15. Section 403(b) Arrangements

Introduction

A unique type of tax-deferred retirement arrangement is available to certain nonprofit organizations and public school systems. Since 1942, the Internal Revenue Code (IRC) has permitted such employers to purchase annuities for their employees on a tax-deferred basis. However, it was not until 1958, through the Technical Amendments Act of 1958 and a later series of IRC amendments, that Congress established the ground rules for today’s sec. 403(b) programs. In the university arena, two distinct retirement arrangements governed by IRC sec. 403(b) may be established. In the first, the employee is typically required to make a contribution if he or she chooses to participate, usually not exceeding 5 percent of salary. The employer then typically contributes a fixed percentage of salary for each participating employee. This arrangement is referred to in this chapter as a sec. 403(b) pension plan. The second provides a vehicle for voluntary employee tax-deferred savings, generally to supplement institutional plans. This arrangement is referred to in this chapter as a tax-deferred annuity (TDA). In the public school arena, a voluntary employee tax-deferred arrangement is typically the only retirement plan offered to employees other than the state’s retirement system.

To be eligible, nonprofit organizations must qualify as charitable under IRC sec. 501(c)(3). These organizations include hospitals, churches, social welfare agencies, and educational institutions. Publicly sponsored schools, colleges, and universities are also eligible. However, a number of nonprofit organizations do not qualify, including some federal, state, and local government offices; civic leagues; labor organizations; recreational clubs; fraternal societies; credit unions; business leagues; and cooperatives.

Until 1989, employers could establish sec. 403(b) arrangements for one or more employees on a selective basis; unlike other qualified retirement plans, these plans were not generally subject to nondiscrimination rules, although certain limited restrictions did apply. However, in plan years beginning after December 31, 1988, sec. 403(b) plans (except those maintained by churches) must satisfy essentially the same nondiscrimination rules as other qualified retirement plans, as changed by the Tax Reform Act of 1986 (TRA ’86). (For further discussion of nondiscrimination rules, see chapter 12.) For plans involving employee salary reduction contributions, special coverage and participation rules apply, similar to those for 401(k) arrangements. (For further discussion of these rules, see chapter 8 on 401(k) cash or deferred arrangements.)

Since many organizations (e.g., hospitals) have contracts with professional persons, 403(b) plan sponsors must determine the true employer/employee relationship. If the employer is not paying Social Security taxes and is not withholding federal income taxes for a particular individual, it is likely that the individual is not considered an employee eligible for a sec. 403(b) plan. Radiologists, pathologists, and anesthesiologists working at a hospital, for example, might fall into this category.

Originally, 403(b) contributors were required to purchase an annuity contract or similar policy from a life insurance company. The IRC has been modified and now allows investment in mutual funds. Sec. 403(b) funding vehicles include: individual and group fixed and variable annuity contracts; custodial accounts held by registered investment companies, and for churches, certain retirement income accounts. Most employers specify the available funding arrangements, particularly in sec. 403(b) pension plans. Under TDA plans, some employers have no restrictions and permit employees to select the type of
arrangement they prefer, as long as they meet the legal requirements of sec. 403(b).

**Plan Features**

*Salary Reduction Agreement*—Under sec. 403(b) pension plans providing employee salary reduction contributions, the employee and the employer enter into an agreement to reduce the employee’s salary by a specified amount. The employer then remits these contributions, together with employer contributions, to an insurance company, custodian, or mutual fund. Under TDAs, the amount of the salary reduction is determined by the employee, as long as it falls within IRC limits. Instead of reducing current pay, employee TDA contributions may be derived from what otherwise would have become a pay increase. In this case, the employee agrees to forgo the pay increase in order for the employer to make TDA contributions of the same amount. In either situation, the language in the agreement must specifically state the level of the contribution, the date the contribution will become effective, and the investment vehicle in which the contribution will be placed.

A salary reduction agreement under a 403(b) pension plan or a TDA must follow the following requirements.

- The agreement must be in writing.
- Contributions can be derived only from money made available after the date of the agreement.¹
- The agreement must specify the amount of the contribution (either as a dollar amount, percentage of pay, or as the maximum permitted by law).

*Contributions*—Annual contributions to a sec. 403(b) pension plan cannot exceed a maximum limit, referred to as the exclusion allowance. The exclusion allowance is generally equal to 20 percent of the employee’s includable compensation from the employer, multiplied by the number of the employee’s years of service with that employer, reduced by secs. 401(a), 403(a), 403(b), and 457 plan contributions paid in prior years through the same employer.

Because the employee’s includable compensation is, in turn, based on taxable income (i.e., income after making a salary reduction), the specific calculation can be complex. In addition to the limit imposed by the exclusion allowance, employee contributions made by salary reduction are limited to $9,500 annually, coordinated with any contributions to a 401(k) arrangement and/or a simplified employee pension (SEP). (For further discussion of SEPs, see chapter 11.) The limit applies until the $7,000 limit for 401(k)s, adjusted annually for changes in the cost of living, reaches $9,500, at which time the 403(b) salary reduction limit will be indexed in the same manner. (In 1996, the annual limit for 401(k) arrangements reached $9,500.) If an employee is required to contribute a set percentage of compensation to an institutional pension plan by salary reduction as a condition of employment, or if the employee contribution is made as a one-time irrevocable election, this contribution is not necessarily applied toward the $9,500 annual limit.

A special annual catch-up election is available for employees of educational organizations, hospitals, home health agencies, health and welfare service agencies, and churches or conventions of churches. Under this provision, any eligible employee who has completed 15 years of service with the employer is permitted to make an additional catch-up salary reduction contribution equal to the lesser of:

- $3,000;
- $15,000 reduced by the total amount of prior contributions that, in any year, exceed $9,500; or
• $5,000 multiplied by the number of years of service the individual has with the employer, minus an individual's lifetime elective deferrals under a 401(k), 403(b), or 457 plan and/or a SEP.

The Employee Retirement Income Security Act of 1974’s overall limits on defined contribution plans under IRC sec. 415(c) also apply to total amounts that can be contributed on behalf of each employee in any one year. (For further discussion of these limits, see chapter 4 on pension plans.)

**Employee Rights**—A participant in a sec. 403(b) plan has a variety of rights and privileges. Some important rights provided to participants in 403(b) arrangements that are not generally required in other retirement plans include the right to select from a variety of settlement options at termination. If salary reduction is involved, participants must have the right to determine the contribution amount and the date contributions will begin.

**Taxation**

Employer contributions and employee salary reduction contributions to sec. 403(b) arrangements are excluded from reportable income at the time they are set aside. During the savings accumulation period, investment earnings on these funds are also exempt from current income taxes. When the employee withdraws funds, they are reported as ordinary income for federal tax purposes. However, the ultimate tax impact may be reduced for individuals who make withdrawals after retirement if their yearly retirement incomes are lower than their working year incomes.

**Social Security**—Employees’ contributions that are attributable to voluntary salary reduction agreements are subject to Social Security taxes, even though they are excluded from employees’ federal income taxes. Future Social Security benefits are then based on the higher income (i.e., not reflecting the salary reduction); thus, retired employees will not receive lower Social Security benefits as a result of participation in a sec. 403(b) plan.

**Regular Distributions**—Distributions from a 403(b) plan are generally taxed as ordinary income in the year received. If an employee rolls a lump-sum distribution into another 403(b) or into an individual retirement account (IRA) within 60 days, no tax applies until distribution. For benefits accrued after December 31, 1986, a 403(b) plan must generally comply with the standard distribution rules governing timing and payouts applicable to qualified retirement plans. (For further discussion of these rules, see chapter 4 on pension plans.)

**Early Distributions**—A 10 percent penalty tax is generally imposed on early distributions (those made before age 59 1/2) from all 403(b) plan accumulations. The tax is in addition to the regular income tax applicable for the year in which the distribution is taken. Some distributions are exempt from the additional tax, including amounts rolled over to an IRA or another 403(b) within 60 days, as are most distributions in the form of an annuity. Payments made on the participant's death or disability, made after the participant has separated from service on or after age 55, used for medical expenses to the extent deductible for federal income tax purposes (under IRC sec. 213), or made to or on behalf of an alternate payee pursuant to a qualified domestic relations order are also exempt from the penalty tax.

Until the end of 1988, the IRC permitted withdrawals at any age, for any reason, from TDAs funded through annuities (although not from those funded through custodial accounts such as mutual funds). As of January 1, 1989, TDAs funded through either annuity or custodial accounts must follow the same early withdrawal rules as 401(k) arrangements. Participants may not make withdrawals prior to age 59 1/2 from TDA accumulations attributable to salary reduction contributions except on account of separation from service,
death, disability, or financial hardship. Withdrawals due to hardship are limited to contributions only; earnings may not be withdrawn. The limits on distributions are not applicable to amounts accrued in annuity contracts but are applicable to custodial accounts, prior to January 1, 1989. Hardship has been defined in IRS regulations, but at present these regulations only apply to sec. 401(k) arrangements. Although IRS may provide different regulations for sec. 403(b) plans, legislative history suggests that it intends to apply the same criteria for 403(b) hardship distributions. (For more information on hardship, see chapter 8 on 401(k) cash or deferred arrangements.)

Bibliography

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The 403(b) participant may revoke the salary reduction agreement for amounts earned while the agreement is in effect, to the extent allowed under 401(k) plans.