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The IRS is Investigating 403(b) Plans

For the past year, the Internal Revenue Service has been investigating 403(b) plans sponsored by school districts, to determine whether such plans are in compliance with applicable tax rules. The IRS also recently stated that it will examine school district plans in all 50 states over the next year. Specifically, the IRS is investigating whether school district 403(b) plans are complying with the so called "universal availability" rule. This rule requires that if an employer sponsors a 403(b) plan, all employees – with certain limited exceptions – must be given the opportunity to participate in the plan. Although employers found in violation of this rule generally can correct the mistake, those that do not take corrective action could have the entire plan disqualified.

403(b) plans are retirement plans sponsored by schools and tax-exempt organizations across the country. These plans – sometimes called "tax deferred annuities" (TDAs) or "tax sheltered annuities" (TSAs) – permit employees to make pre-tax salary deferral contributions, and often provide for employer matching contributions.

The initial IRS investigation takes the form of a "contact letter", which includes a questionnaire to be completed by the employer. Although a response to the initial letter and completion of the questionnaire are not mandatory, the letter does warn the recipient that failure to cooperate could lead to a formal IRS audit of the plan. If the responses to the questionnaire indicate that the employer may have violated the "universal availability" requirement, the IRS sends a follow-up "closing letter", which outlines the possible corrective measures that the employer can take. Samples of the contact and closing letters can be found in the Employee Benefits section of the Firm's website, www.jaeckle.com. The corrective actions, which are summarized below, require the employer to make a special contribution to the plan on behalf of all employees who were wrongly excluded from the plan.

The "universal availability" rule requires that if an employer permits one employee to defer salary into a 403(b) plan, the employer must extend this offer to all employees of the organization, with certain limited exceptions. Participation does not have to be offered to:

- Employees who normally work less than 20 hours per week
- Employees who participate in a 401(k) or 457 plan, or in another 403(b) plan
- Certain students who perform services at schools at which they are enrolled
- Non-resident aliens

An employee outside of these excludible categories must be offered the opportunity to participate in the plan. Employers that sponsor 403(b) plans often mistakenly assume that certain part-time employees and employees in certain support positions can simply be left out of the plan. In school district plans, nurses, substitute teachers, bus drivers and maintenance workers are common examples of wrongly excluded employees.

Failure to observe the universal availability rule can cause the entire 403(b) plan to lose its tax favored status. If that happens, employees will lose the ability to exclude contributions from their taxable income.

Jaeckle Fleischmann & Mugel, LLP

BUFFALO
12 Fountain Plaza
Buffalo, New York 14202-2292
Phone: 716.856.0600
Fax: 716.856.0432

AMHERST
400 Essjay Road, Suite 320
Amherst, New York 14221-8228
Phone: 716.250.1800
Fax: 716.250.1806

ROCHESTER
190 Linden Oaks
Rochester, New York 14625-2812
Phone: 585.899.2930
Fax: 585.899.2931

PHOENIX
7047 East Greenway Parkway, Suite 250
Scottsdale, Arizona 85254-8113
Phone: 480.659.2213
Fax: 480.659.3419

EMPLOYEE BENEFITS ATTORNEYS

Michele O. Heffernan (NY)
mheffernan@jaeckle.com; 716.843.3850

Robert W. Patterson (NY)
rpatterson@jaeckle.com; 716.843.3910

Nicole R. Tzetzo (NY)
ntzetzo@jaeckle.com; 716.843.3859

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To avoid disqualification of the entire plan, the sponsoring employer must correct the failure, by making a contribution to the plan on behalf of each wrongly excluded employee, in an amount which approximates the employee's "lost opportunity cost". The calculation for the required contribution represents an estimate of:

- the hypothetical deferral that the excluded employee would have made to the plan if he or she had been allowed to participate, plus
- the earnings that such contributions would have earned while in the plan.

In order to estimate what the improperly excluded employees would have contributed, the employer can either take the average contribution rate for similarly situated employees – the so called "actual deferral percentage" or "ADP" - or simply assume that the average rate is 3%. In either case, the school district must then:

- make a contribution for each wrongly excluded employee that is a percentage of the employee's compensation equal to one-half of the applicable contribution rate (i.e., either the actual ADP, or 3%); and
- if the employer made matching contributions for the years in question, it must also make a matching contribution for each excluded employee, equal to 100% (rather than one-half) of the salary deferral that each such employee would have made (computed in the manner just described).

Example: Employee A, with annual compensation of $50,000, was incorrectly excluded from a 403(b) plan for one year. The plan provides for employee elective deferrals and a 25% match. The ADP for the employee's group was 10% so the "hypothetical" deferral, which the employee was prevented from making, was 10% of $50,000, or $5,000. The required corrective contribution equals:

- $2,500 (one-half of the hypothetical deferral of $5,000), plus
- $1,250 (the hypothetical matching contribution - 25% of $5,000).

Thus, the total corrective contribution required is ($2,500 + $1,250) = $3,750 plus an adjustment for earnings.

The IRS' recent targeting of school district 403(b) plans isn't the only important development relating to these plans. The IRS proposed comprehensive new regulations to govern 403(b) plan in 2004, which are expected to be finalized this year. Among other things, the new regulations require a written plan document for all covered 403(b) plans. In addition, a great deal of attention has recently been focused on the high fees charged for certain 403(b) investments, particularly insurance company annuities.

Employers that sponsor 403(b) plans should take this opportunity to ensure that their plans fully comply with all applicable laws, and take an appropriate course of action if required. If you have any questions or would like more information regarding 403(b) plans, please contact Robert W. Patterson at rpatterson@jaeckle.com or 716.843.3910 or Michele O. Heffernan at mheffernan@jaeckle.com or 716.843.3850.

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