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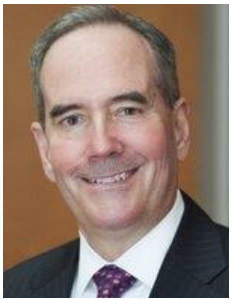
Tax-Exempt Orgs, Beware This 403(b) Plan Compliance Pitfall

By **Greg Needles and Michael Gorman** (October 14, 2021, 5:49 PM EDT)



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The Internal Revenue Service recently published an Issue Snapshot[1] reminding 403(b) plan sponsors of a compliance failure that IRS agents often identify during the audits of government and tax-exempt entities, including hospitals and universities.

The the document reiterates a decades-old rule providing that when an employee participates in both a 403(b) plan sponsored by their employer and a retirement plan sponsored by an entity controlled by the employee — such as a simplified employee pension or Keogh plan established by an employee for their separate consulting business or medical practice — contributions must be aggregated across both plans for purposes of applying the limitations under Section 415 of the Internal Revenue Code of 1986, as amended.

By highlighting this issue, the IRS is putting 403(b) plan sponsors on notice that this is an issue they are likely to investigate in an audit.

Aggregation of Contributions Across 403(b) and Participant-Controlled Plans

IRC Section 415(c) limits the maximum amount of annual additions that can be contributed to a defined contribution retirement plan, such as a 401(a) defined contribution plan, a 401(k) plan and/or a 403(b) plan, on a participant's behalf.

The annual additions for a given year are the sum of the participant's elective deferrals (pre-tax and Roth), the participant's after-tax contributions, and employer contributions made with respect to the participant.

In 2021, the participant's annual additions may not exceed the lesser of 100% of the participant's eligible compensation or $58,000.

The IRC Section 415(c) limit generally applies in the aggregate across all defined contribution plans within an employer's controlled group.

For example, if an employee participates in two 401(k) plans sponsored by two different employers in the same controlled group, contributions and deferrals made on the employee's behalf to both plans in the aggregate cannot be more than the lesser of 100% of the employee's eligible compensation or $58,000.

Notwithstanding this general rule, a participant in their employer's 403(b) plan is treated as the employer sponsoring the 403(b) plan for purposes of applying the IRC Section 415 limit. This results in the employer's 403(b) plan being aggregated not with other plans sponsored by the employer, as is the case generally, but with retirement plans sponsored by entities that the participant owns or controls.

Thus, annual additions to the employer's 403(b) plan must be aggregated with retirement plans of the participant-controlled employer for purposes of applying the IRC Section 415(c) limit, with the aggregate contributions and deferrals made on the employee's behalf limited to not more than the lesser of 100% of the employee's eligible compensation or $58,000.

Certain tax-exempt entities, such as universities and hospitals, are regularly affected by this exception.

For example, professors who participate in their university's 403(b) plan frequently provide consulting services and establish SEPs or Keogh plans to which they make contributions from the revenue generated from their consulting business. Similarly, physicians who are employed by a hospital and participate in the hospital's 403(b) plan may also have their own medical practice that sponsors a retirement plan in which the physician participates.

If the aggregated contributions and deferrals to the organization's plan and the participant-controlled employer's plan exceed the IRC Section 415(c) limit, the excess amounts are deemed to be attributed to the organization's 403(b) plan under Treasury Regulation Section 1.415(g)-1(b)(3)(iv)(C), thereby putting the employer's 403(b) plan at risk.

Steps That 403(b) Plan Sponsors Can Take to Reduce Audit Risk

Recognizing that the IRS is focusing on this issue, what can tax-exempt employers and 403(b) plan fiduciaries do to minimize the risk that their 403(b) plans will violate IRC Section 415(c) because of a defined contribution plan sponsored by a participant-controlled employer?

The first step, which is potentially the most important, is to ensure that the 403(b) plan document addresses this issue directly.

The formal 403(b) plan document should describe how the aggregation rule works and the participant's responsibility to inform the employer of their participation in a participant-controlled employer defined contribution plan. The plan should describe that amounts in excess of the 415(c) limit will first be refunded from the employer's 403(b) plan.

The second step is to confirm the 403(b) plan's summary plan description describes the aggregation rule and the employee's responsibilities in ensuring compliance with the IRC Section 415(c) limit.

The third step that the 403(b) plan sponsor should take is to require that a 403(b) plan participant disclose during the enrollment process whether they also participate in a defined contribution plan sponsored by a participant-controlled employer.

If the participant informs the 403(b) plan sponsor that they are a participant in such a plan, the 403(b) plan sponsor may then communicate with the participant in writing about the aggregation rule and the participant's obligations with respect to the IRC Section 415(c) limit. This will help document the steps that the 403(b) plan sponsor has taken to ensure that 403(b) plan participants to do not violate IRC Section 415(c).

The final step should be to communicate annually with all 403(b) plan participants regarding this aggregation rule. This will provide another opportunity for the 403(b) plan sponsor to document the fact that they are actively encouraging compliance with the IRC Section 415(c) limit and related aggregation rules, which may be helpful in the event of an IRS audit.

Final Takeaway

Ultimately, the IRS expects employers that maintain a 403(b) plan to have procedures and processes in place to inform employees about the aggregation rule, with notices, forms or other written communication to participants that describe the rule. These communications should inform employees they are required to disclose other retirement plans in which they participate.

An employer's failure to inform participants and gather such information from them could lead to the employer's 403(b) plan inadvertently violating the IRC Section 415(c) limit.

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[1] https://www.irs.gov/retirement-plans/issue-snapshot-403b-plan-application-of-irc-section-415c-when-a-403b-plan-is-aggregated-with-a-section-401a-defined-contribution-plan.