

Coping with IRS 403(b) Audits - A Guide for What to Expect

The Internal Revenue Service (IRS) is continuing to audit 403(b) plans, even though, to date, the IRS' 403(b) audit guidelines have not updated for the final 403(b) regulations. **Be prepared**—the IRS may request numerous documents and information relating to your 403(b) plan. Understanding what information could be requested and ensuring you have access to that information will make your IRS audit go smoothly.

How will I be notified that the IRS intends to audit our 403(b) plan?

The IRS will typically send a letter or make a phone call to the 403(b) plan sponsor. The IRS auditor will provide an overview of the audit process, establish primary contacts and point persons, review types of information that will be requested and may establish a physical location for the auditor, which could be in the employer's office. Subsequent information and data will be requested via IRS Form 4564, entitled "Information Document Requests" (IDRs).

Who should be involved with an IRS audit?

The IRS will be looking for specific documentation and explanation of processes and procedures for administration of the 403(b) plan. Therefore, your human resources and the payroll employees may need to be involved in an IRS audit as well as investment providers you have approved under the plan and, if applicable, your third party administrator. Management is generally not directly involved in the IRS audit but should be informed of the audit. In addition, you should consider involving your legal counsel in the audit process.

What are some of the issues found by an IRS examiner when auditing 403(b) plans and what do I need to provide to the IRS examiner?

Based on its audits of 403(b) plans, the IRS has identified several recurring issues. These issues are listed below, along with suggested documentation that you should keep in your files to demonstrate your plan's compliance to the IRS.

IRS Issue: Plan contributions in excess of the Code limits, including any applicable catch-up limits

What documentation should I have in my files?

- √ Worksheets showing how much a participant is permitted to contribute to the plan for each year
- √ Salary reduction agreements indicating the amount each participant has elected to contribute to the plan
- √ Employment records including salary history
- √ Procedures for distributing excess contributions, including applicable tax reporting

What are the IRS Limits on 403(b) Plan Contributions?

The IRS limits the amounts that can contribute to an employee's 403(b) account each year. For longer service employees and employees who are at least age 50, this limit may be increased by available catch-up contribution provisions. A participant who is eligible for both catch-ups must use the 15-year special catch-up *before* contributing under the age 50+ catch-up.

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1. **Elective Deferral Limit:** In general, the total amount that an employee can contribute either as a pre-tax deferral and/or as Roth 403(b) contributions to a 403(b) plan (as well as any other such employee contributions to 401(k) plans, SIMPLE retirement accounts or salary reduction simplified employee pensions) during the year is \$16,500 in 2010.
2. **15-Year Special Catch-up:** If an employee has completed at least 15 full years of service with his current employer and that employer is an educational organization, hospital, home health service agency, health and welfare service agency, church or convention or association of churches (or associated organization), he may increase the annual deferral limit by the *smallest* of :
 - \$3,000;
 - \$15,000 minus any elective deferrals made by the organization and previously excluded under the catch-up election; or
 - \$5,000 times the employee's years of service minus the elective deferrals made to plans of the organization in prior taxable years, not to exceed \$15,000 cumulatively over the 403(b) participant's lifetime.
3. **Age 50+ Catch-up:** a participant who is at least age 50 by the end of the year may contribute an additional amount up to \$5,500 in 2010.

The IRS also reviews total contributions made to a 403(b) plan under an annual additions limit. This annual additions limit provides that the total amount of employer and employee contributions (other than the age 50+ catch-up contributions) and forfeitures made to an employee's 403(b) participant account during a 12-month period (typically, the calendar year) cannot be more in 2010 than 100% of compensation up to \$49,000.

IRS Issue: Excluding eligible employees from plan participation

What documentation should I have in my files?

- √ Annual "universal availability notice" and evidence that the notice has been provided to eligible employees
- √ Employment contracts, indicating whether an employee is a common-law employee or a independent contractor

Eligibility for participation in a 403(b) plan

In general, all common law employees of the employer are permitted to make salary reductions and Roth 403(b) contributions under a 403(b) plan with some very narrow exceptions. An employer can exclude the following employees from participating in the 403(b) plan:

- Employees whose maximum salary reduction and Roth 403(b) contributions under the 403(b) plan would be no greater than \$200 a year
- Nonresident aliens with no U.S. source income
- Student-employees whose compensation is considered FICA wages
- Employees eligible to defer to another 403(b), 457 plan, or 401(k) plan of the employer
- Employees "normally" working less than 20 hours/week

Safe-harbor test for determining whether an employee normally works fewer than 20 hours per week:

New employee: if employee is expected to work less than 1,000 hours/year, the employee can be excluded from participating in the plan, even though the employee may be working for more than 20 hours a week for a period of time (such as permanent substitute teachers).

After the first year of employment: an employer would look to the actual hours worked the prior year and if the employee worked fewer than 1,000 hours in the preceding 12-month period, then that individual could be excluded under the 403(b) plan.

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Universal Availability Notice

At least once each plan year, a 403(b) plan sponsor must provide notice to eligible employees informing them that they have the opportunity to make deferrals (including Roth 403(b) contributions if that feature is permitted under the 403(b) plan) or change deferral elections, when they can make those elections, the maximum amount permitted and whether there are conditions on those elections. Special rules apply to certain church organizations.

IRS Issue: Loans from the plan that do not comply with Code rules

What documentation should I have in my files?

- √ Copies of loan procedures for making loan to participants
- √ Copies of loan procedures for loan defaults and applicable tax reporting
- √ Copies of participant loan application forms

Loans from 403(b) Plans

A loan made to a participant in a 403(b) plan must meet the following requirements:

- The maximum loan amount cannot exceed the lesser of \$50,000 reduced by the participant's highest outstanding loan balance during the last 12 months or 50% of the participant's vested account balance, taking into account all plans of the employer
- The loan must be set forth in a legally enforceable agreement that must specify the amount of the loan, the term of the loan and the repayment schedule
- Repayments must be made in level payments at least as frequently as quarterly
- The loan must be repaid within five years unless the loan is used to acquire a participant's primary residence

IRS Issue: Distributions made to participants that do not comply with Code rules

What documentation should I have in my files?

- √ Copies of procedures for approving and making distributions to participants
- √ Copies of participant distribution forms, with supporting documentation and related tax-reporting

Distributions under a 403(b) Plan

In general, amounts held in a 403(b) plan cannot be distributed until a participant has a hardship, severance from employment or disability, reaches 59½ or dies. Special rules apply to distributions from annuity contracts of either amounts contributed prior to 1989 and certain employer contributions.

IRS Issue: Employers that are ineligible to sponsor 403(b) plans

What documentation should I have in my files?

- √ If you are a 501(c)(3) sponsor, the IRS determination letter which granted that organization tax exempt status under Code Section 501(c)(3)

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Employers eligible to sponsor a 403(b) Plan

Employers that are permitted to establish 403(b) plans include:

- Public school systems: a teaching institution with a faculty, curriculum and enrolled students and includes public primary and secondary schools, state colleges and universities, and public junior colleges
- Tax-exempt 501(c)(3) organizations, which are organized and operated exclusively for religious, charitable, scientific, literary, educational or safety testing purposes. The organization should have a favorable determination letter from the IRS regarding its status under Section 501(c)(3) of the Internal Revenue Code.

What other items should you keep on hand in case of an IRS audit?

√ Written 403(b) plan, including any agreements with third parties delegating administrative duties under the plan

Written 403(b) Plan

A 403(b) plan sponsor is required to maintain a “written plan” and operate the 403(b) plan in accordance with its terms. The written plan must contain all material terms, including eligibility, benefits, applicable limits, contracts available under the 403(b) plan, and the time and form under which benefit distributions would be made. The written plan may contain certain optional features not required under Code Section 403(b), such as hardship, loans, contract to contract exchanges, plan-to-plan transfers, and acceptance of rollovers into the plan. The “written plan” may be either a plan document or a collection of documents (including the contracts, salary reduction agreements, employee handbooks, etc.).

In addition, a plan sponsor is permitted to assign administrative responsibilities to parties other than the employer, but not to participants (other than employees of the employer a substantial portion of whose duties are administration of the plan). Any administrative agreements should be kept with the written 403(b) plan documents.

√ Annuity contracts and custodial account agreements for all of the investment providers under the 403(b) plan.

Funding vehicles for 403(b) plans

There are three different types of investments for 403(b) plans:

- **403(b)(1) annuity contract:** contributions are invested in either individual or group annuity contracts issued by life insurance companies
- **403(b)(7) custodial accounts:** Assets under a custodial account must be held by a bank, trust company, or other authorized entity and must be invested solely in regulated investment company stock (i.e., mutual funds). Any dividends from the investment in mutual funds must be reinvested.
- **403(b)(9) retirement income account:** contributions are held in retirement income accounts maintained for employees of *certain church-affiliated organizations*

√ Information Sharing Agreements with Investment Providers

Information sharing agreements

A 403(b) plan sponsor and an investment provider must share participant information on an ongoing basis for proper administration of the 403(b) plan. Some examples of sharing information include:

- Has the participant had a severance of employment?
- Does the participant have outstanding loans?
- If the participant wants to take a hardship, have the hardship withdrawal rules been satisfied?

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The plan document should require information sharing between the employer and approved investment providers if a 403(b) plan permits contract to contract exchanges (when a participant moves all or a portion of his account under one investment provider to another investment provider under the same 403(b) plan). If an employer subsequently deselects an investment provider, that provider must enter into an information sharing agreement.

Are there additional items other than the list above that may be required because you sponsor a plan which is subject to ERISA?

If your 403(b) plan is subject to ERISA, in addition to providing a summary plan description, including any summary of material modifications, you may be asked to provide copies of the IRS Form 5500 Annual Return/Annual Report and, as a 501(c)(3) employer, if the plan contains employer contributions, documentation that any applicable nondiscrimination testing has been performed.

403(b) plans and ERISA

All 403(b) plans are subject to Title I of ERISA unless an exemption applies. The following 403(b) plans are exempt from ERISA:

- Plans sponsored by a governmental entity (including public schools)
- Plans sponsored by a church or church organization unless the sponsor made a voluntary irrevocable election to have the ERISA provisions apply, or
- Plans that are administered with limited employer involvement, subject to the following requirements:
 - Participation is voluntary for employees (e.g., no negative election or automatic enrollment provisions)
 - It is a salary reduction-only plan – no employer contributions
 - All rights under the plan are enforceable only by the employee, beneficiary or authorized representative of the employee or beneficiary
 - There is limited employer involvement in the plan as outlined in the Department of Labor’s Field Assistance Bulletins 2007-02 and 2010-01
 - The employer cannot receive compensation for performance of its duties under the plan other than compensation to cover reasonable expenses

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