403(b) Plan Design and Compliance

A Practical Guidance® Practice Note by Carol V. Calhoun, Venable LLP

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This practice note discusses the rules that apply when eligible tax-exempt organizations (or their employees) establish tax-sheltered annuities, custodial accounts, or retirement income accounts, as described in Section 403(b) of the Internal Revenue Code (403(b) plans). While all employers are eligible to set up a defined benefit plan, and most tax-exempt nongovernmental employers are eligible to set up 401(k) plans, 403(b) plans are another option for certain tax-exempt and governmental organizations. These organizations may establish a 403(b) plan (sometimes called a tax-sheltered annuity plan or a TSA), which can fulfill most of the functions of a qualified plan, including allowing for pre-tax employee elective contributions, while offering various advantages to employers over a traditional qualified plan design.

This practice note has been updated to address significant changes affecting 403(b) plans pursuant to the Secure 2.0 Act (Division T of Consolidated Appropriations Act, 2023 (Pub. L. No. 117-328)).

This practice note addresses the following topics:

- 403(b) Plan Overview
- Eligible Employers and Employees
- ERISA Coverage of 403(b) Plans
- Qualification Requirements
- 403(b) Plan Contributions
- 403(b) Plan Distributions
- Implementation and Operation
- Correcting 403(b) Plan Errors
- Terminating 403(b) Plans
- EP Subcommittee Report: 403(b) Plan Issues and Recommendations
- Advantages and Disadvantages of 403(b) Plans

For a listing of key documents on hardship distributions in retirement lans, see Hardship Distributions Resource Kit.

For more information on 403(b) plans, see Lexis Tax Advisor -- Federal Topical § 1C:17.01 through Lexis Tax Advisor -- Federal Topical § 1C:17.07 and the IRS website resource for 403(b) plans. For a comparison of 401(k) and 403(b) plan attributes, see Tax Planning for Retirees § 2.28. Also see Pre-approved 403(b) Plans. Also see IRS, Publication 571, "Tax-Sheltered Annuity Plans (403(b) Plans)". For rules regarding 401(k) Plans, see 401(k) Plans: Understanding the Rules.

403(b) Plan Overview

A 403(b) plan is a type of retirement plan providing for deferred taxation on certain contributions and earnings made by specific kinds of tax-exempt organizations (primarily, public schools, and 501(c)(3) tax-exempt organizations) for their employees and by certain ministers. I.R.C. § 403(b)(1). For the participant, a 403(b) plan appears much like a 401(k) plan in that it provides for an individual account for each participant. However, 403(b) plan investment options are more limited. 403(b) plans are subject to some, but not all of the requirements that apply to 401(k) and other retirement plans qualified under I.R.C. § 401(a). A 403(b) plan can allow employees, the employer, or both to contribute to the plan. Also, like a 401(k) plan, a 403(b) plan can include a qualified Roth contribution program.

Although 403(b) plans have been around in some form for over 50 years, the Treasury Department only issued final regulations under I.R.C. § 403(b) in 2007, which generally became effective in 2009. 72 Fed. Reg. 41,127 (July 26, 2007).

For information on how Section 403(b) plans are used, see 403(b) Answer Book (CCH) Q 1:1.

Eligible Employers and Employees

Only certain types of employees are eligible to participate in a 403(b) plan, essentially restricting 403(b) plan sponsors to certain tax-exempt organizations, schools (including colleges and universities) sponsored by state and local governments, and ministers or their employers or deemed employers. A 403(b) plan can also cover employees of certain "disregarded entities" (e.g., a single owner LLC) owned by an eligible employer. I.R.S. CCA 201634021 (Aug. 19, 2016). If a plan permits ineligible employees to participate, the plan may lose its tax-favored status (unless a correction is made under the IRS Employee Plans Correction Resolution System (EPCRS); see Correcting 403(b) Plan Errors later in this practice note). For information on eligible employees, see 403(b) Answer Book (CCH) Q 1:11–Q 1:14. For information on eligible employers, see 403(b) Answer Book (CCH) Q 1:5.

The following types of employees are eligible to participate in a 403(b) plan:

- **501(c)(3) employees.** Employees of tax-exempt organizations established under I.R.C. § 501(c)(3) and cooperative hospital service organizations (501(c)(3) organizations), as described further below. For information on what is a 501(c)(3) organization, see 403(b) Answer Book (CCH) Q 2:1.
- **School employees.** Individuals who are (1) involved in the daily operations of a public school, college, or university that is sponsored by a state, local, or Indian tribal governmental body (public school systems), as described further below under "Public School Systems" or (2) civilian faculty and staff of the Uniformed Services University of the Health Sciences. See below for further discussion.
- **Ministers.** Ministers described in I.R.C. § 414(e)(5), provided they are:
  - Employed by a 501(c)(3) organization
  - Self-employed –or–
  - Not employed by a 501(c)(3) organization, but functioning as a minister in their daily responsibilities with their employer, such as a chaplain for a state-run prison

I.R.C. § 403(b)(1)(A); Treas. Reg. § 1.403(b)-2(b); I.R.S. Maintaining Eligibility to Sponsor a 403(b) Plan.

501(c)(3) Organizations

All 501(c)(3) organizations must be organized and operated exclusively for a purpose that is:

- Charitable
- Religious
- Educational
- Scientific
- Literary
- For public safety testing
- For fostering national or international amateur sports competition –and/or–
- For preventing cruelty to children or animals

I.R.C. § 501(c)(3).

Other 501(c)(3) organization requirements are that none of its earnings may inure to any private shareholder or individual, and the entity may not attempt to influence legislation as a substantial part of its activities nor participate in any campaign activity for or against political candidates. In addition, assets of the organization must be permanently dedicated to an exempt purpose and, upon dissolution, the assets must be distributed for a charitable purpose. Treas. Reg. § 1.501(c)(3)-1.

Most 501(c)(3) organizations (or their parent organizations) are required to have an IRS determination as to their status. There is an exception to the filing requirement for church and related organizations (and other I.R.C. § 508 excepted organizations) and entities organized before October 9, 1969. An online search tool providing a list of organizations with determination letters can be found on the IRS website at EO Select Check. Information regarding the application process is available in I.R.S. Publication 557, Tax Exempt Status for Your Organization.

A cooperative hospital service organization described in I.R.C. § 501(e) is treated as if it were a 501(c)(3) organization if it is organized and operated solely to perform on a centralized basis certain services for two or more tax-exempt or governmental hospitals. Rev. Rul. 72-329.

For information on what is a 501(c)(3) organization, see 403(b) Answer Book (CCH) Q 1:6.

Public School Systems

A public school system eligible to adopt a 403(b) plan is a state-sponsored educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. Included in this category are employees of public schools and state colleges or universities. Treas. Reg. § 1.403(b)-2(b)(14).

The employer must be a state, a political subdivision of a state, or an agency or instrumentality of one of these. I.R.C. § 403(b)(1)(A)(ii). Implementing regulations interpret "state" to include the District of Columbia and Indian tribal governments as provided under I.R.C. § 7871(a)(6)(B). Treas. Reg. § 1.403(b)-2(b)(20).

Both faculty and nonacademic staff (e.g., custodial staff) performing services for the educational organization may be covered by the 403(b) plan, but elected or appointed officials (holding positions in which persons that are not education professionals may serve) are not eligible. Members of the school board and university regents or trustees are not eligible. Treas. Reg. § 1.403(b)-2(b)(10). Additional guidance on this issue may be found in the I.R.S. 403(b) Plan Fix-It Guide.

Employers Not Permitted to Adopt 403(b) Plans

Adoption of a purported 403(b) plan by an organization not eligible to adopt one is a common violation of the I.R.C. § 403(b) rules. Correction under the IRS EPCRS program (discussed below) can preserve the tax-deferred status of contributions made prior to the discovery of ineligibility.

When analyzing employer eligibility, several special situations should be considered:

- **Non-501(c)(3) organizations, even if tax-exempt.** Only a 501(c)(3) organization can adopt a 403(b) plan based on their tax-exempt status under I.R.C. § 503(c). Organizations that are tax-exempt under another subparagraph of I.R.C. § 501(c) are not eligible employers. Examples of ineligible employers are trade associations exempt under I.R.C. § 501(c)(6) and unions exempt under I.R.C. § 501(c)(5).
- **Governmental organizations other than public school systems.** A governmental organization can adopt a 403(b) plan only if it is a public school system, as described above, with the following exceptions:
  - A governmental organization that is also a 501(c)(3) organization can maintain a 403(b) plan. An organization affiliated with government may qualify for I.R.C. § 501(c)(3) exemption if it is separately incorporated or formed to accomplish one or more exempt purposes. For example, a public hospital may receive 501(c)(3) status. However, an organization may not obtain 501(c)(3) status if it has governmental regulatory or enforcement powers that would be beyond those permitted by an organization described in I.R.C. § 501(c)(3).
  - A governmental organization can have mixed functions. For example, a prison would not normally be a public school, and therefore could not maintain a 403(b) plan for its employees. However, employees of the education section of a prison (designed to provide educational opportunities to prisoners) could participate in a 403(b) plan. I.R.S. Gen. Couns. Mem. 38666, 1981 GCM LEXIS 92 (Mar. 27, 1981).
- **Nonqualifying affiliates of a 403(b) plan authorized entity.** An affiliate of an organization authorized to maintain a 403(b) plan cannot participate in the plan unless the affiliate also would be an eligible employer. For example, it is common for a private university described in I.R.C. § 501(c)(3) to own a taxable technology start-up to engage in commercialization of university-based research. Even though the technology company is wholly owned by the university, and its earnings are paid as dividends to the university, employees of the technology company cannot participate in a 403(b) plan. To the extent that some employees may divide their time between the university and its taxable affiliate, only their compensation from the university can be counted for purposes of the 403(b) plan.

Multiple Employer 403(b) Plans Pursuant to Secure 2.0 Act

Among many other retirement plan reform measures, the Setting Every Community Up for Retirement Enhancement (SECURE) Act (Division O of Further Consolidated Appropriations Act, 2020) codified the ability of unrelated employers to participate in a defined contribution multiple employer plan (MEP) qualified under I.R.C. § 401(a) (or an arrangement consisting of IRAs) that is treated as a single plan for certain purposes under ERISA and the Internal Revenue Code. Pub. L. No. 116-94, Div. O, § 101. These so-called pooled employer plans (PEPs), which must be sponsored by an eligible pooled plan provider (PPP), allow tax-qualified retirement benefits to be offered to the employees of multiple unrelated employers that share no commonality of interest beyond participation in the plan. See ERISA §§ 3(2)(C), 3(43), 3(44) (29 U.S.C. §§ 1002(2)(C), 1002(43), 1002(44)). In a PEP, most administrative and fiduciary responsibilities of the plan sponsor may be assumed by the PPP. The SECURE Act also provided for statutory relief from the one-bad-apple rule insofar as a qualification failure relating to individual participating employers of a PEP (or of an MEP comprised of employers having a common interest) will generally not adversely affect the qualified status of the entire plan if the plan provides for appropriate assignation of responsibility. See I.R.C. § 413(e). For more information on the SECURE Act MEP rules, see Pooled Employer Plans and Other Multiple Employer Plans.

Although 403(b) plans were not covered by the SECURE Act's MEP amendments, provisions under the Secure 2.0 Act include them effective for plan years beginning in or after 2023. In particular, the Secure 2.0 Act:

- Allows for 403(b) annuity contracts covered by ERISA to be eligible arrangements for PEPs, subject to the same conditions as apply for qualified defined contribution plans (ERISA § 3(43) (29 U.S.C. § 1002(43), as amended))
- Allows for 403(b) annuity contracts to be purchased under a plan maintained by more than one employer, except in the case of a church plan (but disclaims any inference from this exclusion on whether other similar rules may apply for church plans) (new I.R.C. § 403(b)(15)(A))
- Provides for one-bad-apple relief for plans that (1) contain appropriate plan provisions and (2) are a PEP, an MEP comprised of employers having a common interest, a governmental plan, or an MEP maintained solely by a state, a political subdivision of a state, or an agency or instrumentality of the foregoing (new I.R.C. § 403(b)(15)(B)) –and–
- Allows for single filing of annual deferred vested benefit registration statements and Form 5500 filings for 403(b) MEPs that meet the I.R.C. § 403(b)(15) requirements (new I.R.C. §§ 6057(g), 6058(f))

Pub. L. No. 117-328, Div. T, § 106 (adding I.R.C. §§ 403(b)(15), 6057(g), 6058(f); amending ERISA §§ 3(43), 3(44) (29 U.S.C. §§ 1002(43), 1002(44))).

The statute also calls for further administrative guidance to conform model plan language, as applicable, and establish further rules, in the agency's discretion, relating to issues of qualification and treatment of participating employers that are in violation of 403(b) or MEP requirements.

ERISA Coverage of 403(b) Plans

Most private employer-sponsored 403(b) plans are subject to the Employee Retirement Income Security Act (ERISA), which has several requirements that parallel rules for qualified defined contribution and qualified defined benefit plans under the Internal Revenue Code, but don't otherwise directly apply to 403(b) plans, including:

- Vesting rules under ERISA § 203(a)(2)(B) (29 U.S.C. § 1053(a)(2)(B)) and I.R.C. § 411(a)(2)(B)
- Asset transfer rules under ERISA § 208 (29 U.S.C. § 1058) and I.R.C. § 414(l)
- Qualified joint and survivor annuity rules under ERISA § 205 (29 U.S.C. § 1055) and I.R.C. § 401(a)(11)
- Anti-cutback rules as applied to transfers under ERISA § 204(g) (29 U.S.C. § 1054(g)) and I.R.C. § 411(d)(6)

So, 403(b) plans that are subject to ERISA must also comply with these rules as well as ERISA's reporting and disclosure requirements, and—perhaps more significantly—such 403(b) plan sponsors are subject to ERISA's fiduciary and prohibited transaction rules, unless an exemption applies.

For further information on ERISA reporting requirements, see Dep't of Labor Field Assistance Bulletin 2009-02 (July 20, 2009) and Field Assistance Bulletin 2010-01 (Feb. 17, 2010) (hereinafter, FAB 2010-01).

ERISA fiduciary status may be a particular area of concern in light of recent litigation targeting several university 403(b) plans asserting breaches of fiduciary duty. E.g., Vellali v. Yale Univ., 2019 U.S. Dist. LEXIS 182201 (D. Conn.); Sacerdote v. New York Univ., 2017 U.S. Dist. LEXIS 173599 (S.D.N.Y. 2017); Sweda v. Univ. of Pa., 2017 U.S. Dist. LEXIS 153958 (E.D. Pa. 2017); Clark v. Duke Univ., 2019 U.S. Dist. LEXIS 105696 (M.D.N.C. 2019); and Munro v. Univ. of S. Cal., 2017 U.S. Dist. LEXIS 166135 (C.D. Cal. 2017).

For information on ERISA requirements, see 403(b) Answer Book (CCH) ERISA Requirements and ERISA Coverage of Benefit Plans.

Sponsor-Based Exemptions from ERISA Coverage

The ERISA rules do not apply to governmental plans or nonelecting church plans, which are generally exempt from ERISA. (Church plans may elect to be covered by ERISA.) ERISA § 4(b)(1), (2) (29 U.S.C. § 1003(b)(1), (2)).

Non-ERISA 403(b) Plans

An exemption from ERISA Title I (governing reporting and disclosure, participation and vesting, funding, and fiduciary requirements) is available even for 403(b) plan sponsors that are subject to ERISA if the arrangement meets certain requirements that minimize employer involvement (non-ERISA 403(b) plans). A non-ERISA 403(b) plan is a program with limited employer involvement that provides for the purchase of annuity contracts or custodial accounts invested solely in mutual funds that is not recognized as an

ERISA § 3(2)(A) employee pension benefit plan because it is not treated as "established or maintained by an employer." 29 C.F.R. § 2510.3-2(f); see Dep't of Labor Field Assistance Bulletin 2007-02 (July 24, 2007) (hereinafter, FAB 2007-02); FAB 2010-01.

Department of Labor (DOL) regulations provide safe harbor rules for non-ERISA 403(b) plans. To qualify for the safe harbor, the 403(b) plan must satisfy the following requirements:

- **Voluntary participation.** Participation in the plan must be completely voluntary for employees.
- **Employee enforceability.** All rights under the arrangement are enforceable solely by the employee, a beneficiary of the employee, or an authorized representative of the employee or beneficiary.
- **Restricted employer involvement.** The sole involvement of the employer must be limited to the following activities:
  - Permitting annuity contractors (including any agent or broker who offers annuity contracts or who makes available custodial accounts) to publicize their products to employees
  - Requesting information concerning proposed funding instruments or annuity contractors
  - Summarizing information on funding instruments or annuity contractors for employee review and analysis
  - Collecting contributions as required by salary reduction agreements or by agreements to forego salary increases, remitting such contributions to annuity contractors, and maintaining records of such amounts (i.e., no employer contributions are permitted)
  - Holding in the employer's name one or more group annuity contracts (including the right to act as an employee representative for contract amendments)
  - Limiting the funding instruments made available to employees, or the annuity contractors who may approach employees, in a manner designed to afford employees a reasonable choice in light of all relevant circumstances (described further below)
- **No employer compensation.** The employer receives no direct or indirect consideration or compensation, in cash or otherwise, except reasonable compensation to cover expenses properly and actually incurred in the performance of its duties pursuant to the salary reduction agreements or agreements to forego salary increases.

29 C.F.R. § 2510.3-2(f).

The circumstances that may be considered by an employer desiring to limit the non-ERISA 403(b) plan funding media or products or annuity contractors include (but are not limited to):

- The number of employees affected
- The number of contractors who have indicated interest in approaching employees
- The variety of available products
- The terms of the available arrangements
- The administrative burdens and costs to the employer
- The possible interference with employee performance resulting from direct solicitation by contractors

29 C.F.R. § 2510.3-2(f).

Note that the non-ERISA 403(b) plan safe harbor covers only arrangements that are limited to employee elective deferrals. There can be no employer contributions of any kind. 29 C.F.R. § 2510.3-2(f)(3)(iv). The DOL has provided guidance on other issues concerning the safe harbor, as discussed in the following sections.

Employer Administrative Reviews Permitted for Non-ERISA 403(b) Plans

Certain employer activities designed to ensure that a 403(b) plan continues to be tax compliant under I.R.C. § 403(b) are permissible activities that will not take a non-ERISA 403(b) plan out of the safe harbor. This is because employers have an interest separate from acting as their employees' authorized representatives in ensuring that the 403(b) plan's annuity contracts and custodial accounts are tax compliant. Specifically, for example, the employer can be liable to the IRS for potentially substantial penalty taxes, correction fees, and employment taxes on employee salary deferrals for noncompliance, even if the violation was caused by an employee or annuity contractor. Thus, an employer's compliance monitoring activities are consistent with the safe harbor (including in correcting errors). FAB 2007-02; FAB 2010-01; Dep't of Labor Information Letter (Feb. 27, 1996).

However, to clearly indicate the employer's limited involvement in the plan, where the written plan document allocates responsibility for performing administrative functions to persons other than the employer, the relevant document(s) should identify the parties that are responsible for administrative functions, including those related to tax compliance. The documents should delineate the employer's limited role in the activity and allocate discretionary determinations to the annuity provider or participant or other third party selected by the provider or participant. FAB 2007-02; FAB 2010-01.

Impermissible Employer Discretion in Non-ERISA 403(b) Plans

If the employer exercises discretion in administering the plan, it may be deemed to have taken over control as the plan sponsor, resulting in the loss of ERISA Title I exemption (unless it is a governmental or nonelecting church plan, exempt from Title I requirements). Such prohibited exercises of discretion include determinations authorizing, directly or indirectly through a third-party administrator:

- Administering distributions, including hardship distributions, domestic relations orders, and processing participant loans
- Satisfying applicable qualified joint and survivor annuity requirements –or–
- Plan-to-plan transfers or contract exchanges

FAB 2007-02; FAB 2010-01; Dep't of Labor Adv. Op. 94-30A (Aug. 19, 1994).

Thus, maintaining a non-ERISA 403(b) plan's exemption from ERISA is practical only if the annuity and/or custodial account providers are willing to take on the bulk of administrative duties under the plan, and the employer is willing to concede control of most plan functions to them. As discussed below, this can lead to compliance issues because each vendor is typically unaware of what other vendors are doing.

Qualification Requirements

The following sections outline the qualification rules for all 403(b) plans to be eligible for tax-favored status under Treas. Reg. § 1.403(b)-3:

- Funding restrictions
- Written document requirement
- Nondiscrimination rules
- Auto-enrollment pursuant to Secure 2.0 Act
- Contribution and benefit rules and limitations
- Rollover distribution requirements
- Required minimum distribution rules
- Nontransferability rule

These rules are separate from any requirements under ERISA, which would also apply to 403(b) plans that are subject to ERISA (see the discussion in the previous section, ERISA Coverage of 403(b) Plans, regarding non-ERISA 403(b) plans). See 403(b) Plan Distributions for further discussion on distribution requirements.

For information on plan requirements, see 403(b) Answer Book (CCH) Q 1:15–Q 1:24.

Funding Restrictions

There are only three categories of funding arrangements that can be used for a 403(b) plan:

- **Annuity contracts (Treas. Reg. §§ 1.403(b)-2(b)(2), 1.403(b)-8(c)).** Generally, 403(b) plan annuity contracts must be issued by a state-regulated insurance company and offer an annuity form of benefit.
- **Custodial accounts (I.R.C. § 403(b)(7) and Treas. Reg. § 1.403(b)-8(d)).** These are separate accounts that must be held by a financial institution described in I.R.C. § 401(f)(2) and:
  - Be invested solely in mutual funds or, effective December 29, 2022, a group trust intended to satisfy the requirements of Rev. Rul. 81-100 or successor guidance (see Pub. L. No. 117-328, Div. T, § 128 (amending I.R.C. § 403(b)(7)(A))) (this Secure 2.0 Act expansion does **not** permit investments in collective investment trusts as was proposed in one version of the bill)
  - Comply with the 403(b) plan distribution limitations (described under 403(b) Plan Distributions below)
  - Be operated for the exclusive purpose of providing benefits for participants or their beneficiaries –and–
  - Meet the rules in Treas. Reg. § 1.403(b)-8(d)(2) regarding distribution limitations
- **Church plan retirement income accounts (I.R.C. § 403(b)(9) and Treas. Reg. § 1.403(b)-9).** Church sponsors of 403(b) plans may use retirement income accounts to fund plan benefits, which allow for increased investment flexibility. They must:
  - Be maintained under a separate accounting
  - Limit benefits only to gains or losses on invested assets –and–
  - Be operated for the exclusive purpose of providing benefits for participants or their beneficiaries

Treas. Reg. § 1.403(b)-8. For more information, including discussion of I.R.C. § 403(b)(9)(B) (added by Section 111 of the SECURE ACT), see Church Plans under ERISA and the Internal Revenue Code.

Unlike a qualified plan, a 403(b) plan (other than certain grandfathered self-insured state and local government 403(b) plans or a church retirement income account) cannot be funded through a trust that holds stocks, bonds, or other investments. See Treas. Reg. §§ 1.403(b)-8(c)(3), 1.403(b)-9.

The 403(b) plan must specify which specific contracts will be available under the plan. The issuers of such contracts are known as approved vendors.

For a discussion of church plan requirements, see Church Plans under ERISA and the Internal Revenue Code.

Written Document Requirement

A 403(b) plan must be documented in a written defined contribution plan that satisfies certain regulatory requirements and be operated in compliance with the plan. Specifically, the written plan document must set forth all the material terms and conditions regarding the following:

- Eligibility
- Contributions and benefits
- Contribution limitations
- Contracts available under the plan (approved vendors) –and–
- Time and form of benefit distributions (including rules for rollover and required minimum distributions)

Treas. Reg. § 1.403(b)-3(b)(3)(i).

The plan also may set forth certain optional features that are consistent with but not required under I.R.C. § 403(b). These include:

- Hardship withdrawals
- Plan loans
- Plan-to-plan transfers (or from annuity contract to annuity contract) –and–
- Acceptance of rollovers to the plan

Id.

As provided in the final regulations, the existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan. Without such a central document for a comprehensive summary of responsibilities, there is a risk that many of the important responsibilities required under the statute and final regulations may not be allocated to any party. Failure to adopt a written plan document, or to follow its terms, is a common plan defect that is correctable under the IRS EPCRS program. See Correcting 403(b) Plan Errors and EPCRS Correction Rules and Procedures.

Multiple Documents

The written plan document can consist of more than one document. That is, plans are permitted to incorporate other documents, such as annuity contracts and custodial agreements. Treas. Reg. § 1.403(b)-3(b)(3)(ii).

Considerations for Non-ERISA 403(b) Plan

Consider advising a tax-exempt employer that wishes to maintain non-ERISA 403(b) plan status to exclude from its written plan document any provisions concerning hardship withdrawal distributions, loans, plan-to-plan transfers, and acceptance of rollovers. Employer involvement in those activities can jeopardize the non-ERISA 403(b) plan status. These provisions may appear instead in the annuity contract, custodial account agreement, or other ancillary document prepared by the third party administering the relevant aspect of the arrangement. Under the safe harbor rules, the employer could presumably limit the funding media or products available to employees, or the annuity contractors who may approach employees, to ones that agreed to include and administer such provisions. 29 C.F.R. § 2510.3-2(f)(3)(vii); FAB 2007-02.

Model Language

The IRS has provided model language for 403(b) plans designed to satisfy requirements under I.R.C. § 403(b) for public school sponsors. The model language originally appeared in Rev. Proc. 2007-71 (and was revised in a March 2015 version available on the IRS website). For plans subject to ERISA, the IRS suggests modifying the language using language applicable to qualified defined contributions plans. See also the section entitled “Pre-approved 403(b) Plans and Remedial Amendment Periods,” under Implementation and Operation below.

Nondiscrimination Rules

The section 403(b) nondiscrimination rules are designed to ensure that coverage under a 403(b) plan does not discriminate in favor of highly compensated employees. Church-sponsored 403(b) plans are exempt from these rules. I.R.C. § 403(b)(1)(D). Their application to other plans depends on whether the plan is maintained by a government or a private employer:

- **Governmental and private employer plans** are subject to the universal availability rule for elective deferrals.
- **Private employer plans** are also subject to similar nondiscrimination rules as defined contribution and defined benefit plans qualified under I.R.C. § 401(a).

Universal Availability for Elective Deferrals

Plans of governments and private employers (but not churches) that permit elective deferrals under their 403(b) plans must make them available to all employees, subject to the exceptions for excludable employees noted below. This is the case even if the employee has not met the plan’s age and service requirements for employer contributions. I.R.C. § 410(b)(12)(A)(ii); Treas. Reg. § 1.403(b)-5.

Aggregation rules are as follows:

- Individual 501(c)(3) organizations are treated separately, even if related to other 501(c)(3) entities.
- A single-member limited liability company (LLC) that is a disregarded entity of a 501(c)(3) organization sponsoring

the plan is treated as a branch of the sponsor, so the LLC's employees are treated as employees of the sponsor.

- Government employers are aggregated if they are part of a common payroll.
- If an employer has historically treated geographically distinct units as separate for employee benefit purposes, then such units can be treated separately for universal availability but only if the unit is run independently on a day-to-day basis. An exception to this exception applies to units within the same Standard Metropolitan Statistical Area.

Treas. Reg. § 1.403(b)-5(b)(3); I.R.S. CCA 201634021 (Aug. 19, 2016).

Excludable Employees

Certain employee groups may be excluded from participation in a 403(b) plan without violating the universal availability rule, provided that all employees in that category are also excluded:

- Any employee not willing to contribute more than $200 per year
- Subject to the long-term part-time employee rules described below, employees who work less than 20 hours per week or any lower number stated in the plan document (I.R.C. § 403(b)(12)(A)(ii)), but only if:
  - The employer expects the employee to work fewer than 1,000 hours for the 12 months beginning on the date of hire –and–
  - The employee does work fewer than 1,000 hours in the 12 months beginning on the date of hire and each subsequent plan year (or, if the plan so provides, each subsequent 12-month period) thereafter
- Employees eligible to make salary deferral contributions to another 403(b), government 457(b), or 401(k) plan of the employer
- College work-study students described in I.R.C. § 3121(b)(10) –and–
- Nonresident aliens with no U.S. source income

I.R.C. § 403(b)(12)(A); Treas. Reg. §§ 1.403(b)-5(b)(3)(i), 1.403(b)-5(b)(4)(ii).

Universal availability rule compliance is an issue for many 403(b) plans. For example, a school often hires substitute teachers whose work schedule is unpredictable. The employer may initially not permit elective deferrals based on an expectation they will work less than 20 hours per week and will not exceed 1,000 hours for the year (a permissible exception, as noted above). However, if this is done, the employer needs to carefully track actual hours to ensure that a substitute that ceases to qualify for an exempt category is given the opportunity to participate. As an alternative, many employers simply permit all employees, regardless of hours worked, to make elective deferrals.

In the past, several 403(b) plans misapplied the part-time employee exclusion by extending it to employees for any plan years where an employee did not meet the hours threshold during the immediately prior year, even if they had been permitted to contribute to the plan previously. The IRS offered limited relief for such plans during a limited Relief Period (now expired for all plans), provided they brought their plans into operational compliance by the end of the Relief Period and timely amended the plan in accordance with the transition relief by June 30, 2020. See IRS Notice 2018-95. An employer that did not meet these deadlines can correct the error through use of the Voluntary Correction Program described above, but will need to make certain corrective qualified nonelective contributions (QNECs) to compensate affected employees for the lack of opportunity to make their own contributions.

Long-Term Part-Time Participation Rules Pursuant to Secure 2.0 Act

The SECURE Act amended Section 401(k) to require cash or deferral arrangements (other than collectively bargained plans or 403(b) plans) to let long-term part-time employees (as described below) participate in, at least, the salary deferral feature of the plan. (Employees eligible under these rules need not receive matching contributions or employer nonelective contributions and may be disregarded for discrimination testing.) The rules apply to individuals who are age 21 or over and have three full consecutive years of service in which they complete at least 500 hours of service. The 500-hour year-of-service threshold must also be used for vesting purposes for these individuals. See I.R.C. §§ 401(k)(2)(D), 401(k)(15), as amended by Pub. L. No. 116-94, Div. O, § 112(a). That rule became effective for plan years beginning in or after 2021, provided that 12-month periods beginning before 2021 could be disregarded for the three-year eligibility service requirement (although they must be counted for vesting purposes). Pub. L. No. 116-94, Div. O, § 112(b); IRS Notice 2020-68.

The Secure 2.0 Act made two significant changes to these rules, one of which is to codify them as a parallel ERISA participation requirement that explicitly expands the scope to include salary reduction 403(b) plans that are subject to ERISA. The other significant change is to shorten the service-based eligibility condition from three consecutive years of service with 500 or more hours of service to two such years. These Secure 2.0 Act rules are effective for plan years beginning in or after 2025, provided that no 12-month service period beginning prior to 2023 needs to be taken into account for eligibility and no pre-2021 service period needs to be taken into account for vesting. Pub. L. No. 117-328, Div. T, § 125 (adding ERISA §§ 202(c), 203(b)(4) (29 U.S.C. §§ 1102(c), 1103(b)(4)), and I.R.C. § 403(b)(12)(D) and amending I.R.C. § 401(k)(2)(D)(ii)).

Affected plan administrators should ensure that they are collecting the post-2020 service information for part-time employees that will be needed for compliance when the rules come into effect. Note that these rules do not affect other permissible conditions for participation, such as willingness to make a minimum of $200 in contributions and ineligibility to participate in other plans of the employer or exclusions for work-study students and nonresident aliens.

For further discussions of this rule and the SECURE 2.0 Act, see SECURE 2.0 Act Impact on Retirement Plan Compliance and Administration.

Notice Requirement

There is a notice component to the universal availability rule. Employers must provide all eligible employees with an annual notice concerning the opportunity to make salary deferrals to a 403(b) plan offering elective deferrals. The notice must also advise employees how they can make or change the amount designated for salary deferral purposes. I.R.C. § 403(b)(12)(A); Treas. Reg. § 1.403(b)-5(b)(2).

No Contingent Benefits

Finally, the universal availability rule prohibits 403(b) plans from making an employee's right to receive any employee benefit contingent on their decision to make an employee elective deferral contribution to the 403(b) plan (other than matching contributions; plan loan benefits relating to a deferral amount; or alternative benefits, credits, or cash under a cafeteria plan available in lieu of the 403(b) plan contribution).

Universal Availability Rule Compliance Review

Following are steps for universal availability compliance and monitoring:

- Review the 403(b) plan document and administrator's practices and procedures concerning universal availability.
- Review eligibility rules generally for 403(b) plan compliance. Remember that employers cannot exclude employees based on job classifications, such as visiting professors or adjuncts, student workers or interns, substitute teachers, seasonal or temporary employees, administrative workers, bus drivers, custodial staff, and cafeteria workers. Only individuals falling in a permissible excludable class under the terms of the plan can (and must) be excluded.
- If part-time employees are excluded, establish procedures for determining excludable status and implement periodic testing to ensure the 20-hour-per-week and 1,000-hour-per-year rules continue to be satisfied for all excluded individuals and that the service-based participation rules for long-term part-time employee rules enacted under the Secure 2.0 Act are satisfied for plan years beginning in or after 2025.
- Ensure the annual notice provides an accurate description of the 403(b) plan eligibility requirements and is distributed each year.

For a thorough discussion of issues relating to universal availability compliance, see the 2015 report by the Employee Plans Subcommittee of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT), available at ACT, 2015 Report of Recommendations, pp. 28-38. See also IRS, Issues Snapshot–403(b) Plan –The Universal Availability Requirement.

Other Nondiscrimination Rules

The plans of private employers, but not governments or churches, are subject to the same rules that apply to qualified plans under I.R.C. §§ 401(a)(4) (nondiscrimination in contributions and benefits), 401(a)(17) (compensation limit), 401(m) (matching and after-tax contributions), and 410(b) (minimum coverage). Treas. Reg. § 1.414(c)-5(a)(1).

Unlike the universal availability rule, these nondiscrimination requirements apply on a related-entity basis under the employer aggregation rules of I.R.C. § 414(b), (c), (m), and (o), rather than just to the employer maintaining the plan. On their face, I.R.C. § 414(b) and (c), which define "controlled group," apply only to controlled groups of corporations and two or more trades or businesses under common control. However, regulations take the position that these rules apply to tax-exempt organizations as well (other than churches) and provide rules for determining controlled group status in the case of tax-exempt organizations. Treas. Reg. §§ 1.414(c)-5(a)(4), 1.414(c)-5(b)(3).

Auto-Enrollment Pursuant to Secure 2.0 Act

For plan years beginning on or after January 1, 2025, salary reduction 403(b) plans that are not governmental or church plans that are established on or after December 29, 2022 (enactment date of the Secure 2.0 Act), will be required to have an automatic enrollment feature consistent with requirements for an eligible automatic contribution arrangement (EACA) under I.R.C. § 414(w)(3) and the rules noted below. (The rule also applies to 401(k) plans and other cash or deferral arrangements.) Such plan features automatically enroll all eligible employees and, absent any contrary instructions from the employee, provide for a default elective deferral contribution that will be invested in the plan's qualified default investment alternative (QDIA). The EACA notice requirements will also apply. See Automatic Enrollment and Initial QDIA Notice (401(k) Plan).

This new auto-enrollment rule requires a default initial contribution rate of at least 3% but no more than 10% of the employee's compensation, which must then increase by 1% in succeeding years up to a cap of at least 10% but not more than 15%. However, except for safe harbor 401(k) plans (governed by I.R.C. §§ 401(k)(12) or 401(k)(13)), the cap for any plan that is an EACA is 10% for plan years ending before January 1, 2025.

Plans subject to the requirement must allow for so-called permissible withdrawals as defined for EACAs under I.R.C. § 414(w)(2). That is, participants who are automatically enrolled (and do not override the default contribution) must have the right to request to have amounts attributable to any default contributions distributed to them from the plan if the election is made within 90 days after the first default plan contribution.

This Secure 2.0 Act requirement does not apply to:

- Plans established before December 29, 2022 (except that an employer that joins a plan maintained by multiple employers after that date will need to comply)
- SIMPLE 401(k) plans (governed by I.R.C. § 401(k)(11))
- Governmental plans –or–
- Church plans
- Employers that have been in existence for less than three years or that have 10 or fewer employees

Pub. L. No. 117-328, Div. T, § 101 (adding I.R.C. § 414A).

Contribution and Benefit Rules and Limitations

Benefits under a 403(b) plan are based on contributions made and earnings thereon. The written plan document must specify the types of contributions allowed. 403(b) plan contributions are also subject to limitations, like other qualified plans. In the case of a private employer, such contributions must satisfy certain nondiscrimination requirements, as discussed in the previous section. As with employer contributions under a qualified plan, employer contributions, including those made by the employee under a salary reduction agreement, and earnings are not included in the employee's income until distributed (except for after-tax and Roth contributions). I.R.C. § 403(b)(1).

A 403(b) plan can permit any or all of the following types of contributions, but the plan must specify which types are permitted:

- Elective deferrals
- Employer contributions (including matching, discretionary, and/or mandatory contributions)
- Roth contributions
- After-tax contributions
- Rollover contributions

Each of these are described in the 403(b) Plan Contributions section below. A 403(b) plan may also provide for automatic enrollment. I.R.C. § 414(w). For question about types of contributions, see Defined Contribution Plan Contribution Rules.

Contribution Limits

Similar to contributions under 401(k) plans, contributions to 403(b) plans are subject to:

- Maximum annual limits under I.R.C. § 402(g) on elective deferrals and Roth contributions
- Maximum annual additions under I.R.C. § 415 on all types of contributions (other than rollovers)

Annual Limit on Elective Deferrals and Catch-Up Contributions

Elective deferral limit. The normal annual limit on elective deferrals plus contributions under an eligible Roth contribution program to a 403(b) plan is determined under the I.R.C. § 402(g) threshold, as adjusted for inflation ($23,000 for 2024 and $22,500 for 2023), the same limit that applies to elective contributions under a 401(k) plan. I.R.C. §§ 402(g)(1)(A), 402A(c)(2); Treas. Reg. § 1.403(b)-3(c). See Cost of Living Adjustments Chart for Employee Benefit Plans for all updated amounts. See the paragraph captioned "Onetime election to exceed 402(g) limit" in the below discussion of elective deferrals for a special rule allowing a new 403(b) plan participant to exceed the annual limit. I.R.C. §§ 402(g)(3), 403(b)(12).

Timing rules for the return of any excess deferral resulting from a failure to comply with the elective deferral limit are found in Treas. Reg. § 1.403(b)-4(f)(4).

Catch-up contribution rules. There are two catch-up contribution opportunities for eligible employees to increase the elective deferral limit for a year:

- Age-based catch-up –and–
- 15-years-of-service catch-up

Age-based catch-up contribution. If permitted by the 403(b) plan, employees who are age 50 or over at the end of the calendar year can also make catch-up contributions up to the statutory catch-up limit under I.R.C. § 414(v), as adjusted for inflation ($7,500 for 2024). The amount cannot exceed the employee's compensation for the year. I.R.C. § 414(v); Treas. Reg. § 1.403(b)-4(c)(2).

Beginning in 2025, a higher catch-up contribution limit will apply to individuals who attain age 60, 61, 62, or 63 during the year pursuant to the Secure 2.0 Act. The limit for these individuals will generally be the greater of:

- $10,000 (to be indexed for inflation after 2025) –or–
- 150% of the regular (age 50) catch-up limit for 2024

Pub. L. No. 117-328, Div. T, § 109 (amending I.R.C. § 414(v)(2)).

Under another Secure 2.0 Act rule, effective for plan years beginning in 2024, highly paid participants in salary reduction plans will not be allowed to make catch-up contributions on a pre-tax basis. Plans will only be permitted to allow affected participants to make catch-up contributions if they are directed to a designated Roth account. The restriction applies to individuals whose wages for the preceding calendar year from the plan sponsor exceed $145,000 (to be indexed for inflation). Pub. L. No. 117-328, Div. T, § 603 (amending I.R.C. §§ 414(v), 402(g)(1), 457(e)(18)).

If an employee covered by a 403(b) plan is also covered by a 401(k) plan (or a simplified employee pension or SIMPLE retirement account), the plans are combined in applying the annual limit on elective deferrals and the age-based catch-up limit (although the Secure 2.0 Act's new tier of catch-up contributions for participants age 60–63 uses a different limit for SIMPLE retirement accounts). Treas. Reg. § 1.402(g)-1(b).

15-years-of-service catch-up contribution. A special rule for 403(b) plans under I.R.C. § 402(g)(7) allows plans to provide for a separate catch-up right for employees having at least 15 years of service with a:

- Public school system
- Hospital
- Home health service agency
- Health and welfare service agency
- Church –or–
- Convention or association of churches (or associated organization)

Treas. Reg. § 1.403(b)-4(c)(3)(ii).

If permitted under the plan, this catch-up rule increases the annual limit otherwise applicable by the **least** of:

- $3,000
- $15,000, reduced by the amount of additional elective deferrals made in prior years under this rule
- $5,000 times the number of the employee's years of service for the organization, minus the total elective deferrals made for earlier years –or–
- The participant's compensation for the year (as defined in Treas. Reg. § 1.403(b)-2)

Treas. Reg. § 1.403(b)-4(c)(3)(ii).

Special rules for determining years of service for this purpose are given in Treas. Reg. § 1.403(b)-4(e). Several examples applying the catch-up rules are given in Treas. Reg. § 1.403(b)-4(c). See also I.R.S. Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans), §4.

When both catch-up opportunities are available (because a qualifying individual is age 50 or older by year-end), the employee may utilize both, but regulations require the additional amounts to be applied first to the 15-years-of-service catch-up and then to the age-based catch-up. Treas. Reg. § 1.403(b)-4(c)(4).

Due to its complexity and the subsequent introduction of the age-based catch-up rules, many employers have eliminated the 15-years-of-service catch-up from their 403(b) plans. The IRS 403(b) Fix It Guide identifies allowing this catch-up to an employee who does not have the required 15 years of full-time service with the same employer as a common plan defect.

Limit on Annual Additions under I.R.C. § 415

The annual additions limit that applies to qualified defined contribution plans also applies to the aggregate of all contributions to a 403(b) plan, other than rollover contributions and age 50 catch-up contributions. I.R.C. § 403(b)(1); Treas. Reg. § 1.403(b)-4(b).

The limit is the lesser of:

- The inflation-adjusted statutory limit under I.R.C. § 415(c) ($69,000 for 2024 limitation years) –or–
- 100% of includible compensation (as defined in Treas. Reg. § 1.403(b)-2)

I.R.C. § 415(c)(1); Treas. Reg. § 1.403(b)-4(b)(2); see also Treas. Reg. § 1.415(b)-1(b)(2), (c) for special application rules relating to 403(b) plans.

It is important to establish a separate account to hold excess contributions to prevent commingling with 403(b) plan-eligible contributions. Failure to do so could taint the tax-qualified status of the entire 403(b) plan. 72 Fed. Reg. 41,136; Treas. Reg. §§ 1.403(b)-3(b)(2), 1.403(b)-4(f).

Special rule for former employee contributions. Where contributions continue for a former employee, the former employee's compensation for this purpose is based on the amount earned during the most recent year of service for up to the next five taxable years. Treas. Reg. 1.403(b)-4(d). Thus, it is possible for nonelective employer contributions to a 403(b) plan to continue for up to five years in the case of a retired or terminated participant. See Treas. Reg. §§ 1.403(b)-3(b)(4), 1.403(b)-4(d).

Special rule for church employees. In lieu of the Section 415 limit, a church employee can choose to use $10,000 a year as the limit on annual additions. This is only useful if the employee's includible compensation is less than $10,000 and if the total contributions will exceed 100% of the employee's includible compensation. Moreover, total contributions over the employee's lifetime under this choice cannot be more than $40,000. See Treas. Reg. § 1.403(b)-9(b).

Aggregation of contributions under separate plans. Normally, an employee who participates in a 403(b) plan and a qualified defined contribution plan, simplified employee pension, defined benefit plan that provides for employee after-tax contributions, or individual medical benefit account that is part of a pension or annuity plan need not combine contributions made to the 403(b) plan with contributions to the other types of plans for purposes of the Section 415 limit. However, the plans must be combined if the other plan is maintained by a corporation, partnership, or sole proprietorship over which the employee has more than 50% control. I.R.C. § 415(k)(4).

For example, if a tax-exempt organization maintains both a qualified plan and a 403(b) plan, up to the lesser of $69,000 (for 2024) or 100% of compensation could be contributed to each plan. However, if a doctor employed by a tax-exempt hospital also has a qualified plan for their own private medical practice, the 403(b) plan of the hospital would have to be combined with the qualified plan of the private medical practice in applying the limit.

Incidental Benefit Rule

Requirements imposed on qualified plans under Treas. Reg. § 1.401-1(b)(1)(ii) regarding the extent to which incidental life or accident or health insurance benefits may be provided as plan benefits also apply to 403(b) plans. Treas. Reg. §§ 1.403(b)-3(a)(8), 1.403(b)-6(g).

Nonforfeitability/Vesting

In theory, contributions under a 403(b) plan must be nonforfeitable. Treas. Reg. § 1.403(b)-3(a)(2). As a practical matter, though, there is a work-around built into the regulations whereby forfeitable contributions are treated as not having been made to the 403(b) plan, but rather to a separate I.R.C. § 403(c) annuity (or a tax-exempt employee trust where a custodial account is used), when they are made. (Forfeitable contributions are required to be kept in a separate bookkeeping account than nonforfeitable contributions.) Then, as amounts become vested, and assuming all of the 403(b) plan conditions (other than nonforfeitability) are met for those contributions, those amounts are retroactively treated as having been made to the 403(b) plan for purposes of the maximum limits on contributions when they become nonforfeitable. Treas. Reg. § 1.403(b)-3(d)(2).

In this way, many 403(b) plans subject employer matches, employer discretionary contributions, and/or employer mandatory contributions to a vesting schedule (vesting for employee elective deferrals would be permissible in non-ERISA 403(b) plans, but is highly unusual).

For example, a plan might provide that an employee would be 20% vested after two years, 40% after three years, 60% after four years, 80% after five years, and 100% (nonforfeitable) after six years. If an employee left after two years with an employer contribution account balance of $5,000, the employee would receive only $2,000. The remaining $3,000 in the account would, depending on the plan terms, be used for plan administrative expenses, divided among the accounts of other employees, or used to reduce future employer contributions.

To avoid participants becoming immediately subject to taxation upon a termination of the plan, however, a 403(b) plan that allows for any type of forfeitable contribution should provide for automatic full vesting upon plan termination (as would be mandatory for a traditional qualified plan).

Vesting Requirements for Plans Subject to ERISA

For 403(b) plans that are subject to ERISA, any vesting schedule must be at least as favorable as is required under ERISA. Thus, such 403(b) plans can subject employer contributions to three-year cliff vesting or six-year graded vesting, as described in the example given above (or more liberal vesting schedules). ERISA § 203(a)(2)(B) (29 U.S.C. § 1053(a)(2)(B)) (parallel provisions under I.R.C. § 411(a)(2)(B)).

Rollover Distribution Requirements

If a participant or beneficiary in a 403(b) plan is entitled to a distribution from the plan, the plan must give the participant or beneficiary the option to have the amount directly transferred to another plan rather than being paid to the participant or beneficiary. The qualified plan rollover rules under I.R.C. §§ 401(a)(31) and 402(c) and (f) apply (other than inherited IRA rules). Thus, 403(b) plan rollovers may be made to qualified plans, other 403(b) plans, and eligible governmental 457(b) plans (including to designated Roth accounts) as well as to I.R.C. § 403(a) annuity plans and traditional and Roth IRAs. I.R.C. § 403(b)(8), (10); Treas. Reg. §§ 1.403(b)-3(a)(7), 1.403(b)-7(b).

The qualified plan automatic cash-out rules also apply, so if a plan calls for certain small benefits in excess of $1,000 to be paid to a participant without the participant's election, the amount must be automatically directly transferred to an IRA unless the participant elects to the contrary. See

I.R.C. § 401(a)(31). Under Secure 2.0 Act changes, effective for distributions made in and after 2024, the maximum present value of a participant's nonforfeitable benefit that may become subject to a mandatory cash-out is raised from $5,000 to $7,000. Pub. L. No. 117-328, Div. T, § 304 (amending ERISA § 203(e) (29 U.S.C. § 1053(e)); I.R.C. §§ 401(a)(31)(B)(ii), 411(a)(11)(A)).

Note that although rollovers out of the plan are required, accepting rollovers into a 403(b) plan is not.

Required Minimum Distributions

A 403(b) plan is treated as an individual retirement plan for purposes of satisfying the required minimum distribution (RMD) rule sunder I.R.C. § 401(a)(9). Treas. Reg. §§ 1.403(b)-3(a)(6), 1.403(b)-6. Special rules of application for 403(b) plans, including treatment of grandfathered benefits accruing before 1987, are found in Treas. Reg. § 1.403(b)-6(e). Generally, 403(b) plan annuity contracts are treated like individual retirement accounts for purposes of the RMD rules. For further information on RMDs, see Required Minimum Distribution Rules for Defined Contribution Plans, Required Minimum Distribution Rules for Defined Benefit Plans, and Employee Benefits law § 3A.02[m].

Significant changes to the RMD rules under the Secure 2.0 Act are as follows:

- The applicable age that may trigger an individual's RMD required beginning date was raised from 70½ to 72 under the SECURE Act for individuals attaining age 70½ in or after 2020. The Secure 2.0 Act increases this to (1) age 73 for individuals born between January 1, 1951, and December 31, 1959 or (2) age 75 for individuals born on, in, or after 1960. Pub. L. No. 117-328, Div. T, § 107 (amending I.R.C. § 401(a)(9)(C)).
- As of 2024, designated Roth accounts in defined contribution, 403(b) plans, and eligible 457(b) plans will be excluded from the RMD rules prior to the participant's death. (Distributions required prior to 2024 but payable in 2024 are not covered.) Pub. L. No. 117-328, Div. T, § 325 (adding I.R.C. § 402A(d)(5)).
- The existing special RMD rules for surviving spouses who are the sole beneficiary of a participant who dies before their RMD beginning date are modified to require an affirmative election by the spouse and to determine RMD amounts by treating the spouse as if they were the participant. Pub. L. No. 117-328, Div. T, § 327 (amending I.R.C. § 401(a)(9)(B)(iv)).
- Several rules related to satisfying RMD requirements through benefits provided in the form of a life annuity with a steady stream of payments are to be relaxed. See Pub. L. No. 117-328, Div. T, §§ 201 (adding I.R.C. § 401(a)(9)(J)), 202, 204.
- The excise tax for RMD failures is reduced from 50% to 25% and may be further reduced to 10% if the individual files a return reflecting the excise tax within a correction window. Pub. L. No. 117-328, Div. T, § 302 (amending I.R.C. § 4974).

Nontransferability

Except in the case of a contract issued before January 1, 1963, 403(b) plan contracts must be nontransferable. Thus, an employee could not sell the contract to a third party. I.R.C. § 401(g); Treas. Reg. § 1.403(b)-3(d)(2). Nor can a creditor of the employee seize the contract as payment for a debt, even in a bankruptcy situation. 11 U.S.C. § 541(b)(7). Special rules relating to the exchange of annuity contracts within a 403(b) plan and plan-to-plan transfers are considered in the discussion on distributions further below.

403(b) Plan Contributions

This section describes the different types of contributions permitted under a 403(b) plan. For information on requirements relating to contributions, see 403(b) Answer Book (CCH) Q 1:25–Q 1:35.

Elective Deferral Contributions

Similar to 401(k) plan deferrals, these contributions to a 403(b) plan are made under a salary deferral agreement on a pre-tax basis and reduce the income shown on the employee's Form W-2. I.R.C. §§ 402(e)(3), 403(b)(1)(E), 402(g)(3)(C). For example, if an employee whose salary is $50,000 gross contributes $5,000 to the 403(b) plan as an elective deferral, the wages reported on the Form W 2, Box 1, will be $45,000 rather than $50,000.

403(b) plan elective deferrals are subject to the following rules:

- **Annual limit.** 403(b) plan elective deferrals are subject to the same annual limit as for 401(k) plans, determined on an aggregate basis for the individual, including the additional amounts for catch-up contributions, discussed above. I.R.C. § 402(g).
- **Onetime election to exceed 402(g) limit.** A special rule allows plans to let an employee make a onetime irrevocable election at the time of initial eligibility in a 403(b) plan to contribute without regard to the elective deferral limitation. I.R.C. §§ 402(g)(3), 403(b)(12); Rev. Rul. 2000-35.
- **Social Security / Medicare taxes apply.** Like elective deferrals to a 401(k) plan, elective deferrals to a 403(b) plan are subject to applicable Social Security and Medicare taxes. I.R.C. § 3121(a)(5)(D).

- **Additional tax relief for retired public safety officers.** While elective deferrals and earnings thereon from a 403(b) plan are generally all taxable when distributed, eligible retired public safety officers may use a distribution of up to $3,000 made directly from a 403(b) plan to pay premiums on accident, health, or long-term care insurance, without including the amount in taxable income. The premiums can be for the employee or the employee's spouse or dependents. I.R.C. § 402(l)(3)(B).
- **Parsonage allowance for retired ministers.** If certain conditions are met, a portion of a distribution to a retired minister can be designated as a parsonage allowance excluded from income for income tax (but not Social Security / Medicare taxes) by I.R.C. § 1.07(2).

Employer Contributions

A 403(b) plan may provide for employer matching, discretionary, or mandatory contributions. I.R.C. § 403(b)(1), (7). However, a 403(b) plan that provides for employer contributions (or that provides that 403(b) contributions will be matched in another retirement plan) cannot be a non-ERISA 403(b) plan. 29 C.F.R. § 2510.3-2(f)(3)(iv). Several types of employer contributions are possible:

- **Employer matching contributions.** For matching contributions, the plan states the formula for matching contributions made by the employer based on the amount of the employee's elective deferrals. For example, the employer may contribute an amount equal to 50% of elective deferrals (or, in some cases, elective deferrals and after-tax contributions). Typically, the match will be subject to a cap (e.g., that only contributions equal to the first 6% of an employee's compensation will be matched).
- **Employer discretionary matching contributions.** With a discretionary match, the employer decides how much to contribute toward the match. However, the plan terms must specify how the match is to be divided among employees. For example, it could specify that the match would not apply to contributions that exceeded the first 6% of an employee's compensation, but that the percentage match would depend on the amount the employer chose to contribute for that year.
- **Employer matching contributions based on qualified student loan payments.** For plan years beginning in or after 2024, employers are permitted to make matching contributions to a salary reduction 403(b) plan (and cash or deferral arrangements) based on a participant's repayment of qualified student loans. The match (1) may not apply to loan payment amounts that, aggregated with the individual's elective deferrals, exceed the Section 402(g) limit or the individual's compensation for the year; (2) must apply exclusively to all participants who are eligible for matching contributions on elective deferrals; and (3) must be at the same matching rate and subject to the same vesting rules as the elective deferral match. Pub. L. No. 117-328, Div. T, § 110 (adding I.R.C. § 401(m)(13) and amending I.R.C. § 403(b)(12)).
- **Employer discretionary contribution.** With a discretionary contribution, the plan could specify that the employer may decide each year how much to contribute to the 403(b) plan, but the plan terms must set forth how the amount is to be allocated among employees (e.g., in proportion to compensation).
- **Employer mandatory contributions.** With a mandatory contribution, the plan document states the amount to be contributed by the employer. For example, an employer may contribute to the 403(b) plan 5% of employee compensation each year.
- **Special rule for former employees.** Subject to the limits in Treas. Reg. § 1.403(b)-4(d), an employer may continue to make contributions on behalf of a former employee for up to five years after the year employment ends.

After-Tax Employee Contributions

After-tax employee contributions do not give the employees an immediate tax benefit. However, earnings on the contributions are tax-deferred until distributed from the plan, which could positively affect investment returns. I.R.S. 403(b) Plan Basics.

Roth Contributions

A 403(b) plan is recognized as an applicable retirement plan that may include a qualified Roth contribution program. I.R.C. § 402A(b), (e)(1)(B). Thus, 403(b) plans may allow employees to make elective Roth contributions. These contributions must be maintained separately from pre-tax and after-tax elective contributions and, like after-tax contributions, are treated as an elective deferral, but are **not** excludable from the employee's gross income. However, for qualified distributions made from a Roth account, the earnings on the contributions are tax-free, not merely tax-deferred as for pre-tax or after-tax contributions. I.R.C. § 402A(d)(1); Treas. Reg. § 1.403(b)-3(c) (incorporating rules under Treas. Reg. § 1.401(k)-1(f)(1), (2)).

To be a qualified Roth distribution, the distribution from the 403(b) plan must be made, and must be:

- Made at least five years after the employee first contributes to the Roth account –and–
- Meet one of the following criteria:
    - Occur on or after the date the employee becomes age 59½

- Be made to a beneficiary, or to the employee's estate, after the death of the employee –or–
- Be attributable to the employee's being disabled (as defined under I.R.C. § 72(m)(7))

I.R.C. § 402A(d)(2). For a further discussion regarding Roth contribution programs, see Roth 401(k) Plan Design and Compliance.

Rollover Contributions

A 403(b) plan can (but is not required to) permit rollovers from:

- A qualified plan
- Another 403(b) plan
- A governmental 457(b) plan –or–
- An IRA from which an employee is receiving a distribution

I.R.C. § 402(c)(1), (8).

Such rollovers continue the tax deferral on the amounts from the other plan. Id.

403(b) Plan Distributions

This section describes 403(b) plan distribution rules, describing when benefit distributions are generally permitted and special distributions rules for plan terminations, domestic relations orders, and plan loans. Certain permitted exchanges and transfers that are not treated as distributions are also discussed. For information on requirements relating to distributions, see 403(b) Answer Book (CCH) Q 1:42–Q 1:47.

General Distribution Restrictions

A 403(b) plan's distribution provisions must limit distributions to take into account limitations under I.R.C. § 403(b)(10) similar to defined contribution qualified plans. Certain distributions that are permitted will give rise to penalties on the plan participant. A plan may, but is not required to, limit distributions to avoid penalties on the participant.

Generally, a 403(b) plan can permit a distribution to be made only once the employee:

- Reaches age 59½
- Has a severance from employment
- Dies
- Becomes disabled (within the meaning of I.R.C. § 72(m)(7))
- Encounters financial hardship, subject to special rules as described below
- Is eligible for a qualified reservist distribution –or–
- Is eligible for a qualified birth or adoption distribution (see I.R.C. § 72(t)(2)(H), added by the SECURE Act, Pub. L. No. 116-94, Div. O, § 113, and IRS Notice 2020-68, Part D)

Treas. Reg. § 1.403(b)-6(b) through (d). See also Section 2202(a) of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, and IRS Notice 2020-50 which temporarily permitted distributions that qualified as coronavirus-related distributions.

Several provisions of the Secure 2.0 Act provide for additional (or expanded) distribution opportunities, including eligible distributions:

- For an unforeseeable or immediate financial need relating to necessary personal or family emergency expenses (effective in 2024)
- From pension-linked emergency savings accounts established under the plan (effective in 2024)
- To eligible firefighters (effective immediately)
- To victims of domestic abuse (effective in 2024)
- To terminally ill individuals (effective immediately)
- For qualified disaster recovery expenses (effective immediately)
- For the cost of qualifying long-term care insurance or coverage (effective December 30, 2025)

See Pub. L. No. 117-328, Div. T, §§ 115, 127(e)(2), 308, 314, 326, 331, 334.

However, the restrictions above do not apply to after-tax contributions. Id. Rollover contributions are also exempt. Treas. Reg. § 1.403(b)-6(i). Thus, for example, a plan can permit in-service withdrawals of such amounts, even if the employee has not attained age 59½.

Hardship distribution rules. Under current rules, hardship distributions from 403(b) plans may only be made from elective deferral contributions (excluding income on those contributions). However, the Secure 2.0 Act changes those rules, effective for plan years beginning in and after 2024, to permit hardship distributions from elective deferrals, matching contributions, and QNECs (and income attributable to the foregoing). Pub. L. No. 117-328, Div. T, § 602 (adding I.R.C. § 403(b)(17) and amending I.R.C. § 403(b)(7) and (11)).

To be a hardship distribution, the same rules apply as under the qualified plan distribution rules. They are only permissible for an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse, dependent, or primary beneficiary. IRS regulations provide certain safe harbors under which a distribution will be assumed to meet these tests. Treas. Reg. § 1.403(b)-6(d)(2); see Treas. Reg. § 1.401(k)-1(d)(3). However, under Secure 2.0 Act rules, a plan may not require a participant to seek funds through any available plan loan feature as a condition to receiving a hardship distribution beginning in 2024. I.R.C. § 403(b)(17)(B) (as added by Pub. L. No. 117-328, Div. T, § 602). For additional compliance information, see Hardship and Unforeseeable Emergency Distribution Checklist. A plan sponsor is permitted to rely on the employee's certification that the amount is necessary to satisfy the financial need if certain requirements are met (including notice to the employee that documentation must be retained). Self-certification rules were further enhanced under the Secure 2.0 Act with immediate effect. Pub. L. No. 117-328, Div. T, § 312 (amending I.R.C. §§ 401(k)(14)(C), 403(b)(7)(D), 403(b)(11), 457(b)(4)).

Distributions Subject to Penalties

As with distributions from qualified plans, two sorts of penalties can apply to distributions from a 403(b) plan, even if the withdrawals are permitted under the plan:

- 10% additional tax (in addition to normal income taxes) on early withdrawals under I.R.C. § 72(t) –and–
- Loss of the special tax treatment for Roth contributions distributed within the five-year nonexclusion period under I.R.C. § 402A(d)(2)(B)

Because these limitations apply to the participant, they need not be included in the plan document. However, some plans attempt to limit plan distributions to those that will not give rise to the penalties. The 10% additional tax applies only to the amount of the distribution that is subject to income tax. For example, it would not apply to a distribution to the extent it consisted of after-tax employee contributions, but it would apply to the portion of the distribution that consisted of earnings on those contributions. It also does not apply to the extent that taxes are deferred by rolling the distribution over to another plan. The additional tax applies unless one of the exceptions under I.R.C. § 72(t*)* is met.

For example, a 30-year-old employee could be permitted to take a distribution of elective deferrals from a 403(b) plan upon termination of employment or hardship. However, unless the distribution was rolled over, it would generate normal income taxes plus the 10% additional tax.

Distributions upon Plan Termination

Distributions can be made regardless of the above limitations upon termination of the 403(b) plan. However, if the 403(b) plan contains elective deferrals or is funded through custodial accounts, termination of the plan, and the distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the employer under I.R.C. § 414(b), (c), (m), and (o) on the date of the termination) does not make any contributions to any 403(b) plan that is not part of the terminating plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. An exception to this rule exists when less than 2% of eligible employees are eligible under the other 403(b) plan during the restricted period. Treas. Reg. § 1.403(b)-10(a)(1).

See also Terminating 403(b) Plans below for other issues in terminating a 403(b) plan.

Domestic Relations Orders

The 403(b) regulations include a specific exception to the distribution limitation rules for domestic relations orders. Treas. Reg. § 1.403(b)-10(c). A domestic relations order is defined as any judgment, decree, or order (including approval of a property settlement agreement) that:

- Relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant –and–
- Is made pursuant to a state domestic relations law (including a community property law)

I.R.C. § 414(p)(9).

A governmental or nonelecting church plan can comply with any domestic relations order (and may be subject to state domestic relations laws regarding distributions). Other plans can comply only if the order is a domestic relations order that meets certain requirements for qualified domestic relations orders (QDROs) under I.R.C. § 414(p) and ERISA § 206(d)(3) (29 U.S.C. § 1056(d)(3)). See Rev. Proc. 2007-71.

Remember that sponsors of non-ERISA 403(b) plans (other than governmental or church employers) should not conduct any discretionary administration of the plan's domestic relations order distributions. For a discussion on QDROs, including suitable forms for QDRO administration, see QDRO Resource Kit.

Plan Loans

Loans from 403(b) plans are permissible, depending on the facts and circumstances of the loan arrangement, including whether there is a fixed repayment schedule, the reasonability of the interest rate, and the presence of repayment safeguards that a prudent lender would rely on. As for 401(k) plan loan programs, the prohibited transaction exemption requirements under ERISA § 408(b)(1) (29 U.S.C. § 1108(b)(1)) apply for ERISA-governed plans, and tax treatment is governed by I.R.C. § 72(p).

The plan document (or ancillary document) must contain material terms and conditions for the loans and identify the person responsible for administering the program. If the participant fails to repay a 403(b) plan loan, the participant's account under the plan can be used for repayment similar to other qualified plan loans. Treas. Reg. § 1.403(b)-6(f); see also 29 C.F.R. § 2550.408b-1 and Treas. Reg. § 1.72(p)-1.

The taking out of a loan is not treated as an impermissible distribution. A loan that is in default is generally treated as a taxable distribution from the plan of the entire outstanding balance of the loan (a deemed distribution). A deemed distribution is treated as an actual distribution for purposes of determining the tax on the distribution, including any early withdrawal penalty. However, a deemed distribution is not treated as an actual distribution for purposes of determining whether a plan satisfies the limitations on in-service distributions. Treas. Reg. §§ 1.403(b)-7(d), 1.72(p)-1, Q&A12, 13.

For more information on the rules for qualified plan loans, see Plan Loan Resource Kit.

Exchanges and Transfers Not Treated as Distributions

Subject to applicable requirements, three types of in-service exchanges or transfers, described further in the following sections, are permitted without violating the 403(b) plan distribution (or nontransferability) rules:

- Contract exchanges
- Plan-to-plan transfers –and–
- Asset transfers to governmental plans for purchase of permissive service credit

Treas. Reg. § 1.403(b)-10(b)(1); see also I.R.S. Retirement Plans FAQs regarding 403(b) Tax-Sheltered Annuity Plans.

Such exchanges and transfers are distinguished from rollovers (even direct rollovers from one plan to another). As discussed in the section entitled "Rollover Distribution Requirements" under Qualification Requirements above. Rollovers are available only when a distribution event has occurred. Remember that sponsors of non-ERISA 403(b) plans should not undertake any discretionary actions concerning such exchanges or transfers.

Contract Exchanges

A 403(b) annuity contract or custodial account can be exchanged for (1) another 403(b) contract or custodial account issued by an approved vendor under the same plan that receives plan contributions or (2) another 403(b) contract or custodial account issued by a vendor that is not expressly authorized by the 403(b) plan terms (an unapproved vendor). However, an unapproved vendor exchange is permitted only if:

- The 403(b) plan permits exchanges with unapproved vendors
- The amount of the transferred accumulated benefit after the exchange is at least the same as before the exchange
- The unapproved vendor's contract is subject to distribution restrictions at least as stringent as the plan's terms –and–
- The 403(b) plan sponsor and the unapproved vendor enter an agreement to share information for tax reporting and plan compliance purposes (including information under Treas. Reg. § 1.403(b)-10(b)(2)(i)(C))

Treas. Reg. § 1.403(b)-10(b)(3); Rev. Proc. 2007-71.

Plan-to-Plan Transfers

A 403(b) plan may transfer a contract or custodian account to a different employer's 403(b) plan (e.g., on behalf of transferring employees upon a corporate transaction), subject to the following conditions:

- The participant whose assets are being transferred is an employee (or former employee) of the employer (or business of the employer) sponsoring the receiving plan (or the assets belong to a beneficiary of such a participant).
- The terms of both plans allow for such plan-to-plan transfers.
- The amount of the accumulated benefit after the transfer is at least the same as before the transfer.
- The receiving plan imposes distribution restrictions on the transferred assets that are at least as stringent as the transferring plan's rules. –and–
- If the transferred assets are not the participant's entire interest in the plan, then the receiving plan treats the amount transferred as a continuation of a pro rata portion of their interest in the transferring plan (e.g., with respect to pre-tax versus after-tax contributions).

Treas. Reg. § 1.403(b)-10(b)(3); Rev. Proc. 2007-71.

Certain Contract-to-Plan Transfers to Governmental Plans

A 403(b) plan may transfer assets held in the plan to an I.R.C. § 414(d) governmental defined benefit plan in three circumstances:

- **Purchase of permissive service credit.** A governmental plan that allows participants to make voluntary contributions (in addition to any employee contributions required under the plan) to acquire deemed service credit that will be used for purposes of calculating plan benefits (so-called permissive service credit, described in I.R.C. § 415(n)(3)) may accept such additional permissive service credit contributions through the transfer from a 403(b) plan. Treas. Reg. § 1.403(b)-10(b)(4)(ii)(A). This is an exception from the general rule prohibiting assets transfers between 403(b) plans and plans qualified under I.R.C. § 401(a) or eligible governmental deferred compensation plans under I.R.C. § 457(b). 72 Fed. Reg. 41,132.

- **Repayments of contributions.** The assets from a 403(b) plan account can be transferred to a governmental plan where the amount is treated as a repayment of contributions for an amount previously refunded upon a forfeiture of service credit under the plan, as described in I.R.C. § 415(k)(3). Treas. Reg. § 1.403(b)-10(b)(4)(ii)(B).
- **Rollovers.** Participants may choose to roll over any eligible rollover distribution from a 403(b) plan to a governmental defined benefit that accepts rollovers. I.R.C. § 403(b)(8).

SECURE Act Portability Rules

Portability rules enacted by the SECURE Act allow certain plans, including 403(b) plans, to give participants the opportunity to preserve lifetime income benefits accrued under an investment option of the plan if the investment option ceases being available to the participant. See Pub. L. No. 116-94, Div. O, § 109(a) and (b), adding and amending, respectively, I.R.C. §§ 401(a)(38) and 401(k)(2)(B). Upon a so-called lifetime income investment no longer being available under a plan, the plan may offer (1) a rollover of such investment, via direct trustee-to-trustee transfers, to an accepting qualified plan or individual retirement account or (2) a distribution of the amount attributable to such investment in the form of an annuity contract with a third-party insurer that preserves the terms of the investment. For more information, see Lifetime Income Benefit Rules for Defined Contribution Plans.

Implementation and Operation

IRS Opinion and Determination Letters

To receive and maintain tax-favored treatment, 403(b) plans must comply in form and operation with the requirements described in this practice note. For plan document compliance, employers that adopt pre-approved plans are able to rely on the IRS determination letter program established for pre-approved plans, described below under "Pre-approved 403(b) Plans and Remedial Amendment Periods."

Adopting a pre-approved plan simplifies 403(b) plan administration for employers since the sponsor of the pre-approved plan is responsible for many aspects of plan document compliance, including obtaining an opinion letter and plan updates, among other things.

In 2022, the IRS announced that it was opening up its determination letter program for individually designed qualified plans to 403(b) plans starting in June 2023. Rev. Proc. 2022-40; see also Rev. Proc. 2023-4. Individually designed 403(b) plan sponsors may apply for an initial determination letter as well as upon plan termination and in other limited circumstances.

For initial determination letter requests of existing plans, there is a staggered schedule based on the last digit of the plan sponsor's employer identification number:

Last digit of EIN	Submissions accepted as of:
1, 2, or 3	June 1, 2023
4, 5, 6, or 7	June 1, 2024
8, 9, or 0	June 1, 2025

For submissions in connection with plan termination, the filing must be made within one year after the later of the date of termination or the date the action terminating the plan is taken, but in no event later than 12 months after assets are distributed.

A 403(b) plan determination letter review for an ongoing plan will cover the requirements provided on all Required Amendments Lists (discussed further below) issued prior to the end of the second calendar year preceding the year of submission and all requirements that were in effect prior to that date. The IRS will review terminating plans for all amendments required to be adopted to conform with I.R.C. § 403(b) as of the termination date.

All 403(b) plan sponsors must remain vigilant regarding required plan amendments due to changes to the Internal Revenue Code, Treasury Regulations, or other guidance published by the IRS.

In addition to ensuring compliance with the statutory requirements for tax-favored status, all 403(b) plan sponsors (whether directly or via a third-party administrator) must ensure that the day-to-day operational requirements concerning eligibility, nondiscrimination, contributions, funding vehicles, and distributions continue to be satisfied. Non-ERISA 403(b) plan sponsors may take an active role in ensuring compliance (including facilitating corrections of noncompliance) without jeopardizing the plan's safe harbor status. FAB 2007-02; Dep't of Labor Information Letter (Feb. 27, 1996).

ERISA Considerations

If ERISA applies to the 403(b) plan (see ERISA Coverage of 403(b) Plans above), the plan must satisfy the disclosure and reporting obligations under ERISA Title I, such as:

- Providing updated summary plan descriptions and, as needed, summaries of material modifications to participants for amendments
- Making plan-related documents available
- Filing Form 5500 annual reports
- Meeting ERISA fiduciary responsibilities and avoiding prohibited transactions

For a summary of ERISA responsibilities, see ERISA Title I Fundamentals.

Pre-approved 403(b) Plans and Remedial Amendment Periods

The IRS first established a pre-approved 403(b) plan program for prototype and volume submitter plans in 2013, issuing guidance for an initial cycle (ending June 30, 2020) of IRS plan document review for conformance with I.R.C. § 403(b) requirements and an initial remedial amendment period allowing for the retroactive correction of plan document defects. See Rev. Proc. 2013-22, as modified by Rev. Proc. 2014-28 and Rev. Proc. 2015-22 and clarified by Rev. Proc. 2017-18. Subsequent guidance set up a framework for subsequent cycles of IRS review of pre-approved 403(b) plans, provided further guidance on the initial amendment period, and set deadlines for the adoption of 403(b) plan interim amendments. See Rev. Proc. 2019-39, modified by IRS Notice 2020-35 and Rev. Proc. 2020-40. Under the program, sponsors of pre-approved plans can obtain opinion letters on their plan designs, providing reassurance that their plan documents meet the necessary requirements.

Guidance for issuing opinion letters for pre-approved 403(b) plans for Cycle 2 (on-cycle submissions accepted from May 2, 2022, to May 1, 2023) is found in Rev. proc. 2021-37. This guidance also significantly modifies the pre-approved program in a manner that brings it into closer alignment with the pre-approved qualified plan rules, including by eliminating the prototype and volume submitter plan distinction, establishing a cumulative list of 403(b) requirements for Cycle 2 submissions (IRS Notice 2022-08), allowing for determination letters in the case of certain non-standardized or otherwise tailored plan documents, and detailing rules for cyclical remediation amendment periods following the initial period.

After receipt of the favorable opinion letter from the IRS, the pre-approved plan sponsor must take the steps below to maintain compliance:

- **Amend plan for legal changes.** Amend the plan pursuant to changes in the Internal Revenue Code, Treasury Regulations, or other guidance published by the IRS.
- **Adopt notification procedures.** Establish a procedure to notify adopting employers of plan amendments and restatements and of the need to timely adopt the plan and any plan restatements and the consequences for failing to do so or failing to operate the plan in accordance with plan changes.
- **Disclose plan-related documents.** Provide to the adopting employers the plan document, any restatements thereof, all amendments, and all opinion or advisory letters, in electronic or hard copy form, and comply with the notice requirements under the program or other written guidance.
- **Meet obligations upon discovery of noncompliance.** Upon determining that a 403(b) pre-approved plan as adopted by an employer may no longer satisfy the requirements of 403(b) (in a manner that is not or cannot be corrected by the pre-approved plan sponsor under the EPCRS):
  - Notify the employer that the plan may no longer satisfy I.R.C. § 403(b).
  - Advise the employer that it may incur adverse tax consequences. –and–
  - Inform the employer about the availability of the EPCRS.
- **Document adopting employers.** Maintain a written record of the eligible employers that have adopted the prototype plan or volume submitter plan. The list must include the names, addresses, and employer identification numbers of all eligible employers that, to the best of the plan sponsor's knowledge, have adopted the plan. The plan sponsor must present the list to the IRS, if requested.

Rev. Proc. 2021-37, §§ 9, 10.09, 16, 19.

Pre-approved Plan Document Must Prevail over Conflicting Investment Arrangement

In the event of any conflict between the terms of the pre-approved plan and the terms of investment arrangements under the plan (or of any other documents incorporated by reference into the plan), the terms of the pre-approved plan must govern. An eligible employer may not rely on an opinion letter issued for a 403(b) pre-approved plan if any investment arrangement under the plan provides that the terms of the investment arrangement govern in the event of a conflict. Rev. Proc. 2021-37, § 8.03(4).

Limited Reliance

Even for pre-approved plans, however, the opinion or advisory letter addresses whether the plan document complies with I.R.C. § 403(b). It does not address ERISA requirements (if applicable), investment arrangement terms, other documents incorporated by reference, or whether the plan operates in a compliant fashion.

Remedial Amendment Periods

The IRS system of recurring remedial amendment cycles for pre-approved plans and general plan amendment deadlines are summarized below. Rev. Proc. 2019-39, as modified by Rev. Proc. 2021-37.

A remedial amendment period is a period during which a 403(b) plan may be amended to comply retroactively with the statutory requirements and implementing guidance, so long as the adopting employer operates the plan in conformance with the amendment retroactive to the beginning of the applicable remedial amendment period for the defect. Remedial amendments address so-called form defects, which are plan provisions that cause a plan to fail to satisfy the 403(b) plan requirements or the absence of a provision required by the 403(b) plan requirements.

For form defects in individually designed 403(b) plans that occur after the end of the initial remedial amendment period (i.e., after June 30, 2020), the remedial amendment period begins:

- For a new plan (i.e., a plan established after June 30, 2020), the date the plan becomes effective
- For an existing plan (except as provided below), the earlier of the date the amendment is adopted or becomes effective
- For a provision that becomes noncompliant due to a change in 403(b) requirements, the date on which the change in requirements becomes effective –or–
- For a provision that has been changed and was integral to 403(b) requirement, the date the plan is first operated pursuant to the provision as amended

Rev. Proc. 2019-39, § 5; see also Rev. Proc. 2021-37, § 2.13(1).

The remedial amendment period for pre-approved 403(b) plans is the period for IRS plan review and adoption by participating employers. The beginning date for the remedial amendment period for pre-approved 403(b) plans follows the same rules as those described above for individually designed plans. Rev. Proc. 2019-39, § 11.02; see also Rev. Proc. 2021-37, § 2.15.

The general rule for determining the end of the remedial amendment period for an individual designed 403(b) plan for a form defect occurring after the initial amendment period is as follows:

- For a new plan, the last day of the second calendar year following the year the plan became effective
- For an existing plan (except as provided below), the last day of the second calendar year following the year the amendment was adopted or became effective, whichever is later –or–
- For a provision that is related or integral to a change in 403(b) requirements, the last day of the second calendar year that begins after the Required Amendments List in which the change appears is issued

Rev. Proc. 2021-37, § 2.13(2).

For governmental 403(b) plans, the deadline is the later of the date under the general rule or the 90th day after the close of the third regular legislative session of the legislative body with the authority to amend the plan that begins on or after the date that, as applicable, (1) the plan becomes effective (for new plans), (2) the amendment is adopted or effective, whichever is later (for an existing plan not described in clause (3)), or (3) the issuance of the Required Amendments List in which the required change appears for a provision that is related or integral to a change in 403(b) requirements.

For pre-approved 403(b) plans, unless otherwise provided by the IRS, the remedial amendment period will end no earlier than the end of Cycle 2. Rev. Proc. 2019-39, § 11.03; see also Rev. Proc. 2021-37, § 2.16. Further, so long as an interim amendment was timely made in good faith, the expiration of the remedial amendment period for a form defect in a pre-approved 403(b) plan occurring after the initial remedial amendment period (i.e., after June 30, 2020) is the later of:

- The end of the cycle that includes the date on which the remedial amendment period would have ended if the plan were an individually designed plan –or–
- The end of the first cycle in which an application for an opinion letter than considers the form defect may be submitted

Rev. Proc. 2021-37, § 21.

The IRS issues an annual list of changes in the requirements for qualified retirement plans and for 403(b) plans called the Required Amendments List. This guidance containing the Required Amendments List also furnish amendment deadlines and information on remedial amendment periods for applicable for individually designed plans. For links to Required Amendments Lists dating back to 2016, see IRS, Required Amendment List.

Interim Amendments

403(b) plan sponsors must amend their plans to conform with changes to the 403(b) requirements in a timely manner. The time frame for doing so was extended under Rev. Proc. 2021-37. Under the modified guidance, the deadline for making such interim amendments for a 403(b) pre-approved plan generally is the end of the second calendar year following the year in which the change in 403(b) requirements becomes effective for the plan. However, for governmental 403(b) pre-approved plans, the deadline is 90 days after the close of the third regular legislative session of the legislative body with the authority to amend the plan that begins on or after the date the plan amendment becomes effective if that date is later than the general rule. Rev. Proc. 2021-37, § 21 (modifying Rev. Proc. 2019-39, § 12).

For more information, see Pre-approved 403(b) Plans. See also IRS, 403(b) Pre-approved Plans. For general information on pre-approved plans, see Pre-approved Plan Design and Compliance.

Safe Harbor Deferral-Only 403(b) Plans Pursuant to Secure 2.0 Act

The Secure 2.0 Act provides for a new type of simplified deferral-only 403(b) safe harbor plan for plan years beginning on and after January 1, 2024. These are elective deferral-only plans (no other contribution types are permitted) subject to an annual inflation-indexed limit starting at $6,000, plus a catch-up amount for participants age 50 or older at the end of the plan year (same catch-up limit as for IRAs, currently fixed at $1,000 but which will be adjusted for inflation beginning in 2024).

The plan must be open to all employees meeting the minimum age and service requirements under I.R.C. § 410(a)(1) (age 21 and one year of service), provided that employees covered by collective bargaining agreements and nonresident aliens not receiving U.S.-source income may be excluded. The plan must also have an automatic enrollment feature with a default contribution rate of between 3% and 15% of a participant's compensation (subject to their election to opt out or contribute at a different rate).

Only employers that do not already maintain any other qualified plan or any 403(a) or 403(b) plan, SIMPLE plan, or simplified employee pension are eligible (without regard to plans maintained pursuant to a collective bargaining agreement exclusively for covered employees). Pub. L. No. 117-328, Div. T, § 121 (adding I.R.C. § 403(b)(16)).

Correcting 403(b) Plan Errors

EPCRS for Qualification Errors

The Employee Plans Compliance Resolutions System (EPCRS) is the IRS correction program to address noncompliance issues in tax-favored retirement plans, including 403(b) plans. IRS guidance issued in 2013 substantially expanded the program's application to 403(b) plans. The most recent iteration of EPCRS is found in Rev. Proc. 2021-30 (generally effective July 16, 2021). See IRS, Updated Retirement Plan Correction Procedures and EPCRS Correction Rules and Procedures for an overview. However, this guidance will need to be updated further due to changes in Division T of the Consolidated Appropriations Act, 2023, Pub. L. 117-328, 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0). In Notice 2023-43, the IRS gave some preliminary guidance concerning the SECURE 2.0 changes but indicated that further guidance would be necessary. Corrections completed between the effective date of SECURE 2.0 and the issuance of the Notice will be respected if they reflect a good faith, reasonable interpretation of SECURE 2.0. Compliance with the Notice's terms will also be treated as meeting this standard.

For a discussion regarding EPCRS, see EPCRS Correction Rules and Procedures. For information on correcting 403(b) plan errors, see 403(b) Answer Book (CCH) Correcting 403(b) Plan Errors.

The EPCRS can resolve 403(b) plan operational and documentation failures within one of the three EPCRS units:

- **Self Correction Program (SCP)**
  - No filing with the IRS or penalty is involved, but the sponsor or administrator must have reasonably designed compliance practices and procedures in place
  - Available in the case of an eligible inadvertent failure if:

    (1) The failure was not identified by the IRS prior to any actions demonstrating a specific commitment to implement a self-correction with respect to the failure.

(2) The self-correction is completed within a reasonable period after the failure was identified.

(3) The failure is not egregious, does not directly or indirectly relate to an abusive tax avoidance transaction, as described in section 4.12(2) of Rev. Proc. 2021-30, and does not relate to the diversion or misuse of plan assets.

(4) The self-correction satisfies all of the provisions applicable to self-correction set forth in Rev. Proc. 2021-30 (other than certain provisions set forth below), including that–

- A plan sponsor must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Code requirements, as described in section 4.04 of Rev. Proc. 2021-30;
- A plan sponsor must apply the correction principles and rules of general applicability set forth in section 6 of Rev. Proc. 2021-30;
- A plan sponsor may, but is not required to, self-correct using a correction method set forth in Rev. Proc. 2021-30 (and correction methods described in the revenue procedure are deemed to be reasonable and appropriate methods of correcting a failure); and
- A plan sponsor may not use a correction method that is prohibited under Rev. Proc. 2021-30.

- Notice 2023-43 states that the following requirements of Rev. Proc. 2021-30 are no longer applicable:

(1) The requirement that a plan be the subject of a favorable IRS letter.

(2) The prohibition of self-correction of demographic failures and employer eligibility failures.

(3) The prohibition of self-correction of certain loan failures.

(4) The provisions relating to self-correction of significant failures that have been substantially completed before the plan or plan sponsor is under examination.

(5) The requirement that a significant failure must be completed or substantially completed by the end of a specified correction period (in general, the last day of the third plan year following the plan year for which the failure occurred).

- **Voluntary Correction Program (VCP)**
  - Formal filing with the IRS along with the payment of a penalty is required
  - Available for (1) documentation errors (including failing to adopt a compliant plan document) and (2) operational failures
  - Results in a compliance statement showing IRS approval of proposed correction method
- **Audit Closing Agreement Program (Audit CAP)**
  - Program for plans under IRS audit
  - Involves negotiated correction of an identified failure and the payment of a sanction varying depending on nature and severity of the error

Common 403(b) plan errors corrected under SCP include failures to follow the terms of the plan document, to permit eligible employees to make salary deferrals in violation of the universal availability rule, and to comply with the annual addition limits in I.R.C. § 415. VCP must be used for significant failures in terminated plans, operational failures rectified by plan amendment in ways that are unfavorable to participants, and initial plan document failures. Moreover, VCP may be useful even in instances in which SCP is unavailable, if the correction method to be used is not one explicitly permitted under Rev. Proc. 2021-30 and the taxpayer wishes to have assurances that it will be accepted.

Significance of an error is based on the facts and circumstances, taking into consideration factors such as the extent, scope, and duration of the violation, the percentage of plan assets involved and number/percentage of participants affected, the timeliness of correction, and the reason for the failure.

The Secure 2.0 Act instructs the IRS to modify EPCRS to facilitate and broaden access to the program, including by making many more types of plan failures eligible for correction under SCP. Pub. L. No. 117-328, Div. T, § 305 (guidance required within two years).

Fiduciary Violations

Certain fiduciary errors can be corrected using the DOL's Voluntary Fiduciary Correction Program (VFCP), such as prohibited purchases, sales, and exchanges; improper loans; delinquent participant contributions; and improper plan expenses. For a 403(b) plan subject to ERISA experiencing these types of violations, a VFCP correction would generally be needed in addition to an EPCRS correction, where applicable. 71 Fed. Reg. 20,262 (Apr. 19, 2006); Dep't of Labor, Voluntary Fiduciary Correction Program.

General IRS Correction Guidance

The 403(b) Plan Fix-It Guide also serves as a quick reference for practitioners handling potential 403(b) plan mistakes. This guide contains information on how to identify and avoid errors, along with corrective actions. The guide contains links to other relevant IRS resources on 403(b) plan rules and compliance topics.

Terminating 403(b) Plans

The 403(b) plan regulations explicitly permit employers to terminate their plans. Treas. Reg. § 1.403(b)-10(a)(1); see also Rev. Rul. 2011-7 (analyzing the termination of 403(b) plans and an annuity benefit money purchase plan).

In some circumstances, however, plan termination had not been possible. As a precondition to termination, all plan assets must be distributed. Id. However, in some cases, plan sponsors were unable to distribute some custodial accounts because the participants had not cooperated or could not be located. The regulation states that "delivery of a fully paid individual insurance annuity contract is treated as a distribution," but does not refer at all to a custodial account. Treas. Reg. § 1.403(b)-10(a)(1). And vendors of custodial accounts often take the position that because the contracts are owned by the participants, the plan sponsor has no right to force a distribution of cash without participant consent.

Congress addressed this issue in Section 110 of the SECURE Act. The law directed the Secretary of the Treasury to issue guidance that allows a terminating 403(b) plan to "distribute" an individual custodial account in kind to the participant or beneficiary such that the account continues to be maintained by the custodian on a tax-deferred basis (similar to fully paid individual annuity contracts in Rev. Rul. 2011-7). The custodian must adhere to the Section 403(b) rules in effect at the time the account is assumed, and the employer may not continue to have any material rights relating to the account. Pub. L. No. 116-94, Div. O, § 110.

The IRS issued implementation guidance and expands on distribution options for terminating plans in Rev. Rul. 2020-23. The guidance is retroactively effective for taxable years beginning after December 31, 2008. If the plan is funded exclusively through custodial accounts maintained under individual agreements, an individual custodial account (ICA) may be distributed in kind without additional steps. For a plan that maintains custodial accounts under a group agreement, the plan must create documentation that sets forth relevant information for the ICA, including the value of the participant's nonforfeitable interest in the custodial accounts and the rights and responsibilities of the participant and the custodian. Funds attributable to such distributed ICAs continue to be excluded from the participant's gross income until amounts are distributed so long as the ICA maintains its custodial account status.

EP Subcommittee Report: 403(b) Plan Issues and Recommendations

A 2015 report by the Employee Plans (EP) Subcommittee of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT), titled "Employee Plans: Analysis and Recommendations Regarding 403(b) Plans," analyzes several issues affecting 403(b) plans and their sponsors. ACT, 2015 Report of Recommendations, pp. 15–83. The report identifies specific areas of widespread noncompliance and recommends enhanced IRS formal or "soft" guidance and educational outreach. These areas of concern include the following:

- **Universal availability nondiscrimination rule.** As discussed above, many employers, particularly those with many short-term or part-time personnel, struggle over interpreting or implementing the universal availability rule regulations. Others are simply unaware of its existence. But the consequences of noncompliance are severe (disqualification of the plan in its entirety). The subcommittee recommended steps to increase awareness of the rule and singled out employee exclusion rules as an area deserving further clarification.
- **Orphan 403(b) contracts.** The 403(b) regulations required written plans to be in place generally by 2010, and for available contract vendors to be listed in the plan documentation. Plan sponsors are also required to coordinate plan administration with the vendors of former contracts via information-sharing agreements if any further contributions were to be made during or after 2008. Treas. Reg. § 1.403(b)-10(b). So-called orphan contracts, issued before 2009 and frozen to new contributions (as described in Rev. Proc. 2007-71) raise some compliance questions not directly addressed in the regulations. For example, there is uncertainty as to whether operational compliance under an employee's orphan contract could taint the status of their active 403(b) plan contracts and accounts.

The EP Subcommittee also had several recommendations to improve the EPCRS program as it relates to 403(b) plans:

- Expand the SCP to allow corrections of certain plan loan errors (the most recent EPCRS and forthcoming rules pursuant to the Secure 2.0 Act address this concern).
- Extend the availability of the DOL's VFCP Earnings Calculator to compute lost earnings in more circumstances.

- Develop new VCP schedules focused specifically on common 403(b) plan problems.
- Consider lower fees for 403(b) plan sponsors due to their nonprofit status.

ACT, 2015 Report of Recommendations, pp. 49–55. Subsequent iterations of the EPCRS program have adopted some of these recommendations.

Advantages and Disadvantages of 403(b) Plans

Compared with a qualified plan such as a 401(k) plan, a 403(b) plan has several advantages:

- **Simplicity.** Often vendors will fulfill most functions.
- **No nondiscrimination testing required for elective contributions.** A 403(b) plan avoids the actual deferral percentage (ADP) test applicable to elective contributions in 401(k) plans and merely requires that elective contributions be universally available. This simplifies testing for the employer and means that highly compensated employees will not have their contributions limited because lower paid employees make low or no contributions. However, nondiscrimination testing must still be performed in the case of a nongovernmental 403(b) plan with respect to matching contributions.
- **Plan language available.** The IRS provides prototype language that can be used directly by pre-approved plans and as a guide for individually designed plans.
- **Generous catch-up contributions.** Catch-up limitations on elective deferrals are more favorable than for 401(k) plans.
- **Limited excise taxes.** Excise taxes on excess contributions apply only if the 403(b) contract is a custodial account described in I.R.C. § 403(b)(7), as opposed to an annuity contract.
- **Excess contributions do not disqualify plan.** If excess contributions are made, only the amount in excess of the contribution limits is taxable, as opposed to disqualifying the entire plan due to the separate accounting rules under Treas. Reg. § 1.403(b)-3.
- **Ability to avoid ERISA for nongovernmental/non-church employers.** By adopting a non-ERISA 403(b) plan, an eligible 403(b) plan sponsor that would normally be subject to ERISA can avoid ERISA coverage.

Notwithstanding the advantages noted above, 403(b) plans have some disadvantages compared with qualified plans that need to be considered:

- Employees, particularly those who have not previously worked for tax-exempt or governmental employers, may have less familiarity with 403(b) plans.
- A 403(b) plan, unlike a 401(k) plan, cannot cover an affiliate of a 501(c)(3) organization that is not itself a 501(c)(3) organization (e.g., a taxable research institute wholly owned by a university), unless the affiliate is a disregarded entity under the Internal Revenue Code. This is a particular problem if some employees divide their services between the taxable and tax-exempt entities.
- In-service withdrawals are available for employer contributions only upon attainment of age 59½. I.R.C. §§ 403(b)(7)(A)(ii) and 403(b)(11). This contrasts with a 401(k) plan, which can provide for in-service withdrawals of employer contributions as early as:
  - Five years after the employee begins plan participation (Rev. Rul. 1968-24) –or–
  - Two years after the money is contributed to the plan (Rev. Rul. 71-295) (Some states (e.g., New Jersey and Pennsylvania) impose income taxes on all 403(b) contributions.)
- Fewer providers and more limited types of providers for 403(b) plans may result in relatively higher fees.

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Carol Calhoun has significant experience with employee benefits matters, including qualified retirement plans, health and welfare arrangements, executive compensation, and insurance and annuity products. Carol has significant experience with standard pension plans – both defined benefit and defined contribution; 401(k); the full array of government and nonprofit plans, including 403(b) and 457; excess benefit plans; cafeteria/flexible spending; and a wide variety of welfare plans (e.g., health, life, and disability).

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