403(b) Guide for 501(c)(3) Organizations

January 2020

This guide is not intended and may not be used to avoid tax penalties, and was prepared to support the promotion or marketing of the matters addressed in this document. The taxpayer should seek advice from an independent tax advisor.

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INTRODUCTION

This *403(b) Plans – A Guide for 501(c)(3) Organizations* is intended to assist 501(c)(3) tax-exempt organizations who sponsor 403(b) plans by providing general information about the Internal Revenue Code (“Code”) and the Employee Retirement Income Security Act of 1974 (“ERISA”) rules governing operation and administration of 403(b) plans.

A tax-sheltered 403(b) annuity, also known as a tax deferred annuity or “403(b) plan” is a deferred compensation arrangement, which may only be sponsored by organizations that are exempt from taxation under Code Section 501(c)(3) and public school systems. Please note that this Guide focuses solely on 403(b) plans sponsored by Code Section 501(c)(3) organizations and does not address 403(b) plans sponsored by public school systems or entities that have both governmental and non-profit status.

Code Section 403(b) plans are generally funded through salary reduction agreements under which eligible employees elect to make contributions from their salary. Employers may also choose to make contributions either as a fixed percentage, as a fixed dollar amount or as a matching contribution.

Please note that this *Guide* is intended for general informational purposes only. No part of this *Guide* is intended to provide tax or legal advice – this is Voya Financial® interpretation of the Code and ERISA rules. Any questions involving tax or legal matters should be referred to your 403(b) plan’s legal counsel or tax advisor.

For more information on 403(b) plans, please visit Voya® dedicated website at http://foremployers.voya.com/retirement-plans/403b-regulations/

SECTION I - ERISA CONSIDERATIONS

403(b) Plans that are subject to ERISA

All 403(b) plans are subject to Title I of ERISA unless an exemption applies. The three scenarios by which a 403(b) plan can be exempt from ERISA are:

- the 403(b) plan is maintained by a governmental entity
- the 403(b) plan is maintained by a church or,
- the 403(b) plan is administered in accordance with a safe harbor available for plans that are maintained with limited employer involvement.

Employee Retirement Income Security Act of 1974 ("ERISA") Defined
In addition to the Code, this is the basic federal law governing employee benefit plans.

Safe harbor exemption from ERISA

For those 403(b) plans sponsored by non-governmental/non-church organizations that are tax-exempt under IRC Section 501(c)(3), a safe harbor exemption may apply if the employer maintains limited employer involvement by satisfying the following criteria as provided by the Department of Labor ("DOL") under Reg. Section 2510.3-2(f):

- Participation is voluntary for employees (e.g., no negative election or automatic enrollment provisions).
- It is a salary reduction-only 403(b) plan – that is, the only contributions permitted under the plan are salary reduction and Roth 403(b) contributions. No employer contributions are allowed.
- All rights under the 403(b) plan are enforceable only by the employee, beneficiary or authorized representative of the employee or beneficiary.
- There is limited employer involvement in the 403(b) plan. Limited involvement for an employer means permitting providers to publicize their products, requesting and summarizing information regarding the available funds or products, collecting salary reduction contributions and forwarding the contributions to the provider(s), signing a group annuity contract with a provider and limiting the number of funds and products under the 403(b) plan. However, the employer must provide participants with a reasonable choice of investments. According to the DOL, an employer may limit the number of providers to which it will forward salary reduction contributions as long as employees may transfer all or a part of their funds to any provider whose annuity contract or custodial account complies with the Code requirements and who is willing to enter into an information sharing agreement with the employer. In the view of the DOL, a "reasonable choice of investments" is generally ***more*** than one 403(b) vendor and more than one investment product.
- The employer cannot receive compensation for performance of its duties under the 403(b) plan other than compensation to cover reasonable expenses.

In response to the requirement in the final 403(b) regulations that an employer must be more involved in operating its 403(b) plan, the DOL released Field Assistance Bulletins ("FAB") No. 2007-02 and 2010-01 which provide a roadmap for those employers who wish to continue to maintain their 403(b) plan under the safe harbor.

The FABs make clear that the ultimate determination of whether or not a 403(b) plan meets the non-ERISA safe harbor depends on individual facts and circumstances. As a result, the DOL will make an assessment of such a plan's non-ERISA status on a case-by-case basis. However, the DOL notes that the following activities would be considered non-discretionary determinations of the employer and thus be consistent with the requirements of the safe harbor:

- Conduct administrative reviews of the program's structure and operation;
- Fashion and propose plan corrections;
- Develop improvements to the 403(b) plan's administrative processes that will obviate the recurrence of tax defects;
- Obtain the cooperation of independent entities needed to correct tax defects;
- Keep records of its activities;
- Certify facts related to an employee known by the employer to a funding vehicle provider;
- Adopt a written 403(b) plan;
- Conduct periodic review of documents making up the 403(b) plan for conflicting provisions and compliance with the tax rules; and

- Choose whether to include optional features such as loans and hardships in the 403(b) plan, provided that the vendor takes on the responsibility for discretionary determinations.

However, the following employer activities would cause a 403(b) plan to fall outside of the safe harbor, thus subjecting the plan to ERISA:

- Authorize plan-to-plan transfers;
- Process distributions;
- Satisfy applicable QJSA requirements;
- Determine eligibility for hardship distributions, QDROs and loans;
- Negotiate with funding vehicle providers to change the terms of their products for purposes other than compliance with the Code and regulations; and
- Selecting a TPA to perform discretionary administrative functions on behalf of the plan.

Department of Labor ("DOL") Defined
One of the federal government agencies responsible for the enforcement of the reporting and disclosure provisions of ERISA.

ERISA Requirements for Fiduciaries

If a 403(b) plan is subject to ERISA, there are stringent duties and requirements placed on plan fiduciaries. A fiduciary is a person who exercises discretionary control over the management of the 403(b) plan or its assets or who is paid to give investment advice regarding plan assets. At least one fiduciary must have the ultimate authority to control and manage the operation and administration of the plan (usually the plan administrator).

Plan Administrator Defined
A fiduciary who is responsible for the day-to-day administration of the 403(b) plan including determination of eligibility for participation in the plan and determination of participant benefits.

A fiduciary must:

- Operate the 403(b) plan for the exclusive benefit of participants and beneficiaries, and control expenses of administration,
- make decisions with the level of care, skill, and diligence that a prudent person familiar with retirement plans would use under the same circumstances,
- diversify investments to minimize the risk of large losses, unless it is clearly prudent not to do so;
- hold 403(b) plan assets within the jurisdiction of U.S. courts,
- act in accordance with the terms of the written plan documents unless the documents are in conflict with ERISA, and
- not engage in prohibited transactions.

Prohibited Transactions Defined
Fiduciaries must operate a 403(b) plan for the exclusive benefit and in the best interest of participants. To satisfy this requirement, a fiduciary must not engage in economic transactions that directly or indirectly involve plan assets and parties related to the plan unless the plan is covered by a statutory ERISA exemption or an exemption granted by the DOL. Prohibited transactions cover the sale, exchange or lease of property, extension of credit, provision of goods or services, transfer or use of plan assets, the investment in employer securities or employer real estate in excess of legal limits, and any situation where a plan fiduciary may have a conflict of interest (e.g., self-dealing, kickbacks, etc.).

The plan administrator is responsible for:

- determining eligibility for participation in the 403(b) plan,
- determination of benefits,
- approval or denial of claims,
- distribution of summary plan descriptions, summary annual reports and statement of vested benefits,
- filing Form 5500 and other required filings,
- maintaining the 403(b) plan records for at least six years,
- determining if a domestic relations order is a QDRO, and
- providing written explanation of rollover treatment to participants.

A 403(b) plan fiduciary who breaches his or her responsibilities may be subject to both criminal and civil penalties.

The DOL has provided information on fiduciary responsibilities under a retirement plan subject to ERISA which can be found here: https://www.dol.gov/agencies/ebsa

Investment of Plan Assets under ERISA Section 404(c)

One of the most important fiduciary responsibilities is investment of 403(b) plan assets. Although it is not required, a fiduciary can shift the responsibility for investment losses onto participants by electing to operate the plan under ERISA Section 404(c). In order to comply with ERISA Section 404(c), participants must be:

- Permitted to choose from a broad range of investment alternatives consisting of at least three diversified investment categories, each of which is characterized by materially different risk and return factors,
- Permitted to give investment instructions as frequently as the market volatility of the particular investment alternative dictates (but in no event, less frequently than quarterly), and
- Be provided with sufficient information to make informed investment decisions.

Compliance with these rules only insulates fiduciaries from poor investment decisions made by participants and beneficiaries. Fiduciaries are still liable for selecting funds, monitoring investments and general fiduciary responsibilities under ERISA.

A participant who does not submit investment instructions to the plan administrator will be treated as exercising actual control over the assets in his or her account if the plan's fiduciaries default investments are made in accordance with the DOL's regulations.

In order for participants to be deemed to exercise actual control over assets in their account when the plan makes default investments on their behalf, the plan must provide a notice to the participants of their rights and obligations. Specifically, within a reasonable time before the beginning of each year, each participant must be provided a notice explaining his or her rights under the plan to designate how contributions and earnings will be invested. In addition, the notice must explain how, in the absence of any investment election by the participant, the contributions and earnings will be invested. The notice must also inform each participant that they will have a reasonable period of time after receipt of the notice and before the beginning of the year to make a designation of how contributions and earning should be invested.

Bonding

Every fiduciary of a 403(b) plan who handles or has authority to handle plan assets must be bonded. The bond coverage must be at least 10% of the plan assets handled by the bonded individual. The bond must not be for less than $1,000 and need not be for more than $500,000.

IRS Plan Reporting Filings

An ERISA 403(b) plan is required to file a Form 5500 annual return filed. Beginning with the first plan year beginning on or after January 1, 2009, ERISA 403(b) plans are subject to full Form 5500 disclosure requirements. Also, a large ERISA 403(b) plan, which is generally a plan with 100 or more participants as of the beginning of the plan year, will be required to have an independent audit conducted as part of its Form 5500 filing.

Disclosure Requirements

A plan administrator must automatically provide certain information (as applicable) to participants and beneficiaries, such as a summary plan description, summary of material modifications, summary annual report, periodic benefit pension statement, 404(c) disclosure, qualified default investment alternative notice, automatic contribution arrangement notice, and participant plan and investment fee disclosures.

For more details on reporting and disclosure requirements for ERISA plans, please see the DOL's *Reporting and Disclosure Guide for Employee Benefit Plans* at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meeting-your-fiduciary-responsibilities.pdf

In addition, depending on plan design, a plan administrator may need to provide additional notices to plan participants and beneficiaries, such as a notice of opportunity to make elective deferrals, safe harbor notice, automatic contribution arrangement notice, eligible rollover distribution notice, explanation of income tax withholding requirements, explanation of automatic rollover, consent to distribution explanation, qualified joint and survivor annuity explanation and qualified preretirement survivor annuity explanation. To assist plan administrators with these requirements, the IRS prepared a Reporting and Disclosure Guide for Employee Benefit Plans in cooperation with the Treasury, DOL and the Pension Benefit Guarantee Corporation (PBGC). The Guide can be found at: http://www.irs.gov/pub/irs-tege/irs_reporting_disclosure_guide.pdf.

ERISA requires the disclosure of fees and expenses by service providers to plan fiduciaries, ***and*** by plan fiduciaries to participants and beneficiaries in ERISA 403(b) plans.

Sponsor Fee Disclosure

ERISA requires plan fiduciaries, when selecting and monitoring service providers and plan investments, to act prudently and solely in the interest of the plan's participants and beneficiaries. Responsible plan fiduciaries also must ensure that arrangements with their service providers are "reasonable" and that only "reasonable" compensation is paid for services. Fundamental to the ability of fiduciaries to discharge these obligations is obtaining information sufficient to enable them to make informed decisions about services provided to an employee benefit plan, the costs of such services, and the service providers.

A covered service provider (CSP) must provide responsible fiduciaries with information they need to:

- Assess reasonableness of total compensation, both direct and indirect, received by the CSP, its affiliates, and/or subcontractors;
- Identify potential conflicts of interest; and
- Satisfy reporting and disclosure requirements under ERISA.

As such, before entering into a contract or arrangement for services, or extension or renewal thereof, service providers are generally required to disclose to plan sponsors: (a) all direct and indirect fees and compensation that they expect to receive in the amount of $1,000 or more; (b) a description of services to be provided in exchange for such compensation; and (c) whether such services will be provided as a fiduciary or as a registered investment advisor.

Participant Fee Disclosure

Providing information about plan and investment-related expenses is part of ERISA's requirements that plan fiduciaries act prudently and solely in the interest of the plan's participants and beneficiaries. The DOL feels participants need this additional information to understand the cost of participating in the plan so they can more effectively manage their accounts. That is, when a plan allocates investment responsibilities to participants or beneficiaries, the plan administrator must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan and the plan's investment options, including fee and expense information, to make informed decisions with regard to the management of their individual accounts. A plan administrator must provide to each participant or beneficiary certain plan-related information and investment-related information.

Plan-related information includes general information, administrative and individual expense information. This information needs to be provided to participants on or before the date they can first direct their investments, and then again annually thereafter.

In addition to the plan-related information that must be furnished up front and annually, participants must receive statements, at least quarterly, showing the dollar amount of the plan-related fees and expenses (whether "administrative" or "individual") actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made. These specific disclosures may be included in quarterly benefit statements required under ERISA.

The second category of information that must be disclosed under the final rule is investment-related information. This category contains several subcategories of core information about each investment option under the plan, including performance data, benchmark information, fees and expenses, internet website address and glossary.

Investment-related information must be furnished to participants or beneficiaries on or before the date they can first direct their investments, and then again annually thereafter. It also must be furnished in a chart or similar format designed to facilitate a comparison of each investment option available under the plan. The DOL has made available a model comparative chart, which when correctly completed, may be used by the plan administrator to satisfy the rule's requirement that a plan's investment option information be provided in a comparative format.

Claims Procedures

A benefits claim is a request made by or on behalf of a participant or beneficiary for plan benefits in accordance with reasonable procedures established by the plan. If no procedure has been established, the claim is considered filed when the claimant makes a written or oral communication reasonably calculated to bring the claim to the attention of the individual or committee that primarily handles the employer's benefit matters. ERISA generally requires a plan to provide adequate notice in writing of the denial of a claim for benefits and to give a reasonable opportunity for full and fair review of the decision to deny the claim. DOL regulations provide the following guidelines for determining when claims procedures are reasonable:

- the procedures must be described in the SPD;
- the procedures must not contain any provision, or be administered in such a way, that improperly prevents or hampers filing or processing a claim;
- the procedures must comply with the rules for claim procedures set forth in the DOL regulations; and
- the procedures must specifically provide for certain written notices to participants and beneficiaries.

SECTION II - ELIGIBILITY

Eligible Employers

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

- Public school systems: a teaching institution with a faculty, curriculum and enrolled students and includes public primary and secondary schools, state colleges and universities, and public junior colleges.
- Organizations qualified under Code Section 501(c)(3).

501(c)(3) Organizations Defined

A tax-exempt organization qualified under Code Section 501(c)(3) organized and operated exclusively for religious, charitable, scientific, literary, educational or safety testing purposes. In addition, certain public institutions, such as government-operated hospitals, libraries and museums may also have a favorable determination letter from the IRS regarding their status as Code Section 501(c)(3) organizations.

A 501(c)(3) organization includes not only the organization whose employees participate in the 403(b) plan, but also any other tax exempt organization that is under common control. Common control is based on 80% of the directors or trustees being either representatives of, or directly or indirectly controlled by an exempt organization.

It should be noted that in such a "controlled group" situation, only entities that are either tax-exempt organizations under Code Section 501(c)(3) or public schools may participate in a 403(b) plan, e.g., a public university and a 501(c)(3) alumni association. If a tax-exempt organization operates a for-profit corporation, the employees of the for-profit corporation cannot participate in the organization's 403(b) plan.

Church-related organizations

There are three types of church-related organizations that can sponsor 403(b) plans:

- Churches (also known as "steeple churches"), conventions or associations of churches, or elementary or secondary schools controlled, operated, or principally supported by a church or a convention or association of churches;
- Qualified church controlled organizations (QCCOs), which are nonprofit organizations under IRC Section 501(c)(3) that:
  - Offer goods, services or facilities to the general public on an incidental basis only, or at nominal charge which is substantially less than the cost of providing the goods, services or facilities; and
  - At least 75% of support comes from church sources;
- Non-qualified church controlled organizations (nonQCCOs), which are also 501(c)(3) nonprofit organizations.

  However, nonQCCOs:
  - Offer goods, services or facilities to the general public on more than an incidental basis and at more than a nominal charge; and
  - Normally receives more than 25% of its support from either governmental sources, or receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities which are not unrelated trades or businesses or both.

Determination of church status, including the type of church-related affiliation, should be made by the employer and its legal counsel.

Eligible Employees

Only common law employees are permitted to participate in a 403(b) plan. In general, independent contractors and leased employees are not considered common law employees and may not be covered by a 403(b) plan.

Independent Contractor Defined

A person who provides services to the employer pursuant to one or more written or oral contracts, if such person is not a common-law employee.

Leased Employee Defined

An individual who provides services to an employer of a type historically performed by employees, pursuant to an agreement with the employer and a leasing organization, on a substantially full-time basis for a period of at least one year provided the services performed are under the primary direction or control of the employer.

Universal Availability

Salary reduction and Roth 403(b) (if permitted under the 403(b) plan) contributions are subject to the "Universal Availability Rule," which is satisfied only if the 403(b) plan permits every eligible employee (subject to the exceptions listed below) to have the opportunity to make salary reduction and Roth 403(b) contributions of at least $200 annually. An employer is not permitted to impose a minimum percentage of contributions on salary reduction and Roth 403(b) contributions as an administrative convenience.

A 403(b) plan may exclude the following employees from making salary reduction and Roth 403(b) contributions:

- Employees whose maximum salary reduction and Roth 403(b) contributions under the 403(b) plan would be no greater than $200,
- nonresident aliens with no U.S. source of income,
- Student-employees whose compensation is not subject to FICA wages,
- Employees eligible to make deferred compensation contributions to a 457(b) plan, a 401(k) plan or another 403(b) plan sponsored by the employer, or
- Employees who normally work less than 20 hours per week,

An employee is considered to work fewer than 20 hours per week only if:

- For the 12-month period beginning on the date the employee's employment began, the employer reasonably expects the employee to work fewer than 1,000 hours of service in such period; and
- For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period.

<u>"Once in, always in" Rule</u>

Under the "fewer than 20 hours per week" exception rule, once an employee becomes eligible to have salary reduction contributions made on his or her behalf to the plan under this standard, the employee cannot be excluded from eligibility to have salary reduction contributions made on his or her behalf in any later year. Thus, if a 403(b) plan elects this provision and an employee completes 1,000 hours of service in any year, then the employer must allow that employee to participate in the 403(b) plan in any later year, regardless of the number of hours of service that employee subsequently completes. This is known as the "once in, always in" rule. That is, the only way that an employee could be excluded as having worked "fewer than 20 hours per week" is if that employee never completed at least 1,000 hours of service in any year.

For example, ABC Organization's 403(b) plan document excludes employees from making salary reduction contributions if the employee works fewer than 20 hours per week. Ms. Y, an employee at ABC Organization, is hired in 2019 and is not permitted to participate in the ABC 403(b) plan in 2019 since she is reasonably expected to complete less than 1,000 hours of service per year. However, in 2019, Ms. Y completes 1,050 hours of service. Since Ms. Y completed more than 1,000 of service in 2019, she must be permitted to make elective deferrals to the ABC 403(b) plan in all subsequent years, regardless of the number of hours she subsequently performs under the "once in, always in" rule. Additionally, ABC Organization must remember to provide Ms. Y, as an eligible employee, with the annual Universal Availability Notice informing her of the opportunity to participate in the school's 403(b) plan.

Plan Year Defined
Any 12-month period elected by the employer and stated in the 403(b) plan document over which 403(b) plan records and administration are maintained.

Notice to Eligible Employees to meet "Universal Availability"

At least once each plan year, an employer must provide employees who are eligible to participate in a 403(b) plan a notice informing them that they have the opportunity to make salary reduction and, if applicable, Roth 403(b) contributions, or change deferral elections, when they can make those elections, the maximum amount permitted and whether there are conditions on those elections. If the 403(b) plan permits catch-up contributions, these contributions should also be included in the notice.

Automatic Enrollment and Qualified Default Investment Arrangement (QDIA)

Some ERISA 403(b) plan sponsors have an automatic enrollment feature in their plans as a way of increasing plan participation. The following is a chart that explains the different types of automatic enrollment options and the features of each type of option.

Plan Provision	Eligible Automatic Contribution Arrangement (EACA)	Qualified Automatic Contribution Arrangement (QACA)
Eligible Employees	May cover new hires only or existing employees who did not previously make an affirmative election to participate or not participate in the plan However, plan must cover all eligible employees to take advantage of the six-month ACP correction rule.	Must cover all new hires and existing employees who did not previously make an affirmative election to participate or not participate in the plan
Rate of automatic deferral	No specific rate required but must be uniform	3% minimum deferral rate required
Automatic Rate Escalator – Deferral amount increases each year	Optional	Required. The rate must increase for those automatically enrolled by at least one percentage each year, to at least 6%, but not to exceed 10%.
Participant Withdrawal of Automatic Contributions before distributable event	Permissible: participants may request a distribution of default contributions made in the first 30 to 90 days. Participant is not entitled to any associated match	Only available if the EACA rules are met
ACP Testing	Required where applicable but plan sponsor has a six-month ACP correction rule rather than 2 ½ months	Safe harbor contribution so no ACP testing required. Note: ACP testing would still be required for after-tax (non-Roth) contributions
Safe Harbor Design	Optional – With traditional match of 100% on first 3% and 50% on next 2% or an enhanced match formula; or a 3% nonelective contribution 100% vesting required on safe harbor contribution	Required - With alternative match of 100% on the first 1% plus 50% on the next 5% deferred; or a 3% nonelective contribution 100% vesting required on safe harbor contribution after 2 years
Notice Requirements	➢ Annual notice distributed within a reasonable period before start of the plan year (e.g., at least 30 but not more than 90 days prior). ➢ Newly eligible employees, distributed no earlier than 90 days and no later than eligibility date, or as soon as practicable, but before the pay date of the pay period in which the employee is first eligible. ➢ The employee must have reasonable time, after receiving the notice, to opt out or elect a different deferral percentage.	Same as EACA
QDIA Requirements*	Optional	Optional

*A QDIA provides plan fiduciaries relief from liability for investment losses where participants and beneficiaries are permitted to direct investment of the assets in their plan accounts.

A QDIA may be:

- Life-cycle or targeted-retirement-date fund
- Balanced fund or
- Professionally managed account.

Other Types of Contributions

There are no Code provisions restricting the permissibility of other types of contributions. For that reason, 403(b) plans may contain eligibility requirements for non-salary reduction contributions subject to specific nondiscrimination requirements. A 403(b) plan may require an employee to reach a certain age and/or work for the employer sponsoring the 403(b) plan for a certain period of time in order to receive employer contributions.

Rehired Employees and Breaks In Service

With respect to employer contributions, if a participant terminates employment and is later reemployed before incurring a one-year break in service, s/he will be considered to be a participant as of his or her reemployment date. However, if a participant terminates employment and is later reemployed after incurring a one-year break in service, his or her prior years of service for vesting and eligibility purposes will include his or her prior service subject to the following rules:

- In the case of a terminated participant who did not have any percentage of vesting in his or her employer contributions, his or her prior years of service will not be taken into account if the number of consecutive one-year breaks in service equals or exceeds the greater of (a) five or (b) the aggregate number of pre-break years of service.
- A terminated participant who did not have any years of service before incurring a one-year break in service will be eligible to participate in the 403(b) plan as of the date of his or her reemployment, or if later, as of the date s/he would have otherwise been eligible to participate in the plan.
- Subject to the employer electing in the 403(b) plan document, a terminated participant who is reemployed by the employer before incurring five consecutive one-year breaks in service and who had received a distribution of his or her vested employer contributions, may elect to repay the full amount which had been distributed to the participant. If the participant repays the distributed amount, then any forfeited amounts will be reinstated. The repayment must be made before the earlier of five years after the first date on which the participant is subsequently reemployed by the employer or the close of the first period of five consecutive one-year breaks in service beginning after the distribution. If a distribution occurs for any reason other than a severance from employment, the time for repayment is not permitted to end earlier than five years after the date of distribution. In the event the former participant repays the full amount distributed, the undistributed forfeited amount of the employer contributions will be restored in full.

Hour of Service Defined

Any hour for which an employee is paid or entitled to be paid. An hour of service includes payments made due to vacation, sickness, holiday, disability, layoff, jury duty, military duty, or leave of absence, even if the employee no longer works for an employer.

Year of Service Defined

A plan year where at least 1,000 hours of service are credited to an employee for purposes of determining eligibility and vesting.

One-Year Break in Service Defined

A computation period (generally, a plan year) during which an employee fails to complete more than 500 hours of service. Generally, hours of service are credited for “authorized leaves of absence” and “maternity and paternity leaves of absence” in order to prevent the employee from incurring a one-year break in service.

SECTION III - CONTRIBUTIONS AND RELATED LIMITATIONS

Contributions to a 403(b) Plan

A 403(b) plan may provide for more than one type of contribution, including participant and/or the employer contributions in the 403(b) plan document. The following is an overview of the rules for 403(b) contributions.

Participant Contributions

Salary Reduction: amounts deferred on a before-tax basis by a participant from compensation.

Roth 403(b): amounts deferred on an after-tax basis by a participant from compensation. Note: If a 403(b) plan permits Roth 403(b) contributions, participants must have the choice to make salary reduction contributions or Roth 403(b) contributions or a combination of the two types of contributions. A participant's election to make Roth 403(b) contributions is irrevocable once the election is made.

In-Plan Roth Rollovers & Conversions – A plan may permit a participant to take a portion of their vested plan balance and roll it over to the plan's designated Roth account. The plan may specify which sources of vested contributions are available for rollover in such a manner, as well as if distributable (Rollover) and/or non-distributable (Conversion) amounts are allowed to be rolled over and how often such rollovers can be made. Any amount rolled over or converted will be includable in gross income for the year in which it is moved to the designated Roth account, minus any basis on the amount transferred. The plan does not withhold taxes from the IRR transaction—a participant may want to increase their payroll tax withholding or make an estimated tax payment to account for the additional taxable amount. The plan must offer Roth Contributions in order to make In-Plan Roth Rollovers (IRRs) and Conversions available.

Special rules apply if amounts from an IRR are withdrawn within the 5-year taxable period.

Salary Reduction Agreement Defined

A participant elects in a salary reduction agreement to defer salary reduction or Roth 403(b) contributions from his or her salary into a 403(b) plan. A participant must make or modify a salary reduction agreement election at any time before the affected salary would otherwise become payable. Also, the salary reduction agreement must be legally binding under law. For example, in most states, an individual who is under the age of 18 or who is mentally incapable of entering into a contract may not make a salary reduction agreement.

Rollovers into plan: If permitted by the plan, an individual may roll over eligible amounts from an *eligible rollover plan* to a 403(b) plan.

Eligible Rollover Plan Defined

An eligible rollover plan is another 403(b), 401(a)/(k), or governmental 457(b) plan or traditional Roth IRA and SIMPLE IRA after two years of participation. While ROTH IRAs meet the definition of an eligible retirement plan, they are not allowed to be rolled into other plan types.

Payments after Severance from Employment

A participant who has had a severance from employment may be able to defer certain payments to a 403(b) plan for up to the later of 2½ months or the end of the calendar year following severance from employment. Payments that are eligible to be deferred include regular compensation, payments for overtime, commissions, bonuses, sick pay, vacation pay or other leave that would have been payable or available if the participant had not had a severance from employment.

Employer Contributions

Employer contributions made to a 403(b) plan may be a discretionary amount, a fixed amount or percentage or may match participants' salary reduction or Roth 403(b) contributions. Employer contributions must meet the nondiscrimination tests.

Non-Elective Employer Contributions: may either be a discretionary amount or based on the 403(b) plan's contribution formula.

Employer Matching Contributions: contributions that match all or a portion of a participant's salary reduction or Roth 403(b) contributions.

An employer may require that a participant complete a certain number of hours of service (not more than 1,000) and/or be employed on the last day of the year in order to receive an allocation of the employer contributions.

Employer Contributions after Severance from Service

Employers are permitted to make contributions to a 403(b) plan on behalf of retired or terminated participants for a period of up to 5 years after the year of the participant's retirement or termination. Such contributions may be made to participant accounts up to the Code Section 415(c) annual additions limit for each of the 5 post-retirement years, based on the terminated employee's final year's includible compensation.

Eligible 403(b) Investments

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

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

Taxation of Contributions

Federal and State Income Taxation

In general, salary reduction and employer contributions, including earnings thereon, are subject to federal and state income tax only when directly distributed from the plan. However, Roth 403(b) contributions are generally subject to federal and state income tax when these amounts are contributed, but earnings on those amounts may be distributed tax-free if certain conditions are met.

Taxation under the Federal Insurance Contributions Act ("FICA")

FICA imposes a tax on employers and employees in order to provide retirement and welfare benefits to individuals who are no longer employees. FICA taxes are based on wages paid to employees of an employer. Only salary reduction and Roth 403(b) contributions, because they are deferred from a participant's compensation, are subject to FICA taxes when contributed to a 403(b) plan. However, no contributions to a 403(b) plan, regardless of source, and earnings under a 403(b) plan are subject to FICA taxes when distributed.

Saver's Tax Credit

A nonrefundable tax credit for salary reduction and Roth 403(b) contributions may be available to certain participants. The maximum annual contribution eligible for the credit is $2,000, and the maximum credit rate is 50%. The credit is pro-rated and depends on a participant's adjusted gross income and his/her federal income tax filing status. The chart below indicates the AGI levels for various filers and the percentage of credit available (for 2020, subject to annual cost of living adjustments).

Joint-filer AGI	Head of Household AGI	All Others - AGI	Credit
$0 – $39,000	$0 – $29,250	$0 – $19,500	50%
$39,001 – $42,500	$29,251 – $31,875	$19,501 – $21,250	20%
$42,501 – $65,000	$31,876 – $48,750	$21,251 – $32,500	10%

Vesting Requirements

Participant Contributions

Salary reduction, Roth 403(b) and rollover contributions must always be 100% vested, i.e., nonforfeitable upon being contributed to the plan. For this purpose, as well as for distribution reasons, salary reduction and Roth 403(b) contributions must be accounted for separately. In addition, if permitted by the plan, rollover contributions may be distributed at any time.

Employer Contributions

A 403(b) plan may require that a participant earn the right to his or her account balance attributable to employer or matching contributions by completing a certain number of years of service. The applicable vesting schedule(s) are stated in the 403(b) plan document. An employer may choose a vesting schedule that is at least as liberal as one of the following vesting schedules:

3-year cliff vesting schedule

- 0-2 Years of Service: 0%
- 3 Years of Service: 100%

6-year graded vesting schedule

- 0-2 Years of Service: 0%
- 2-3 Years of Service: 20%
- 3-4 Years of Service: 40%
- 4-5 Years of Service: 60%
- 5-6 Years of Service: 80%
- 6 Years of Service: 100%

ERISA would require fully vesting participant accounts upon plan termination.

Changing a Plan's Vesting Schedule

An employer may amend the 403(b) plan's vesting schedule, subject to the following requirements:

- the vested portion of a participant's account balance may not be impacted by the new vesting schedule, and
- participants with at least three years of service must be allowed to elect which of the two vesting schedules apply to their total account balance and their ongoing contributions.

for Amounts Subject to Vesting Schedules

The IRS final 403(b) regulations state that only vested amounts are considered 403(b) monies, with all other nonvested monies tracked separately until those amounts are vested (i.e., nonforfeitable). Thus, if the 403(b) plan provides for a graded or cliff vesting schedule, the vested portion will be treated as amounts held under a 403(b) contract; the amount that is not vested is forfeitable and would be treated as amounts held under a contract to which Section 403(c) would apply (or such provision of the Code as may apply). As a participant becomes vested in some or all of the portion of that separate tracking, the vested amounts are now considered 403(b) monies.

When a participant terminates employment without being 100% vested, the non-vested portion of his or her account may be used to reduce future employer contributions, pay 403(b) plan expenses or be reallocated among remaining participants' accounts as specified by the 403(b) plan.

Timing of Contributions

Employer contributions for a plan year can be made to the 403(b) plan after the end of the plan year, subject to the terms of the plan document.

If a 403(b) plan is subject to ERISA, generally, the salary reduction contributions (including ROTH 403(b)) and loan repayments must be contributed to the 403(b) plan as soon as they can reasonably be separated from the employer's general assets, but no later than the 15th business day of the month following the month in which the contribution was withheld from participants' compensation or received by the employer.

With respect to 403(b) plans with fewer than 100 participants, salary reduction contributions and loan repayments are deemed to be timely if deposited with 7 business days after the amounts are withheld from wages.

If a 403(b) plan is not subject to ERISA, the 403(b) regulations provide that contributions must be remitted to the 403(b) plan's funding vehicle no later than is reasonable for the proper administration of the 403(b) plan.

Annual Contribution Limits

The two annual separate limits for contributions made to a 403(b) plan are:

Code Section Limit	Contributions to be Included
Code Section 415(c)	All contributions and forfeitures made to the plan except age 50+ and rollover contributions

Code Section Limit	Contributions to be Included
Code Section 402(g)	Salary reduction contributions and Roth 403(b) contributions This limit is coordinated with all elective deferrals made by a participant under another 403(b) plan, a 401(k) plan, a salary reduction simplified employee pension (SARSEP) plan or a SIMPLE retirement plan in a tax year.

The following is a general description of the various limitations. For more detailed information, please refer to IRS Publication 571 – T*ax-Sheltered Annuity Plans for Employees of Public Schools and Certain Tax-Exempt Organizations.* This Publication can be found on the IRS website at IRS Publication 571.

Code Section 415(c) Contribution Limits

Code Section 415(c) provides that annual additions to a 403(b) plan on behalf of a participant cannot exceed the lesser of:

- $57,000 (for 2020, subject to annual cost of living adjustments) or
- 100 percent of the participant's includible compensation.

Watchout: If a participant in a 403(b) plan also participates in another defined contribution retirement plan of the employer, such as a 401(a) qualified plan, in general, the amounts contributed to a participant's 403(b) account are considered "separate" for Code Section 415(c) contribution limitation purposes from the amounts under the 401(a) plan. However, a participant will have a combined Code Section 415(c) contribution limit in the case where s/he also participates in a defined contribution plan (typically, a Keogh plan) in which s/he has a controlling interest in that plan sponsor (more than a 50% interest) ("Common Control Rule"). In the Common Control Rule situation, all retirement plans are deemed to be "owned" by the participant. If a plan sponsor adopts an IRS pre-approved 403(b) plan document, one of the requirements of the plan is that participants are provide with notice regarding the need to coordinate 415 limits with any other plans that are required to be aggregated with the participant's 403(b) account.

For example:

Doctor Jones is employed by a 501(c)(3) hospital that maintains a 403(b) plan and also owns a private practice where s/he is a 60 percent shareholder. Doctor Jones' private practice sponsors a 401(a) plan. Because Dr. Jones is deemed to "own" both the 403(b) plan and the 401(a) plan, the retirement plans must be combined for purposes of Code Section 415(c).

Includible Compensation

Generally, includible compensation is the amount of compensation determined on a calendar year basis received from the employer sponsoring the 403(b) plan that is includible in the employee's gross income for the most recent period that may be counted as a "one-year period of service" and also includes:

- Salary reduction and Roth 403(b) contributions,
- Deferrals under 457(b) and 403(k) plans,
- Qualified transportation benefits excluded from gross income under Code Section (132(f)(4)),
- Code Section 125 cafeteria plan salary reduction amounts, and
- Deferrals under a salary reduction simplified employee pension ("SARSEP") and a savings incentive match plans for employees ("SIMPLE").

Includible Compensation does not include:

- Employer contributions, and
- Contributions made to the 403(b) plan that are considered made pursuant to a one-time irrevocable election.

One-Year Period Service Defined
For full time employees: generally, the current taxable year.
For part-time and retiring employees: the most recent one-year period of service consists of the service in the current year and the service for as many previous years as is necessary to total one full year of service.

Code Section 401(a)(17) Compensation Limit

For purposes of employer contributions, the Code requires that compensation be limited to $285,000 (for 2020, subject to annual cost of living adjustments).

Code Section 402(g) Contribution Limits

In general, Code Section 402(g) imposes a limit on salary reduction and Roth 403(b) contributions. The limit is $19,500 in 2020 and is subject to annual cost of living adjustments. This limit is coordinated with all elective deferrals made by a participant under another 403(b) plan, a 401(k) plan, a salary reduction simplified employee pension (SARSEP) plan or a SIMPLE retirement plan in a tax year.

If an employer maintains a 457(b) deferred compensation plan, the salary reduction contribution limits of 403(b) plans do not impact an individual's ability to make deferrals to a 457(b) deferred compensation plan. Generally, this means for the 2020 calendar year that a participant can defer up to $19,500 to a 403(b) plan and separately defer up to $19,500 to a 457(b) plan before catch-ups.

15-Year Catch-Up Provision

A 15-year catch-up election for salary reduction and Roth 403(b) contributions is available to employees of "eligible employers." Employees who have <u>15 or more years of service with an eligible employer</u> may be able to contribute an amount up to $22,500 (for 2020, as indexed annually for cost of living adjustments). For eligible employees, the general $19,500 limit is increased by the lesser of the following amounts:

- $3,000,
- $15,000 reduced by salary reduction and Roth 403(b) contributions not included in gross income for prior taxable years because of this provision (which was effective 1/1/87), or
- $5,000 times years of service minus all prior elective deferrals made to Code Section 403(b), 401(k), SARSEP and SIMPLE plans of the employer in prior taxable years.

Note: the 15-year catch-up of up to $3,000 per year cannot exceed cumulatively $15,000 over the lifetime of the employee. If prior elective deferral contributions are less, on a yearly average, than $5,000, a participant may be eligible to make catch-up contributions.

Note: If prior elective deferral contributions are less, on a yearly average, than $5,000, a participant may be eligible to make catch-up contributions.

For example:

Mary Smith, a nurse, who has worked 15 years for a hospital, has never used the increased limit and has made $30,000 in salary reduction and Roth 403(b) contributions in prior years. Ms. Smith's calculation would be as follows:

The lesser of a), b) or c):

a) $3,000	*$ 3,000*
b) $15,000 (because increased limit was never used)	*$15,000*
c) $5,000 times 15 minus $30,000	*$45,000*

Therefore, in 2020, Mary Smith is eligible to use the 15-year catch-up to make salary reduction contributions in the amount of $3,000.

Eligible Employer for Purposes of the 15-Year Catch-Up Election Defined

- An educational organization described in Code Section 170(b)(1)(A)(ii). This type of educational organization normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place which its educational activities are regularly carried on.
- A hospital
- A home health service agency. This type of organization must be specifically designated as such an organization under section 1861(o) of the Social Security Act by the Secretary of Health and Human Services.
- A health and welfare agency. This is an organization whose primary activity is to:
  - Provide medical care (such as a hospice),
  - Prevent cruelty to individuals or animals,
  - An adoption agency, or
  - An agency that provides substantial personal services to the needy.
- A church, convention or association of churches, or an organization described in Code Section 414(e)(3)(B)(ii) (this is an organization that is tax-exempt under Code Section 501 and that is controlled by or associated with a church or a convention or association of churches)

Age 50 Plus Catch-Up Provision

If a participant is at least 50 years old by the end of a calendar year, s/he is eligible to make additional contributions to a 403(b) plan in the amount of $6,500 (for 2020, as indexed annually for cost of living adjustments), provided s/he has contributed the maximum amount up to the Code Section 402(g) limit as well as any available amounts under the 15-year catch-up. As with the Code Section 402(g) limit, the age 50 plus catch-up contributions are coordinated with age 50 plus catch-up contributions under another 403(b) plan, a 401(k) plan, a SARSEP or a SIMPLE retirement plan. Age 50 plus catch-up contributions are not subject to the Code Sections 415(c) and 402(g) limits. In addition, an employer is permitted to make matching contributions with respect to these catch-up contributions.

Overview of 403(b) Contribution Limits: 2020	
Employee Deferral	**$19,500**
15-year catch-up	**3,000**
Age 50+ catch-up	**6,500**
Employer contributions*	**34,500**
	$63,500*

***The age 50+ catch-up contributions do not count toward the 415(c) contribution limit of $57,000.**

Contributions in Excess of the Code Section 415(c) Contribution Limit

Excess Annual Additions are contributions made to a 403(b) plan that are in excess of the Code Section 415(c) limit. Under the final 403(b) regulations, excess contributions (and earnings) that are not corrected by the end of the year of the excess must be separately accounted for. In addition, the IRS provides for a method of correction under EPCRS if not corrected by the end of the year of the excess.

If the employee also participates in a defined contribution plan in which s/he has “common control” and s/he has an excess of the Code Section 415(c) limit, the excess must first be corrected under the 403(b) plan.

Excise Tax

Code Section 4973 imposes a 6% cumulative excise tax on excess contributions made to a custodial account. (The excise tax is not applicable to excess contributions made to an annuity contract.) However, the excise tax does not apply to excess deferrals under a custodial account. The excise tax is imposed specifically on the employee (and not the employer or provider), and is not tax deductible. The excise tax is determined as of the close of the taxable year and is imposed for each taxable year until the excess contribution is eliminated by an allowable method of correction.

Contributions in Excess of the Code Section 402(g) Contribution Limit

Excess deferrals are salary reductions and Roth 403(b) contributions made by a participant in excess of the Code Section 402(g) limit. To correct an excess deferral, both the excess and any associated earnings must generally be distributed to a participant by the April 15 immediately following the close of the taxable year in which the contribution was made. The excess deferral is includible in income in the year deferred; however, earnings associated with the excess deferral are includible in income in the year distributed. The distribution is not rollover eligible and is not subject to the IRS 10% premature distribution penalty tax.

Generally, if correction of excess deferrals does not occur by the April 15 following the year in which the deferral was made, the excess deferral may only be distributed to the participant once s/he is entitled to receive a distribution. Such distributions are subject to double taxation. That is, the excess deferral is taxable in the year the excess was made and in the year the amount is distributed. Additional correction methods may be available under EPCRS.

Military Leave

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”), veterans returning to employment from certain military service are entitled to the restoration of pension benefits that would have accrued but for the employee’s military service. Specifically, the re-employed veteran’s military service is considered service with the employer for purposes of 403(b) plan contributions. Make-up contributions on behalf of re-employed veterans are neither subject to the contribution limitations for the year made, nor are they considered in applying the limits to any other contributions made during the year. However, the make-up contributions are subject to the applicable limitations (including any previous cost-of-living adjustments that were in effect) with respect to the year the contribution relates.

In calculating the amount of any make-up contributions, compensation used for such calculation is the compensation the participant would have earned had the participant not engaged in military service. There is no requirement that the 403(b) plan provide for earnings to be credited to make-up contributions for any period before the contributions were actually made or make-up forfeitures occurring during the period of military service. Also, if the 403(b) plan contains a vesting schedule, re-employed veterans must receive credit for purposes of vesting service for periods of military service. If any contribution under the 403(b) plan is contingent upon the making of contributions by the participant (e.g., matching contributions), the participant must make up the missed contributions before receiving the employer's contribution. For additional information refer to the Department of Labor website at https://www.dol.gov/agencies/ebsa.

If an employer provides differential pay to individuals who are on military leave, that individual may defer all or a portion of that pay to a 403(b) plan. Differential pay is amounts an employer pays an individual who has been called to active military service as a way of replacing some or all of the difference between the individual's military pay and the compensation the individual would have received from the employer had s/he remained in active employment.

If a participant takes a loan from the plan and then performs military service, then the plan can provide for:

- The participant to be obligated to continue to repay the loan while on military leave or
- The suspension of loan repayments until the individual returns from military leave.

If the loan is suspended during the period of military leave, interest will still accrue on the loan; however, the Service members Civil Relief Act of 2003 generally prohibits the plan or contract from charging more than 6% interest on that loan during active military service, provided that participant provides written notice and appropriate documentation of his military service no later than 180 days after the termination of the military service. In addition, if loan repayments are suspended during the military leave, loan repayments must resume upon rehire and the repayment period may only extended beyond the loan's maximum repayment period by the length of military service.

A reservist or national guardsman is permitted to take a distribution from a 403(b) plan, which is not subject to the IRS 10% premature distribution penalty tax if all of the following requirements are met:

- The participant was ordered or called to active duty after September 11, 2001.
- The participant was ordered or called to active duty for a period of more than 179 days or for an indefinite period as a member of a reserve component.
- The distribution consists of salary reduction or Roth 403(b) contributions.
- The distribution was made no earlier than the date of the order or call to active duty and no later than the close of the active duty period.

All or part of a qualified reservist distribution can be recontributed to an IRA within 2 years after the end of military duty.

In addition, an employer sponsoring a 403(b) plan must treat an individual who dies or becomes disabled while performing qualified military service as if the individual has resumed employment on the day preceding death or disability and terminated employment on the actual date of death or disability. Therefore, beneficiaries obtain additional benefits such as accelerated vesting, incidental death benefits or other survivor benefits that are provided to those participants who terminate employment due to death.

SECTION IV- NONDISCRIMINATION TESTING

Nondiscrimination Testing for Salary Reduction and Roth 403(b) Contributions

The nondiscrimination requirement for salary reduction and Roth 403(b) contributions requires "universal eligibility."

Nondiscrimination Testing for Contributions Other Than Salary Reduction and Roth 403(b) Contributions

With respect to contributions other than salary reduction and Roth 403(b) contributions, 403(b) plans are generally subject to the same nondiscrimination requirements as 401(a) plans. The contribution may be allocated in a method that satisfies either a design-based safe-harbor formula (which are deemed to be non-discriminatory) or a formula that must be tested to ensure that it does not impermissibly discriminate in favor of HCE**s**.

In addition to complying with the annual compensation limits, there are a number of nondiscrimination tests which a 403(b) plan must meet on an annual basis. In order to perform these tests, an employer must identify the HCEs.

Highly Compensated Employee ("HCE") Defined

An employee who:

- was at any time a 5-percent owner during the plan year or the preceding plan year; or
- received compensation from the employer in excess of $130,000 (for 2020 and adjusted annually for cost-of-living) during the preceding plan year, and if the employer elects for such preceding plan year, the employee was in the top paid group (i.e., top 20 percent of employees by compensation) of the employer for such preceding plan year.

In general, the following is a list of nondiscrimination test that must be performed on an annual basis by a 403(b) plan sponsored by a Code Section 501(c)(3) organization:

Nondiscrimination Test	Description
Code Section 410(b) – coverage test	A 403(b) plan must cover a certain portion of employees
Code Section 401(a)(4) – general non-discrimination contribution test	Employer non-elective contributions cannot discriminate in favor of HCEs
Code Section 401(a)(4) – general non-discrimination test	Benefits, rights and features cannot discriminate in favor of HCEs
Actual Contribution Percentage ("ACP") Test	Matching contributions and voluntary after-tax contributions cannot discriminate in favor of HCEs

Note: A 403(b) plan may be required to perform other nondiscrimination testing as needed and contingent upon plan design.

Minimum Coverage Requirements under Code Section 410(b)

The minimum coverage requirements provide that the classification of employees covered by a 403(b) plan does not discriminate in favor of HCEs. Some 403(b) plans automatically meet the minimum coverage requirements. Other 403(b) plans will need to pass one of two minimum coverage tests – the ratio percentage test or the average benefit test.

The minimum coverage requirements are complex. If your 403(b) plan does not permit a certain classification of employees to participate or if your organization is a member of a controlled group of organizations and some of the organizations do not participate in your 403(b) plan, you need to be familiar with the minimum coverage requirements. The following is a simplified explanation of the requirements to provide you with general information that you may need when discussing your 403(b) plan's specific requirements with your tax advisor.

<u>Ratio Percentage Test</u>

The ratio percentage test requires a 403(b) plan to benefit a percentage of NHCEs that is at least 70% of the percentage of HCEs benefiting under the 403(b) plan.

<u>Average Benefit Test</u>

If a 403(b) plan cannot pass the ratio percentage test, then the 403(b) plan must pass the average benefit test. The average benefit test is a two-part test – a nondiscriminatory classification test and the average benefit percentage test. Both tests must be satisfied in order to pass the average benefit test.

Nondiscriminatory classification test: The classification of Employees benefiting must be a "reasonable" classification that does not discriminate in favor of HCEs. A reasonable classification is based on all of the facts and circumstances, such as whether the classification is made under objective business criteria such as job categories, method of compensation and geographic location.

Average Benefit Percentage Test: This test requires that the average benefit percentage of NHCEs be at least 70% of the average benefit percentage of the HCEs.

General Nondiscrimination Testing of Employer Nonelective Contributions under Code Section 401(a)(4)

To satisfy Code Section 401(a)(4), employer nonelective contributions under a 403(b) plan cannot discriminate in favor of HCEs. This type of testing is too complex to include in this *Guide*. However, there are two types of contribution formulas which, if adopted by the employer, no 401(a)(4) general testing is required.

- The formula provides the same contribution percentage or a flat dollar amount for all employees, or one that provides higher contributions for employees earning over a dollar break point that complies with permitted disparity rules under Code Section 401(l), and
- The formula provides contributions based on a uniform points formula taking into account the age, service and/or compensation of the employee, provided that the average contribution (as a percentage of compensation) for all NHCEs is at least as great as the average contribution for all HCEs.

General Nondiscrimination Testing of Benefits, Rights and Features under Code Section 401(a)(4)

To satisfy Code Section 401(a)(4), benefits, rights and features under a 403(b) plan cannot discriminate in favor of HCEs based on all relevant facts and circumstances. Examples of rights and features include loan provisions, particular forms of investment, rate of matching contributions and rollover contributions. As this nondiscrimination test is based on specific facts and circumstances, this type of testing is beyond the scope of this *Guide*.

Actual Contribution Percentage ("ACP") Discrimination Test

The amount of matching contributions made to a 403(b) plan cannot discriminate in favor of HCEs. To ensure that matching (including contributions that match age 50 plus catch-up contributions) contributions are not discriminatory, the 403(b) plan must satisfy the ACP test.

The Code provides two methods of applying the ACP test, a prior year testing method and the current year testing method. A 403(b) plan must specify which of these methods it will use in applying the ACP test.

<u>Prior year testing method</u>: under this method, matching contributions will satisfy the ACP test if:

- The actual contribution ratio ("ACR") for HCEs for the current plan year does not exceed the ACR of the NHCEs for the preceding plan year, multiplied by 1.25, or
- The lesser of (a) the ACR for HCEs for the current plan year does not exceed by more than 2% of the NHCEs for the preceding plan year or (b) the ACR for HCEs for the current plan year is not more than the ACR of the NHCEs for the preceding plan year multiplied by 2.

<u>Current year testing method</u>: under this method, the ACR of NHCEs for the current plan year are compared with the ACR of HCEs for the current plan year. Under this method, matching contributions will satisfy the ACP test if:

- The ACR for HCEs for the current plan year does not exceed the ACR for NHCEs for the current plan year, multiplied by 1.25, or

- The lesser of (a) the ACR for HCEs for the current plan year does not exceed by more than 2% that of NHCEs for the current plan year or (b) the ACR for HCEs for the current plan year is not more than the ACR of the NHCEs for the current plan year multiplied by 2.

A 403(b) plan may correct a failed ACP test by forfeiting non-vested contributions, recharacterizing salary reduction or Roth 403(b) contributions, distributing excess contributions and in certain circumstances, the employer may make an extra contribution to the NHCEs in the amount needed to satisfy the tests.

"Safe Harbor" Contributions

An employer may elect to make a "safe-harbor" contribution to its 403(b) plan as an alternative to passing the ACP nondiscrimination test applied to matching contributions. These safe-harbor contributions must be either a basic matching formula, an enhanced matching formula or a non-elective contribution formula (see below)

Basic Matching Formula: a matching contribution is made to each eligible NHCE based on the following formula:

- 100% match on the eligible NHCEs salary reduction and/or Roth 403(b) contributions up to the first 3% of compensation, plus
- 50% of the eligible NHCEs' salary reduction and/or Roth 403(b) contributions for the next 2% of compensation.

Enhanced Matching Formula:

The enhanced matching formula requires that the employer make matching contributions on behalf of each eligible NHCE that, for any rate of elective contributions, provides an aggregate amount of matching contributions at least equal to the aggregate matching contributions that would have been provided under the basic matching formula.

Under either of the matching formulas, the rate of matching contributions may not increase as the employee's rate of elective contributions increases, and the rate of matching contributions that applies to any HCE must not be greater than the rate of matching contributions that would apply to any NHCE who has the same rate of elective contributions. Matching contributions used to meet this ACP safe harbor must be 100% immediately vested and are not available for hardship withdrawals. In addition, the 403(b) plan cannot require NHCEs to work at least 1,000 hours during a plan year or be employed on the last day of the plan year in order to receive a safe harbor matching contribution.

Non-elective contribution formula**:**

In addition to the above, it is also possible to offer an alternative match provided it is paired with at least a 3% non-elective contribution formula and the match does not exceed 4% of an eligible employee's compensation and cannot be allocated based on more than 6% of employee elective deferrals. The 3% non-elective contribution must meet certain minimum vesting and withdrawal conditions.

Notice of Safe Harbor Contributions to Participants

An employer must provide each employee who is eligible to participate in the 403(b) plan a written notice of the safe harbor contributions formula in accordance with IRS guidance.

SECTION V - DISTRIBUTIONS

Permissible Distributions from 403(b) Plans

The Code permits a 403(b) plan to make distributions to a participant or beneficiary when a participant has a distributable event. A list of distributable events under a 403(b) plan are listed below. Note that a 403(b) plan document can be more restrictive than the Code requirements.

403(b)(1) Annuity Contracts

Salary reduction and Roth contributions (including earnings) may generally be distributed only upon:

- Attainment of age 59 ½
- Severance from employment
- Death
- Disability, or
- Hardship.

Note: Hardship withdrawals are limited to salary reduction contributions made after 12/31/88 (not including earnings) and amounts attributable to QNECs and QMACs (including earnings).

Exceptions to the above distribution rules:

No Code withdrawal restrictions apply to:

- ’88 cash value (salary reduction contributions (including earnings) as of 12/31/88)
- Employer contributions (including earnings)

Note, however, employer contributions (and earnings) made to an annuity contract issued after December 31, 2008 may not be distributed before:

- the participant’s severance from employment, or
- the occurrence of an event, such as after a fixed number of years, the attainment of a stated age, or disability.

403(b)(7) Custodial Accounts

Salary reduction, Roth and employer contributions (including earnings) may only be distributed upon:

- Attainment of age 59 ½
- Severance from employment
- Death
- Disability, or
- Hardship.

Note: Hardship withdrawals are limited to:

- Salary reduction contributions and
- ’88 cash value (earnings on salary reduction contributions and employer contributions (including earnings) as of 12/31/88)

Distribution of Roth 403(b) Contributions

Distributions of Roth 403(b) contributions will be tax-free for federal income tax purposes if they are “qualified distributions” and the following criteria is met:

- The funds must be held for a 5-year holding period, AND
- The distribution is due to attainment of age 59 1/2, death, or disability.

In general, the 5-year holding period begins on the first day of the calendar year for which the employee first makes Roth 403(b) contributions to the 403(b) plan and ends when 5 consecutive taxable years have been completed.

If a participant rolls over amounts from a designated Roth account, the following rules apply:

- If a *direct* rollover is made from a designated Roth account to an eligible rollover plan, the 5-year holding period begins on the first day of the calendar year for which the employee first made designated Roth contributions to the prior plan.

- If an *indirect* rollover is made from a designated Roth account to an eligible rollover plan, the 5-year holding period begins on the first day of the calendar year that the employee makes a designated Roth contribution to receiving 403(b) plan.

Distribution of Rollover Contributions

If permitted by a 403(b) plan, amounts rolled over into the plan can be distributed to a participant before a participant has a distributable event as described above.

Types of Distributions

The common distribution options under a 403(b) plan are:

- Lump sum distribution
- Immediate or deferred annuity
- Direct rollover to an eligible rollover plan
- Deferred distribution
- Periodic payments from the 403(b) plan
- Combination of these options
- In addition, if a participant dies, a spousal beneficiary may continue the account subject to the RMD rules. However, no additional contributions or rollovers may be made to the account.

Severance from Employment

A 403(b) plan may allow a participant who has terminated employment with the employer to receive his or her vested account balance upon severance from employment in accordance with the 403(b) plan rules.

Required Minimum Distributions ("RMD") under Code Section 401(a)(9)

The Code requires that payment of benefits under a 403(b) plan must begin no later than the April 1 of the calendar year following the later of the calendar year in which the participant reaches age 70 1/2 or retires from the employer sponsoring the 403(b) plan.

The amount of the RMD is based on the participant's account balance (as of the previous December 31) divided by the applicable life expectancy. Generally, there is a single table that is used to determine a participant's applicable life expectancy that does not take into account a participant's designated beneficiary unless the participant's sole primary beneficiary is a spouse whose is more than 10 years younger than the participant. In this case, the applicable life expectancy is the participant's and spouse's joint and last survivor life expectancy. Life expectancies are determined under tables provided by the IRS.

Pre-'87 Account Balance

For RMD purposes, if the vendor maintains the records necessary to identify the 12/31/86 cash value, such cash value (as of 12/31/86) does not have to be factored into the RMD amount until the April 1 of the calendar year following the year in which the participant attains age 75 or retires, whichever is later.

Death

Distributions, upon death of a participant, are made to a designated beneficiary. Generally, a 403(b) plan will offer various distribution options, although regulations require death benefits to be distributed within a certain period of time. The timeframe depends upon whether the beneficiary is a spouse or non-spouse.

If RMD payments *have not begun upon a participant's death*, payments must be distributed to a designated beneficiary no later than:

- **Designated Beneficiary Rule:** Payment of the deceased participant's account balance must begin no later than December 31 of the calendar year immediately following the calendar year of the participant's death, payable over a period not to exceed the life expectancy of the beneficiary.

- **Designated Beneficiary is Surviving Spouse**: If the designated beneficiary is the surviving spouse, the payments to the spouse must begin by the later of:
    - December 31 of the calendar year immediately following the calendar year in which the employee dies, or
    - December 31 of the calendar year in which the employee would have attained age 70 1/2.

The payments to the surviving spouse must be made over a period not to exceed the spouse's life expectancy.

In the alternative, a spouse or non-spouse beneficiary may elect to have death benefits paid under the five-year rule.

- **Five-year rule:** The deceased participant's entire account balance must be distributed to a designated beneficiary no later than the December 31 of the calendar year containing the fifth anniversary of the participant's death.

If RMD payments *have begun to be made to a participant before death*, payments of the deceased participant's account balance must continue to a beneficiary (regardless of whether the beneficiary is a spouse or non-spouse) beginning no later than December 31st of the calendar year immediately following the calendar year of the participant's death and must be paid over the longer of:

- the remaining life expectancy of the appropriate beneficiary (once the designated beneficiaries have been determined), or
- the remaining life expectancy of the participant.

The following chart indicates how payments generally must be made to designated beneficiaries over life expectancy:

Designated Beneficiary	How Life Expectancy is calculated
Spouse is sole beneficiary	<u>Year following the year of participant's death</u>: the life expectancy of the spouse based on the age of the spouse in the year following the year of the participant's death <u>Subsequent years</u>: the spouse's left expectancy is recalculated annually <u>For the years after the year of the spouse's death</u>: the spouse's remaining life expectancy is calculated in the year of the spouse's death, reduced by one annually thereafter
Nonspousal beneficiary	<u>Year following the year of the participant's death</u>: the life expectancy of the beneficiary is based on the age of the beneficiary in the year following the year of the participant's death <u>Subsequent years</u>: the beneficiary's life expectancy is reduced by one annually
No designated beneficiary (i.e., either a trust that is not being looked through or the participant's estate)	<u>The year following the year of the participant's death</u>: The participant's life expectancy is based on the attained age of the participant in the year of the participant's death <u>Subsequent years</u>: the participant's remaining life expectancy is reduced by one annually

Trust as Beneficiary

Only an individual may be a designated beneficiary for purposes of determining the distribution period under Code Section 401(a)(9). Consequently, a trust itself may not be the designated beneficiary even though the trust is named as a beneficiary. However, if the trust is being "looked through" distributions made to the trust will be treated as paid to the beneficiaries of the trust if certain conditions are met.

Rules of a Look-Through Trust

- The trust is a valid trust under state law,
- The trust is irrevocable or will become irrevocable upon the death of the participant,
- The beneficiaries of the trust are identifiable from the trust instrument, and
- Appropriate documentation required under the RMD rules has been provided to the plan administrator (see below).

A participant who names a trust as a beneficiary and who intends the trust be a "look through" trust during his/her lifetime, must either:

- Provide to the plan administrator (or the party who maintains the plan's beneficiary information) a copy of the trust document and agree to provide any subsequent amendments to the trust, or
- Provide to the plan administrator a list of all of the beneficiaries under the trust, indicating that the participant's spouse is the sole, primary beneficiary and that the spouse's age is more than 10 years younger than the participant, and
- Certify that the list of beneficiaries is correct and complete and that all necessary requirements are satisfied with respect to the trust, and
- Agree to provide corrected certifications to the extent that an amendment changes any information previously certified, and
- Agree to provide a copy of the trust document to the plan administrator upon request.

If a look-through trust has been named as his or her designated beneficiary, upon a participant's death, the trustee of the trust must, by the October 31st of the year following the year of the participant's death, either:

- Provide the plan administrator with:
  - a final list of all of the beneficiaries of the trust as of the September 30th of the calendar year following the calendar year of the participant's death,
  - a certification that, to the best of the trustee's knowledge, this list is correct and complete and that all applicable requirements are satisfied, and
  - agree to provide a copy of the trust instrument to the plan administrator upon request, or
- Provide the plan administrator with a copy of the actual trust document.

Disability

A 403(b) plan may permit a disabled participant to receive a distribution of 100% of his or her account balance. An individual is considered *disabled*, under Code Section 72(m)(7), if s/he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or be of a long-continued and indefinite duration.

Hardship Withdrawals

The rules for distributions from 401(k) and 403(b) plans on account of "hardship" are found under the 401(k) regulations. The Bipartisan Budget Act of 2018 (BBA 2018) and The Tax Cuts and Jobs Act of 2017 (TCJA 2017) simplified the hardship distribution rules governing 401(k) and 403(b) plans.

To be eligible for a hardship distribution, a participant must experience:

- ***An immediate and heavy financial need***, and
- ***The distribution must be necessary to satisfy the financial need.***

Hardship distributions are not rollover eligible. As a result, hardship distributions are subject to a federal voluntary 10% withholding requirement and, unless an exception applies, an IRS 10% premature distribution penalty tax.

Immediate and Heavy Financial Need Standards

Following the Internal Revenue Service's issuance of final hardship regulations, there are seven safe harbor events that qualify for an immediate and heavy financial need, effective for hardship withdrawals taken on or after January 1, 2020:

- Certain medical expenses incurred by the employee, the employee's spouse, a dependent of the employee or primary beneficiary of the participant, provided that such medical expenses would be deductible (without regard to the limits of Internal Revenue Code Section 213(a);
- Costs directly related to the purchase of a principal residence for the employee (does not include mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, the employee's spouse, child, dependent, or primary beneficiary;
- Payments necessary to prevent the eviction or foreclosure on the mortgage of the employee from the employee's principal residence;
- Payments for burial or funeral expenses for the participant's deceased parent, spouse, child, dependent, or primary beneficiary;
- Certain expenses incurred for the repair of damage to the participant's principal residence, determined without regard to the casualty loss limitations under Internal Revenue Code Section 165 as modified by TCJA 2017 (i.e., the damage to the principal residence does not need to arise as part of a federally declared disaster); and
- Losses and expenses incurred on account of a federally declared disaster designated as such by the Federal Emergency Management Agency (FEMA). Additionally, this new safe harbor:
    - Is available only to the employee who lived or worked in the disaster area. Expenses or losses of an employee's relative or dependent will not be considered eligible under this safe harbor event;
    - Is not subject to a specified deadline for a hardship distribution request related to the disaster-relief safe harbor; and
    - An employer may choose to add this disaster-relief safe harbor to the plan at a later date (for example, when such a disaster occurs), provided that the amendment to permit the disaster-relief safe harbor is adopted by the end of the plan year in which it is effective.

For these purposes, a primary beneficiary under the plan is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant.

Standard for Determining the Amount Necessary to Satisfy the Financial Need

The final hardship regulations provide that there is **one method** of determining whether the participant has any other financial resources available to satisfy the requested hardship amount. As a result, an employer may no longer make this determination based on a facts and circumstances method. The following criteria must be used to assess the amount necessary to satisfy a financial need:

- The amount withdrawn cannot exceed the participant's need (including any amounts necessary to pay any federal, state, or local income tax or penalties reasonably anticipated to result from the distribution);
- The participant must first request all other available distributions under all the employer's qualified and nonqualified plans, including available ESOP dividends; and
- The participant must represent in writing or via telephone on a recorded line to the plan administrator that s/he has insufficient cash or other liquid assets that are "reasonably available" to satisfy the need. A plan sponsor may rely on such employee's representation "unless the employer has actual knowledge to the contrary."

A participant is not required to take a nontaxable loan from the plan in order to satisfy the standard for determining the amount necessary to satisfy the financial need.

If a participant takes a hardship withdrawal, this standard does not require a plan to prohibit that participant from making elective contributions and employee after-tax contributions to 401(k), 403(b) or governmental 457(b) plans of the employer for the 6-month period immediately following a hardship distribution.

An employer may decide, as a matter of plan design, to impose a suspension of employee contributions to other plan types (including a 457(b) plan sponsored by a nonprofit organization and a nonqualified plan under IRC Section 409A).

Contribution Sources Under a Plan Available for a Hardship Distribution

While BBA 2018 broadened the sources available for a hardship withdrawal effective as of 1/1/2019, there are special rules applicable to 403(b) plans:

- A 401(k) plan ***may*** permit a hardship withdrawal to include qualified matching contributions (QMAC) and their earnings, qualified nonelective contributions (QNEC) and their earnings, and earnings on elective deferrals.
- A 403(b) plan ***cannot*** allow a hardship withdrawal to include earnings on elective deferrals; Section 403(b) of the Internal Revenue Code does not permit the withdrawal of such earnings for hardships.
- Employer contributions, including earnings (however, QMAC and QNECs under a 403(b)(7) product are not permitted to be distributed on account of hardship).
  - If the product is a 403(b)(7) custodial account, withdrawal of employer contributions due to hardship is not permitted under the Internal Revenue Code.
  - If the product is a 403(b)(1) annuity contract, amounts attributable to QNECs and QMACs may be distributed to a participant requesting a hardship withdrawal, provided that both the product terms and 403(b) plan so provide.

Rollovers and Federal Mandatory 20% Tax Withholding

If a participant receives a distribution that is eligible for rollover, 20% federal income tax withholding is automatically withheld from the distribution. The following are not eligible for rollover:

- A required minimum distribution,
- A distribution that is one of a series of substantially equal periodic payments (at least annually) made (a) over the life or life expectancy of the participant or over the joint lives or joint life expectancy of the participant and the participant's beneficiary or (b) over a specified period of ten or more years,
- The portion of a distribution that is not included in gross income, or
- A hardship distribution.

A **direct rollover** is a direct transfer from a 403(b) plan to an eligible rollover plan. In a direct rollover, the check is payable to the financial institution issuing the other eligible rollover plan for the benefit of the participant or beneficiary and there is no tax withholding.

An **indirect rollover** occurs when a participant or beneficiary receives a check for the distribution and makes a rollover within 60 days of receipt of the check. The mandatory 20% income tax withholding applies to any eligible rollover distribution made directly to a participant or beneficiary. Even though taxes have been withheld, the participant or beneficiary may contribute the amount withheld from the distribution in federal income tax withholding as part of a rollover to the subsequent eligible rollover plan. If the participant or beneficiary does not replace the federal income tax withheld, s/he will be taxed on this amount. In certain circumstances, the IRS may waive the 60-day rollover requirement.

A spouse or alternate payee who is a former spouse who receives a death benefit distribution is also eligible to rollover the distribution to an eligible rollover plan in which s/he participates.

Non-spouse beneficiaries can directly roll their distributions to an inherited IRA instead of taking a distribution. The inherited IRA must satisfy the required minimum distribution rules.

Contract to Contract Exchanges

A contract to contract exchange is a transfer among vendors' products within the same 403(b) plan, subject to the following rules:

- The written 403(b) plan must provide for the transfer;
- The benefit transferred must be equal to the benefit received by the subsequent product (excluding any applicable contractual charges); and
- The distribution rules of the receiving product must be at least as stringent as the prior product;
- In addition, the employer and vendor must agree to share certain participant information on an ongoing basis, including:
  - whether and when a severance of employment has occurred to determine whether the participant has a distributable event
  - information on whether a participant is entitled to a loan; and
  - information concerning whether the hardship withdrawal rules have been satisfied.

Plan to Plan Transfers

A plan-to-plan transfer is a transfer among the same or different employers' 403(b) plans, subject to the following rules:

- The individual whose 403(b) account is being transferred must be an employee or former employee of the employer of the receiving 403(b) plan;
- Both 403(b) plans must provide for the transfer in their plan document;
- The benefit transferred must be equal to the benefit received by the subsequent employer's plan (excluding any applicable contract charges);
- The distribution rules of the receiving employer's 403(b) plan must be at least as stringent as the prior employer's 403(b) plan; and
- If the transfer involved only a portion of the 403(b) account, the receiving 403(b) plan needs to be able to account for which contributions are employee contributions and which are employer contributions.

Contract Exchange	403(b) Plan-to-403(b) Plan Transfer	Transfer to Purchase Service Credits	Rollover
➢ Among approved products under same 403(b) plan whether the same or different vendor ➢ Participant or beneficiary with an account can make a contract exchange if the 403(b) plan permits this optional feature ➢ No *distributable event* required ➢ Amounts only move directly from one 403(b) product approved under the plan to another product approved under that same 403(b) plan ➢ Considered a tax-free transfer from the 403(b) product making the transfer. No *tax reporting* at the time of the contract exchange ➢ Grandfathered features under the prior 403(b) product preserved following the contract exchange (if separately tracked by prior and new product) ➢ Product receiving the contract exchange is subject to information sharing rules with the employer	➢ Among different 403(b) plans, even if both 403(b) plans are sponsored by same employer ➢ Participant or beneficiary maintaining an account under the 403(b) plan can make a plan-to-plan transfer if both the 403(b) plan making the transfer and the 403(b) plan receiving the transfer permit transfers ➢ Amounts only move directly from one 403(b) plan to another 403(b) plan ➢ Considered a tax-free transfer from the 403(b) plan making the transfer. No *tax reporting* at the time of the plan-to-plan transfer ➢ Grandfathered features under the 403(b) plan making the transfer preserved by the 403(b) plan receiving the transfer (if separately tracked by prior and new product)	➢ From a 403(b) plan to a federal, state, or local governmental defined benefit retirement system to buy *permissive service credit* under that governmental retirement system ➢ Participant with both a 403(b) account and benefit due under the governmental defined benefit retirement system can make a transfer to purchase service credit if the 403(b) plan permits the transfer and the governmental defined benefit retirement system determines the amount of the credit to be purchased and accepts the transfer ➢ Amounts only move directly from the 403(b) plan to the governmental defined benefit retirement system ➢ Considered a tax-free transfer from the 403(b) plan. No tax reporting at the time of the transfer	➢ Rollover out: eligible amounts can be rolled over via either an indirect or direct rollover from the 403(b) plan to all eligible retirement plans. Spousal beneficiaries may roll eligible amounts into an eligible retirement plan in which they participate. Nonspousal beneficiaries may only roll over eligible amounts via a direct rollover to an inherited IRA. ➢ Rollover in: eligible amounts may be rolled over to a 403(b) plan from an eligible retirement plan (for purposes of rollovers in, an eligible retirement plan does not include a Roth IRA). Spousal beneficiaries may roll over eligible amounts into an eligible retirement plan in which they participate or to their own traditional or Roth IRA. ➢ A distributable event is required in order to roll over ➢ The plan receiving the rollover must permit rollovers in ➢ Tax reporting required at the time that the amounts are rolled over. Tax withholding in required for in-direct rollovers. ➢ Amounts rolled over do not retain grandfathered features under the 403(b) plan

IRS 10% premature distribution penalty tax

In general, an IRS 10% premature distribution penalty tax applies to the taxable portion of a distribution if a participant receives a distribution before reaching age 59 1/2.

The IRS 10% premature distribution penalty tax does **not apply** if the distribution is made on account of one of the following reasons:

- Death of the participant,
- The participant becomes disabled,
- Payments are made in at least annual installments over the life (or life expectancy) of the participant or the joint lives of the participant and the designated beneficiary,
- Separation from service on or after attainment of age 55,
- Payments made for medical care, but not in excess of amounts allowable as a deduction under regulations,
- Corrective distributions of excess contributions and excess deferrals,
- Payments are made to an alternate payee under a QDRO,
- Payments of a federal levy for collection of taxes; or
- As a "qualified reservist distribution," which is a distribution of salary reduction or Roth 403(b) contributions that are (a) made to a reservist or national guardsman who was called to active duty after September 11, 2001 for a period in excess of 179 days or for an indefinite period of time, and (b) made during the period beginning on the date of the order or call to duty and ending at the close of the active duty period. In addition, a qualified reservist distribution can be repaid to an IRA at any time during the two-year period after the end of the active duty period.

Loans

An employer may offer loans to participants under a 403(b) plan. Loan programs give participants access to certain amounts of money in their accounts during active employment without incurring tax liability if the loans are made under certain guidelines. Under a loan provision, participants may be allowed to borrow from, and repay loans directly, to their own accounts. Participants will be required to repay the loans with interest. The interest is paid from after-tax dollars, is nondeductible, and will be subject to tax when finally withdrawn from the 403(b) plan. A provision permitting loans must be provided in the 403(b) plan document and the plan must establish written loan guidelines that outline the specific rules governing the loans. The Code and ERISA, if applicable, govern loans made to participants under a 403(b) plan.

In general, loans must:

- Be made available to all participants on a reasonably equivalent basis. Regulations require that loans be made available to all participants without regard to race, color, religion, sex, age or national origin. Loans cannot generally be made available to HCEs on better terms or in a greater amount or percentage than for other participants. This rule does not apply to participants who are former employees, retirees, beneficiaries or alternate payees under a QDRO.
- Be made in accordance with specific provisions that are set forth in the 403(b) plan.
- Bear a reasonable rate of interest. The rate of interest on a loan must be "commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances." Many 403(b) plan sponsors use a rate between prime rate and prime plus two points. Others use standard bank rates for secured loans.
- Be adequately secured. Up to 50% of the vested value of a participant's account balances can be used to secure a loan.
- The loan must be set forth in a legally enforceable agreement that must specify the amount of the loan, the term of the loan and the repayment schedule.

<u>Maximum and Minimum Loan Amounts</u>

Loans must be the lesser of (a) $50,000 reduced by the participant's highest outstanding loan balance during the last 12 months or (b) 50% of the vested account balance. The IRS rationale is that the 50% cap is necessary to ensure that the program meets its primary purpose of providing retirement income.

Loan Repayment Requirements

Loans must be repaid in level payments at least as frequently as quarterly within 5 years. The exception is if the participant is buying or building his or her primary residence, then the program can allow a repayment period of more than 5 years.

Spousal Consent

A 403(b) plan that is subject to ERISA must comply with the Qualified Joint and Survivor Annuity ("QJSA") and Qualified Pre-retirement Survivor Annuity ("QPSA") requirements. In order not to be subject to these rules:

- The plan must provide that upon death, the participant's entire vested account balance is payable to the participant's surviving spouse unless the surviving spouse consents to the designation of another beneficiary.
- The participant does not elect payments in the form of a life annuity. (The QJSA/QPSA requirement does not apply at all if the plan does not offer life annuities as payment options.)
- No amounts transferred from another plan were subject to the QJSA and QPSA requirements.

If amounts subject to the QJSA and QPSA rules are transferred into the plan, these amounts remain subject to these rules.

In addition, a plan may choose to be subject to the QJSA and the QPSA requirements.

Qualified Joint and Survivor Annuity: a QJSA is an immediate annuity for the life of the participant with a survivor annuity for the life of the spouse. The amount of the survivor annuity cannot be less than 50% and not more than 100% of the amount of the annuity that is payable during the joint lives of the participant and spouse.

Qualified Preretirement Survivor Annuity: a QPSA is an immediate annuity for the life of the surviving spouse purchased with not less than 50% of the value of the participant's account balance determined as of the date of death.

If a plan is subject to the QJSA or QPSA requirements, the plan administrator must provide each participant (vested, non-vested, married or unmarried) with a written explanation of the following:

- Terms and conditions of the QJSA or QPSA.
- The participant's right to make and the effect of an election to waive the QJSA or QPSA.
- The requirement that the spouse must to consent to the participant's waiver. The spouse's consent must be in writing, must acknowledge the effect of a participant's waiver, and must be witnessed by a 403(b) plan representative or notary public. The consent must specify the nonspouse beneficiaries who will receive benefits upon the participant's death. It must also specify, in the case of a participant's waiver of a QJSA, the particular optional form of benefit selected by the participant.
- The participant's right to make and the effect of, a revocation of a previously made election to waive the QJSA or QPSA, and
- A description of the condition and other material features of the plan's other forms of benefit and their relative values.

Waiver of the QJSA

An election to waive the QJSA form of benefit must be made no earlier than 180 days before the date on which the benefit is payable.

Waiver of the QPSA

In general, a participant may waive the QPSA only after the first day of the plan year in which the participant reaches age 35. A plan may allow a participant to waive the QPSA before then if that waiver becomes invalid at the beginning of the plan year in which the participant reaches age 35. A participant must then execute a new waiver in order to avoid the QPSA requirement. A participant who separates from service before age 35 is allowed to waive the QPSA any time after the date of separation.

Qualified Optional Survivor Annuity ("QOSA"): an annuity for the life of the participant with a survivor annuity for the life of the spouse equal to a percentage of the amount payable during the joint lives of the participant and the spouse. The waiver rules for a QOSA following the QJSA waiver rules.

The survivor portion of the qualified optional survivor annuity is determined by the 403(b) plan's QJSA benefit. If the QJSA provides a survivor benefit of less than 75%, the QOSA must have a survivor benefit of 75%. If the QJSA provides a survivor benefit of at least 75%, the QOSA must have a survivor benefit of 50% of the annuity payable during the participant's lifetime.

Automatic Rollovers

If a 403(b) plan provides for an automatic cash out upon a participant's severance from employment when the participant fails to elect a distribution method, vested amounts in excess of $1,000 but less than or equal to $5,000 (not counting amounts held in rollover accounts) are subject to automatic rollover to an IRA.

Locating Missing Plan Participants

For 403(b) plans subject to ERISA, the DOL issued Field Advisory Bulletin 2014-01 to provide guidance to plan fiduciaries regarding action steps required when plan participants or beneficiaries cannot be located upon plan termination. While this guidance only applies to retirement plans subject to the ERISA, the suggested steps may be helpful to nonERISA plans seeking to locate missing individuals. In addition, the IRS provided input on locating missing participants. That information can be found at: http://www.irs.gov/Retirement-Plans/Missing-Participants-or-Beneficiaries.

Step One: DOL Search Methods

- A plan fiduciary must first attempt to deliver notice to participants and beneficiaries by routine methods, such as delivering notice by first class mail or electronic notification.
- Next, if a participant or beneficiary still cannot be located, a plan fiduciary must attempt to find the missing individual through **EACH** of the below search methods, *regardless* of the size of the account balance. These methods are:

  - **Use Certified Mail**.
  - **Check Related Plan Records**. Plan fiduciaries of the terminated retirement plan must ask both the employer and administrator(s) of related plans (e.g., health plans) to search their records for a more current address for the missing individual. If there are privacy concerns, the retirement plan fiduciary can request the employer or other plan fiduciary to contact or forward a letter on behalf of the terminated plan to the participant or beneficiary, requesting the individual to contact the retirement plan fiduciary.
  - **Check with Designated Plan Beneficiary**. Plan fiduciaries must attempt to identify and contact any individual that the missing individual has designated as a beneficiary (e.g., spouse, children, etc.) in a related plan for updated information concerning the location of the missing individual. If there are privacy concerns, the plan fiduciary can request the designated beneficiary to contact or forward a letter on behalf of the terminated plan to the missing participant or beneficiary, requesting the missing individual to contact the plan fiduciary.
  - **Use Free Electronic Search Tools.** Plan fiduciaries must make reasonable use of Internet search tools that do not charge a fee to search for a missing participant or beneficiary. Such online services include Internet search engines, public record databases (such as those for licenses, mortgages and real estate taxes), obituaries and social media**.**
  - **Additional Search Steps:** If a plan administrator follows the required search steps, but does not find the missing participant or beneficiary, s/he should consider the size of a participant's account balance and the cost of further search efforts in deciding if any additional search steps are appropriate. For example, a plan administrator could use Internet search tools, commercial locator services, credit reporting agencies, information brokers, investigation databases and other similar services that may involve charges.

Step Two: DOL Distribution Options

After utilizing all of the search methods described above, if a plan fiduciary still cannot locate a missing individual, the plan may distribute the account balance in accordance with one of the following distribution options:

- **Preferred Distribution Option - Individual Retirement Plan Rollovers** – The DOL suggest that in order to preserve funds for retirement, a plan fiduciary can establish an IRA (inherited IRA in the situation of a nonspouse beneficiary) for the missing individual. In order to fulfill its responsibilities under ERISA, a plan fiduciary must follow the DOL's regulatory guidance safe harbor for making distributions for a missing participant or beneficiary into an IRA under DOL Reg. Section 2550.404a-3.
- **Alternative Arrangements** - If providers are not willing to issue an IRA to a missing individual or the plan fiduciary determines based on facts and circumstances not to make a direct rollover to an IRA on behalf of a missing participant or beneficiary, the plan fiduciary may either establish (1) an interest-bearing federally insured bank account in the name of a missing individual or (2) transfer the missing individual's account balance to the state unclaimed property funds in the state in which the individual was last known to reside or work. Unfortunately, since these are distributions, neither of these methods would preserve the tax-deferred status of the amounts. In addition, the amounts distributed would become subject to mandatory income tax withholding and a possible additional tax for premature distributions and any interest accrued would also be subject to income taxation.

Other Considerations

IRS Withholding Rules. The DOL's guidance specifically states that plan fiduciaries should *not* use 100% income tax withholding as a means to distribute plan benefits to missing participants or beneficiaries.

USA PATRIOT Act. The IRS will not require the customer identification and verification provision (CIP) when a plan fiduciary establishes an account for a missing individual. The CIP requirements will apply when the missing individual first contacts the IRA issuer or federally insured bank to claim the account balance.

State law issues. A plan fiduciary should be aware of any state laws, including those governing signature requirements and escheat, which are beyond the scope of the DOL guidance.

The Pension Benefit Guaranty Corporation has recently expanded their missing participant program to include certain defined contribution retirement plans (including 403(b) plan subject to ERISA) that terminate on or after January 1, 2019. More information can be found at: https://www.pbgc.gov/news/press/releases/pr17-12.

SECTION VI - MISCELLANEOUS

403(b) Plan Documents

Plan sponsors may adopt an IRS pre-approved 403(b) plan document in the form of either a prototype or volume submitter plan which complies with the Code Section 403(b) requirements. An employer that adopts a 403(b) pre-approved plan generally has assurance that its plan document, in form, complies with Code Section 403(b). A 403(b) plan sponsor may also adopt an individually designed plan document. A 403(b) plan sponsor needs to ensure that it operates its plan in accordance with its written terms.

On September 30, 2019, the IRS released Revenue Procedure 2019-39. The Procedure establishes a recurring remedial amendment system for individually designed and IRS pre-approved 403(b) plans. In addition, the guidance creates an annual Required Amendments List to be published by the IRS.

Qualified Domestic Relations Orders ("QDRO")

Although benefits under a 403(b) plan are not permitted to be assigned or alienated, a plan may provide that a participant's account balance be subject to a domestic relations order. A domestic relations order is a judgment, decree, or other order made pursuant to a state domestic relations law that relates to the provision of child support, alimony, or marital property rights (including the division of community property). An order may provide that all or a portion of a participant's account balances be paid to an "alternate payee" pursuant to a Qualified Domestic Relations Order ("QDRO"). An alternate payee is either the participant's spouse, former spouse, child, or other dependent.

The plan administrator is responsible for determining whether a domestic relations order is a QDRO. In order for a QDRO to be "qualified," it must contain the following information:

- the name and last known mailing address of the participant and each alternate payee,
- the name of each plan to which the order applies,
- the dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee, and
- the number of payments or time period to which the order applies.

In order for a QDRO to be "qualified," it must NOT contain the following:

- the order must NOT require a plan to provide an alternate payee or participant with any type or form of benefit, or any option not otherwise provided under the 403(b) plan,
- the order must NOT require a plan to provide for increased benefits,
- the order must NOT require a plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO, and
- the order must NOT require a plan to pay benefits to an alternate payee in the form of a QJSA for the lives of the alternate payee and his or her subsequent spouse.

QDROs - Plan Administrator Responsibilities

Providing a model or sample QDRO to participants and/or their attorneys can be a time-saver to everyone involved. The model document would include suggested wording for a QDRO that is specific to your plan. An attorney, or the participant or spouse (if representing himself) would insert the names, addresses and the distribution amount, then present the order to the judge or other official for signature.

Once the plan administrator receives a signed domestic relations order, s/he must determine whether or not the order meets the criteria of a QDRO.

If your plan document allows an alternate payee to take an immediate distribution, then the alternate payee's distribution election should be stated in the QDRO.

IRS Tax Liens and Levies

The IRS has the right to impose a tax lien or levy on a 403(b) plan account. However, the 403(b) plan should not distribute any 403(b) plan assets to the IRS until the participant has attained a distributable event as specified in the 403(b) written plan.

Bankruptcy

A participant's account under a 403(b) plan is exempt from the claims of that participant's creditors in a bankruptcy proceeding. A participant in a 403(b) plan who is involved in a bankruptcy proceeding should not list a plan loan as a debt because it is collateralized by the outstanding balance of the loan.

IRS Correction Programs for Sponsors of 403(b) Plans

The ECPRS is a comprehensive system of correction programs for sponsors of 403(b) plans that have not met applicable Code requirements for a period of time. This system permits employers to correct qualification failures thereby continue to provide their employees with retirement benefits on a tax-favored basis. The three components of the EPCRS are:

- the Self-Correction Plan (**SCP**), which permits plan sponsors to correct certain plan failures without contacting the IRS or incurring a fee,
- the Voluntary Correction Plan (**VCP**), which permits a plan sponsor to, any time before audit, pay a limited fee and receive the Service's approval for correction of plan failures, and
- the Audit Closing Agreement Plan (**Audit CAP**), which permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

For further information regarding EPCRS please visit the IRS website at http://www.irs.gov/Retirement-Plans/Correcting-Plan-Errors

The IRS has also provided a 403(b) Plan Fix-It Guide to assist 403(b) plan sponsor in finding, fixing, and avoiding common mistakes in 403(b) plans. The Guide can be found at: https://www.irs.gov/retirement-plans/403b-plan-fix-it-guide.

DOL'S Voluntary Fiduciary Correction Program ("VFCP") and the Delinquent Filer Voluntary Correction Program ("DFVC")

The VFC program is designed to encourage employers to voluntarily comply with ERISA by self-correcting certain violations. VFCP describes how to apply acceptable methods for correcting violations, and examples of potential violations and corrective actions.

Additional information can be obtained from the following website:

https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement/oe-manual/chapter-15

https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/correction-programs/dfvcp

Termination of a 403(b) Plan

If permitted by the terms of the 403(b) plan, an employer may terminate the plan and distribute accumulated benefits to the participants and beneficiaries. To terminate a 403(b) plan, the employer must take the following steps:

- Adopt a binding resolution:
  - establishing a plan termination date,
  - ceasing plan contributions,
  - fully vesting all benefits on the termination date, and
  - authorizing the distribution of all benefits as soon as administratively practicable after the termination date.
- Generally, stop contributions by the employer or any related entity to any other 403(b) plan during the period that begins on the termination date and ends 12 months after all benefits have been distributed from the terminated plan;
- Notify all plan participants and beneficiaries about the plan's termination;
- Provide a Special Tax Notice to participants and beneficiaries; and
- Distribute all plan assets within 12 months of the plan's termination date to participants and beneficiaries. Distribution of a fully paid individual insurance annuity contract is sufficient to satisfy the distribution requirements.

If a 403(b) plans is subject to ERISA, it must file a final Form 5500 for the year in which all amounts are distributed from the plan.

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