) for the taxable year of the violation. Thus, all amounts contributed to the affected annuity contract or contracts for the year of the violation are includible in gross income.

a. The excess deferrals are taxable again on distribution.
b. 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.

In Part from Publication 571 (for complete Pub 571 click here):

Tax treatment of excess deferrals. If the excess deferral is **distributed no later than April 15**, it is included in your income in the year contributed and the earnings on the excess deferral will be taxed in the year distributed.

Example: William's maximum contribution for 2004 was $13,000. All of William's contributions were made through salary reductions. He contributed $14,000 in 2004, an excess deferral of $1,000. He notified his plan administrator and his employer of the excess contribution on March 15, 2005, and the excess deferral was distributed on April 13, 2005. Because the excess deferral was distributed before April 15, 2005, the excess deferral will be included in his income for 2004, and any earnings on the excess is included in his income in the year they are distributed.

If you do not receive a distribution of excess elective deferrals by April 15 of the year following the year it is contributed, it will be included in your earned income in the year contributed and in the year distributed.

Example: Assume that, in the above example, a distribution of the excess deferral was not made to William by April 15, 2005. Because the distribution was not made timely, the excess deferral will be taxed in 2004 (the year contributed) and again in the year the excess deferral is distributed. The earnings on the distribution will be taxed in the year they are distributed.

Excess Annual Addition
An excess annual addition is a contribution that is more than the employee's limit on annual additions determined under IRC 415 Limits.

In the year that the employee's contributions are more than his or her limit on annual additions, the excess amount will be included in the employee's income.

Amounts in excess of the limit on annual additions that are due to elective deferrals may be distributed if the excess contributions were made for any one of several reasons, including:

- A reasonable error in determining the amount of elective deferrals that could be made under the limit on annual additions, or
- A reasonable error in estimating your compensation.

Excise Tax
If the employee's 403(b) account invests in mutual funds, and the limit on annual additions is exceeded, the employee may be subject to a 6% excise tax on the excess contribution. The excise tax does not apply to funds in an annuity account or to excess deferrals.

The excise tax must be paid each year in which there are excess contributions in the account. Excess contributions can be corrected by contributing less than the applicable limit in later years or by making permissible distributions. The excise tax cannot be deducted.

Reporting requirement. Form 5330 must be filed if there has been an excess contribution to a custodial account and that excess has not been corrected.

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Failure to Properly Withhold

Responsible (for underpayment and penalties):

Publication 15 Excerpt (for complete Pub 15 click here):

Collecting underwithheld taxes from employees. If you withheld no income, social security, or Medicare taxes or less than the right amount from an employee's wages, you can make it up from later pay to that employee. **But you are the one who owes the underpayment**. Reimbursement is a matter for settlement between you and the employee. Underwithheld income tax must be recovered from the employee on or before the last day of the calendar year.

Trust fund recovery penalty. If income, social security, and Medicare taxes that must be withheld are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the employer or business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so.

A responsible person can be an officer or employee of a corporation, a partner or employee of a partnership, an accountant, a volunteer director/trustee, or an employee of a sole proprietorship. A responsible person also may include one who signs checks for the business or otherwise has authority to cause the spending of business funds.

Willfully means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows that the required actions are not taking place.

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Failure to Identify and Report Defaulted Loans

Provisions of section 72(p):

In Part from Publication 575 (for complete Pub 575 click here):

Exception for qualified plan, 403(b) plan, and government plan loans. At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (403(b) plan), or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

- Is used to buy the employee's main home, or
- Must be repaid within 5 years.

If a loan qualifies for this exception, the employee must treat it as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all the employee's loans from all plans of the employer (and certain related employers) exceeds the lesser of:

- $50,000, or
- Half the present value (but not less than $10,000) of the employee's nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

The employee must reduce the $50,000 amount if he or she already had an outstanding loan from the plan during the 1-year period ending the day before the employee took out the loan. The amount of the reduction is the highest outstanding loan balance during that period minus the outstanding balance on the date the employee took out the new loan. If this amount is zero or less, ignore it.

Substantially level payments. To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan. This level payment requirement does not apply to the period in which the employee is on a leave of absence without pay or on a rate of pay that is less than the required installment. Generally, this leave of absence must not be longer than one year. The employee must repay the loan within 5 years from the date of the loan (unless the loan was used to buy the employee's main home). The installment payments must not be less than the original payments.

However, if the plan suspends the loan payments for any part of the period during which the employee is in the uniformed services, the employee will not be treated as having received a distribution even if the suspension is for more than one year and the term of the loan is extended. The loan payments must resume upon completion of such period and the loan must be repaid within 5 years from the date of the loan (unless the loan was used to buy the employee's main home) plus the period of suspension.

Example: On July 1, 2004, you borrowed $40,000 from your retirement (403(b)) plan. The loan was to be repaid in level monthly installments over 5 years. The loan was not used to buy your main home. You make 9 monthly payments and start an unpaid leave of absence that lasts for 12 months. You were not in a uniformed service during this period. You must repay this loan by June 30, 2009 (5 years from the date of this loan). You can increase your monthly installments or you can make the original monthly installments and on June 30, 2009, pay the balance.

Example: The facts are the same as in the above example, except that you are on a leave of absence performing service in the uniformed services for two years. The loan payments were suspended for that period. You must resume making loan payments at the end of that period and the loan must be repaid by June 30, 2011 (5 years from the date of the loan plus the period of suspension).

Denial of interest deduction. If the loan from a qualified plan is not treated as a distribution because the exception applies, the employee cannot deduct any of the interest on the loan during any period that:

- The loan is secured by amounts from elective deferrals under a qualified cash or deferred arrangement (section 401(k) plan) or a salary reduction agreement to purchase a tax-sheltered annuity, or
- The employee is a key employee as defined in section 416(i) of the Internal Revenue Code.

Reporting by plan. If the loan is treated as a distribution, you should receive a Form 1099-R showing code "L" in box 7.

In Part from Publication 575 (for complete Pub 575 click here):

Loans Treated as Distributions

If the employee borrows money from the retirement (403(b)) plan, you must treat the loan as a nonperiodic distribution from the plan unless it qualifies for the exception explained above. This treatment also applies to any loan under a contract purchased under the retirement (403(b)) plan, and to the value of any part of the employee's interest in the plan or contract that the employee pledges or assigns (or agrees to pledge or assign). It applies to loans from both qualified and nonqualified plans, including commercial annuity contracts the employee purchases directly from the issuer. Further, it applies if the employee renegotiates, extends, renews, or revises a loan that qualified for the exception above if the altered loan does not qualify. In that situation, the employee must treat the outstanding balance of the loan as a distribution on the date of the transaction.

How much of the loan is taxable is determined using the allocation rules for nonperiodic distributions discussed under Figuring the Taxable Amount, Publication 575. The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):
4.72.13.8.5 (03-01-2005)

Early Distribution Tax under *IRC section 72(t)*
(1) *IRC section 72(t)* restricts premature distributions from a 403(b) plan by imposing a 10% additional income tax with respect to distributions that are made prior to the events described in *IRC section 72(t)*. These events differ from those under *IRC sections 403(b)(7)* and *(b)(11)* which prevents access to the funds prior to the events described therein.

(2) The section 72(t) tax generally applies to all distributions except for those:

a. made after the attainment of age 59 1/2, separation from service after age 55, death, disability, or
b. which are part of a series of substantially equal payments made over the life or life expectancy of the employee or the joint lives or life expectancies of the employee and the employee's designated beneficiary.

(3) A distribution allowable under *IRC section 403(b)(7)* or *(b)(11)* may nevertheless be subject to *IRC section 72(t).*

- For example, the tax applies to early distributions of non-salary reduction contributions made to an annuity contract even though IRC section 403(b)(11) would not restrict such distributions.

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Failure to Satisfy Hardship Distributions Requirements

Financial hardship:

Hardship distributions. A 403(b) plan may allow an employee to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 403(b) plan are limited to the amount of the employee's elective deferrals and generally do not include any income earned on the deferred amounts. If the plan permits, certain employer matching contributions and employer discretionary contributions may also be included in hardship distributions. Hardship distributions cannot be rolled over to another plan or IRA.

A distribution is treated as a hardship distribution only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution is made both on account of an **immediate and heavy financial need** of the employee and is **necessary to satisfy that financial need**. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

A distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to the employee's total elective deferrals as of the date of distribution, reduced by the amount of previous distributions of elective contributions.

Under the Proposed 403(b) Regulations, rules governing Hardship Distributions from 403(b) plans are the same as those for Cash or Deferred Arrangements (401(k)). See section 1.401(k)-1(d)(3) of the 401(k) regulations for details on hardship distributions.

Immediate and Heavy Financial Need

Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. **A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.**

A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- Funeral expenses; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

Distribution necessary to satisfy financial need. A distribution may not be treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee.

This determination generally is to be made on the basis of all relevant facts and circumstances. The employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

An immediate and heavy financial need generally may be treated as not capable of being relieved from other resources reasonably available to the employee if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

- Through reimbursement or compensation by insurance or otherwise;
- By liquidation of the employee's assets;
- By cessation of elective contributions or employee contributions under the plan; or
- By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

A need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

- The distribution is not in excess of the amount of the immediate and heavy financial need of the employee.
- The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer.

Distributions and Rollovers

Rollover:

In Part from Publication 571 (for complete Pub 571 click here):

Tax-Free Rollovers

An employee can generally roll over tax free all or any part of a distribution from a 403(b) plan to a traditional IRA or an eligible retirement plan. The most that can rolled over is the amount that, except for the rollover, would be taxable. The rollover must be completed by the 60th day following the day on which the distribution is received.

Rollovers to and from 403(b) plans. An Employee can roll over, tax free, all or any part of a distribution from an eligible retirement plan to a 403(b) plan.

If a distribution includes both pre-tax contributions and after-tax contributions, the portion of the distribution that is rolled over is treated as consisting first of pre-tax amounts (contributions and earnings that would be includible in income if no rollover occurred). This means that if the employee rolls over an amount that is at least as much as the pre-tax portion of the distribution, he or she does not have to include any of the distribution in income.

For more information on rollovers and eligible retirement plans, see Publication 575.

If money or other property is rolled over from a 403(b) plan to an eligible retirement plan, see Publication 575 for information about possible effects on later distributions from the eligible retirement plan.

Nonqualifying distributions*.* You cannot roll over tax free:

- Minimum distributions (generally required to begin at age 70 1/2),
- Substantially equal payments over an employee's life or life expectancy,
- Substantially equal payments over the joint lives or life expectancies of an employee's beneficiary and the employee,
- Substantially equal payments for a period of 10 years or more,
- Hardship distributions, or
- Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or excess annual additions and any allocable gains.

Eligible retirement plans*.* The following are considered eligible retirement plans.

- Individual retirement arrangements.
- Qualified retirement plans. (To determine if the plan is a qualified plan, ask the plan administrator.)
- 403(b) plans.
- Government eligible 457 plans.

Direct rollovers of 403(b) plan distributions. An employee has the option of having the 403(b) plan make the rollover directly to the IRA or new plan. Before the employee receives a distribution, the plan will give him or her information on this. It is generally to the employee's advantage to choose this option because the plan will not withhold tax on the distribution if the employee chooses it.

Withholding. If an employee receives a distribution that qualifies to be rolled over, the payer must withhold 20% of it for taxes (even if the employee plans to roll the distribution over).

Distribution received by the employee. If the employee receives a distribution that qualifies to be rolled over, the employee can roll over all or any part of the distribution. Generally, the employee will receive only 80% of the distribution because 20% must be withheld. If the employee rolls over only the 80% received, tax must be paid tax on the 20% not rolled over. The employee can replace the 20% that was withheld with other money within the 60-day period to make a 100% rollover.

Hardship exception to rollover rules. The IRS may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

To obtain a hardship exception, the employee must apply to the IRS for a waiver of the 60-day rollover requirement. Apply for the waiver by following the general instructions used in requesting a letter ruling. These instructions are stated in Revenue Procedure 2005-4 found in Internal Revenue Bulletin 2005-1. A user fee must be paid with the application.

In determining whether to grant a waiver, the IRS will consider all relevant facts and circumstances, including:

1. Whether errors were made by the financial institution,
2. Whether the employee was unable to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
3. Whether the employee used the amount distributed (for example, in the case of payment by check, whether the check was cashed), and
4. How much time has passed since the date of distribution.

Excess employer contributions. The portion of a distribution from a 403(b) plan transferred to a traditional IRA that was previously included in income as excess employer contributions is not an eligible rollover distribution.

Its transfer does not affect the rollover treatment of the eligible portion of the transferred amounts. However, the ineligible portion is subject to the traditional IRA contribution limits and may create an excess IRA contribution subject to a 6% excise tax (see chapter 1 of Publication 590).

Qualified Domestic Relations Order. An employee may be able to roll over tax free all or any part of an eligible rollover distribution from a 403(b) plan that the employee receives under a qualified domestic relations order (QDRO). If the interest in the 403(b) plan is received as an employee's spouse or former spouse under a QDRO, all of the rollover rules apply as if it were received by the employee. The interest in the plan can be rolled over to an eligible plan or another 403(b) plan. For more information on the treatment of an interest received under a QDRO, see Publication 575.

Spouses of deceased employees. The spouse of a deceased employee can roll over the qualifying distribution attributable to the employee. The rollover can be made to any eligible retirement plan. It cannot be rolled over to a Roth IRA.

If after money and other property is rolled over from a 403(b) plan to an eligible retirement plan, a distribution is taken from that plan, the employee will not be eligible to receive the capital gain treatment or the special averaging treatment for the distribution.

Second rollover. If a qualifying distribution is rolled over to a traditional IRA, the employee can, if certain conditions are satisfied, later roll the distribution into another 403(b) plan. For more information, see IRA as a holding account (conduit IRA) for rollovers to other eligible plans, in Publication 590.

Frozen deposits. The 60-day period usually allowed for completing a rollover is extended for any time that the amount distributed is a frozen deposit in a financial institution. The 60-day period cannot end earlier than 10 days after the deposit ceases to be a frozen deposit.

A frozen deposit is any deposit that on any day during the 60-day period cannot be withdrawn because:

1. The financial institution is bankrupt or insolvent, or
2. The state where the institution is located has placed limits on withdrawals because one or more banks in the state are (or are about to be) bankrupt or insolvent.

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Eligible Distribution:

Distributions

IRS 403(b) Examination Guidelines Excerpt (for complete [403(b) Exam Guidelines click here](#)):
4.72.13.8 (03-01-2005)

Early Distribution Restrictions
(1) Congress intended that pre-tax contributions to a 403(b) plan should generally be used for retirement and thus, *IRC section 403(b)* imposes early distribution restrictions on contributions to a 403(b) annuity contract. These restrictions are based on distribution events and relate to the earliest date at which distributions from a 403(b) annuity contract may be made. Distributions generally may not be made prior to a distribution event. A 403(b) plan may properly distribute amounts any time after such an event has occurred (as long as the minimum distribution rules are complied with).

4.72.13.8.1 (03-01-2005)

Annuity Contracts
(1) Under *IRC section 403(b)(11)*, salary reduction contributions (and amounts attributable thereto) used to purchase annuity contracts described in section 403(b)(1) for years beginning after December 31, 1988, are not permitted to be distributed earlier than:

a. attainment of age 59 1/2
b. death
c. disability
d. severance of employment or
e. hardship of the employee (not including earnings).

Note: Amounts held in a 403(b)(1) annuity contract as of the close of the last year beginning before January 1, 1989, and amounts contributed as non-salary reduction contributions are not subject to distribution restrictions.

(2) Certain loans may also violate *IRC section 403(b)(11) or (b)(7)*. For example, a loan that is repaid through a reduction in the participant's accrued benefit results in an actual distribution for purposes of *IRC section 403(b)(11).*

Example: Employee A began participating in a 403(b) plan (Plan) in 1989. The Plan is funded through both salary reduction and non-salary reduction contributions, which are invested in annuity contracts. A is 30 years old, has not separated from service and is not disabled. In 2005, A makes a $5,000 withdrawal that is not a hardship withdrawal. If any portion of the withdrawal is attributable to salary reduction contributions and the earnings thereon, the early distribution restrictions of *IRC section 403(b)(11)* would be violated.

Example: The same facts as to the above **example,** except that the Plan provides only for non-salary reduction contributions. A's withdrawal does not violate *IRC section 403(b)(11)* (although A must pay an early distribution tax under *IRC section 72(t)).*

4.72.13.8.2 (03-01-2005)

Custodial Accounts
(1) Under *IRC section 403(b)(7)*, a distribution from a custodial account may not be paid or made available to a distributee before the employee attains age 59 1/2 , severs employment, dies or becomes disabled.

(2) Salary reduction contributions may be distributed upon hardship of the employee.

Example: Employee A is a participant in a 403(b) plan (Plan). Contributions under the Plan are strictly non-salary reduction. In 2005, A withdraws $10,000 from the Plan. A has not severed employment or become disabled. A is 40 years old. The funds in A's 403(b) account are invested in a custodial account. Since the contributions are invested in a custodial account, A's withdrawal violates *IRC section 403(b)(7).*

In Part from Publication 571 (for complete Pub 571 click here):

Minimum Required Distributions

An employee must receive all, or at least a certain minimum, of his or her interest accruing after 1986 in the 403(b) plan by April 1 of the calendar year following the later of the calendar year in which the employee become age 70 1/2 or the calendar year in which the employee you retires.

Check with the employer, plan administrator, or provider to find out whether this rule also applies to pre-1987 accruals. If not, a minimum amount of these accruals must begin to be distributed by the later of the end of the calendar year in which the employee reaches age 75 or April 1 of the calendar year following retirement, whichever is later. For each year thereafter, the minimum distribution must be made by the last day of the year. If the employee does not receive the required minimum distribution, the employee is subject to a nondeductible 50% excise tax on the difference between the required minimum distribution and the amount actually distributed.

For more information on minimum distribution requirements and the additional tax that applies if too little is distributed each year, see Publication 575.

No Special 10-Year Tax Option

A distribution from a 403(b) plan does not qualify as a lump-sum distribution. This means the employee cannot use the special 10-year tax option to calculate the taxable portion of a 403(b) distribution. For more information, see Publication 575.

4.72.13.7.4 (03-01-2005)

Excise Taxes

For years after December 31, 1988, the excise tax under IRC section 4974 for failure to make minimum distributions applies to 403(b) plans.

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(Non) Compliance Issues.

IRS 403(b) Examination Guidelines Excerpt (for complete 403(b) Exam Guidelines click here):

CONTRACT LAGUAGE REQUIREMENTS

4.72.13.5.1.3 (03-01-2005)

Contract Limit

(1) As indicated in text 13.5.1.2, *IRC section 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.

4.72.13.5.1.3.1 (03-01-2005)

Contract Terms

(1) Under *IRC section 403(b)(1)(E)*, a contract purchased by an employer must comply with the requirements of *IRC section 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 *IRC section 402(g)*. Thus, in order to be a valid contract under *IRC section 403(b),* the contract by its terms must preclude the making of excess deferrals.

(3) Section 403(b) contracts must reflect the 402(g) limit.

4.72.13.10 (03-01-2005)

Tax Consequences of *IRC Section 403(b)* Failures

(1) This section lists typical *IRC section 403(b)* failures or defects and indicates the scope of resulting tax consequences.

(2) In general, there are three categories of failures:

a. plan failures,
b. annuity contract failures, and
c. transactional failures. Note: Because of overlap, however, these categories should be used as a guide only and any failure discovered on an examination should be analyzed based on the particular facts related to the failure.

(3) In general, plan failures affect the plan as a whole and result in income inclusion with respect to all annuity contracts purchased under the plan.

(4) Annuity contract failures generally relate to the annuity contract and result in income inclusion with respect to the affected annuity contract.

(5) Transactional failures generally arise from a transaction with respect to an otherwise valid 403(b) plan or annuity contract. They result in income inclusion with respect to a portion of contributions made to purchase the annuity contract.

(6) These failures may also result in additional income tax withholding, FICA taxes, FUTA taxes (with respect to an ineligible employer), FICA and FUTA withholding, and excise taxes. However, if the failures are corrected pursuant to one of the Service's correction programs, the Service will not pursue the collection of income tax or withholding for income tax resulting from the failure. Corrections of failures may result in their own tax consequences.

4.72.13.10.1 (03-01-2005)

Plan Failures
(1) Plan failures cause a plan not to be a 403(b) plan.

a. The plan for this purpose is the aggregate annuity contracts (including custodial accounts and retirement income accounts) established by the employer on behalf of its employees, unless the plans are separate or the plans are properly disaggregated.
b. Except with respect to text 4.72.13.10.1.1, employer is defined as the common law employer and any related employer under IRC section 414(b), (c), (m) or (o).

(2) For plan failures, all contributions made to the plan beginning in the taxable year of the failure are includible in the participants' gross income (except contributions subject to a substantial risk of forfeiture). Contributions made under a defective 403(b) plan may not be rolled over to an eligible retirement plan.

(3) Ineligible employer. If the employer was never eligible to maintain a 403(b) plan, the plan was never a 403(b) and *IRC section 403(c)* or *IRC section 83* governs.

a. If the employer was a 501(c)(3) organization but loses its 501(c)(3) status, the exclusion is lost for any contributions made while the employer is ineligible.
b. The plan may regain its status as a 403(b), but includible compensation includes only compensation earned during the most recent one-year period of service while the employer was eligible, and only years of service performed while the employer was a 501(c)(3) organization are included in years of service.

(4) Annuity contracts not purchased until participants reach retirement age or status. In this case, the plan is intended to be funded through annuity contracts (and not custodial accounts) but the employer fails to purchase the annuity contracts (until retirement age). In the absence of appropriate funding vehicles, the plan from its inception is not a 403(b) plan.

(5) Discrimination with respect to non-salary reduction (including matching and non-matching) or salary reduction contributions. The *IRC section 4979* excise tax may apply if the plan has excess aggregate contributions under *IRC section 401(m)(6).*

(6) Failure to satisfy the minimum participation rules.

(7) Inadequate coverage.

4.72.13.10.2 (03-01-2005)

Annuity Contract Failures
(1) Following is a list of failures that generally pertain to the annuity contract.

a. These failures cause a participant's annuity contract to fail to satisfy the requirements of *IRC section 403(b)*, and consequently, all contributions made under the annuity contract in the taxable year of the failure will be includible in the participant's gross income (except contributions that are subject to a substantial risk of forfeiture).
b. The earnings on premiums paid for the purchase of a 403(b)(1) annuity contract (and not custodial accounts) are not includible in gross income.

(2) Annuity contract failures may also cause other problems for the plan. If the failure is systemic, the plan in its entirety may be adversely affected. For example, this might be true in failures a. through e., g. and j. below if a single insurer or custodian is involved.

a. Annuity contract not purchased from an insurance company or not a 403(b) annuity contract (for example, the purchase of a life insurance contract).
b. Custodial account not maintained by bank or an approved non-bank trustee.
c. Failure of custodial account to invest exclusively in regulated investment company stock.
d. Violation of incidental death benefit requirements.
e. Failure of annuity contract (and not a custodial account) to satisfy the nontransferability requirement of *IRC section 401(g)* (in either form or operation).
f. Impermissible distribution under *IRC section 403(b)(7)* or (b)(11). This failure includes an improper transfer (see *Rev. Rul. 90-24*), a distribution disguised as a loan, and the executing on a security in the event of default on a loan. The *IRC section 72(t)* tax may also apply.
g. Failure to provide a direct rollover (in form or operation).
h. Pattern of violating the minimum distribution rules.
i. Uncorrected excess deferrals. The exclusion does not apply with respect to an annuity contract with excess deferrals that are not timely corrected. The excess deferrals are includible in gross income in both the year contributed and the year distributed. See *IRC section 402(g)(6)* and text 4.72.13.5.
j. Failure of annuity contract to preclude excess deferrals. For plan years beginning on or after January 1, 1998, the exclusion does not apply with respect to contributions made to purchase the contract.

4.72.13.10.3 (03-01-2005)

Transactional Failures

(1) Following is a list of failures that do not adversely affect the 403(b) status of the annuity contract or plan as a whole.

a. Excess 415 amounts. Excess 415 amounts result in current income inclusion of the excess. The annuity contract or custodial account is bifurcated into a non-qualified annuity (comprised of the excess and earnings thereon) and qualifying 403(b) annuity. If excess 415 amounts are made to a custodial account, the *IRC section 4973* excise tax also applies. See text 4.72.13.5.2.
b. Certain loans. The amount of a loan that does not satisfy the requirements of *IRC section 72(p)* is a deemed distribution that is includible in gross income. (If the participant's account balance is reduced to satisfy the loan balance, there is an actual distribution which could violate *IRC sections 403(b)(11)* and (b)(7) and the failure becomes an annuity contract failure.)
c. Isolated instance of failure to satisfy minimum distribution requirements. The participant may be subject to the *IRC section 4974* excise tax if the tax is not waived by the Service. The required minimums are includible in gross income on distribution.
d. Salary reduction agreement not legally binding. Amounts contributed under the inadequate agreement are includible in gross income. In the absence of non-salary reduction contributions, the entire annuity contract is adversely affected. This failure may also overlap with a failure to provide salary reduction contributions universally to all non-excludable employees. See text 4.72.13.4.
e. Salary reduction agreement applies to amounts currently available to the employees at the effective date of the agreement.
f. Participation of non-employees.
g. Timely corrected excess deferrals.

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