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# 403(b) Salary Deferral Plan

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## Tax-Sheltered Annuities

### Eligible Employers

Religious, charitable, educational, scientific, and literary organizations described in IRC Sec. 501(c)(3), certain governmental employers and public school systems may establish 403(b) plans for their employees.<sup>1</sup>



### Who Contributes To The Plan?

While employer contributions are allowed, typically it is the *employee* who makes the contributions by agreeing to have his or her salary reduced by the contribution amount. If the employer contributes its own funds, the arrangement is subject to many of the same federal tax and labor laws that govern regular qualified plans, such as 401(k) plans. Certain 403(b) plans must satisfy non-discrimination tests. For example, if a non-governmental employer provides a matching contribution, the plan must meet the same Average Contribution Percentage test required of 401(k) plans. The 403(b) plan may be exempt from this test if it provides a “safe harbor” contribution similar to those applicable to 401(k) plans.

### Contribution Limits

For 2023, the total of employer contributions and employee deferrals added to a participant’s account generally may not exceed the lesser of 100% of compensation<sup>2</sup> (limited to a maximum of \$330,000), or \$66,000 per year. An employee’s elective contributions are generally limited to \$22,500 annually. Total elective deferrals for employees of qualifying organizations with 15 years of service may be up to \$25,500. For those age 50 or older, additional “catch-up” contributions of \$7,500 may also be made.

### Employer Obligations

In 2007, the IRS issued new 403(b) regulations, generally effective January 1, 2009. These regulations impose specific responsibilities on the employer to ensure the plan operates in accordance with IRS rules. These requirements include:

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<sup>1</sup> The discussion here concerns federal income tax law. State or local income tax law may vary.

<sup>2</sup> The term “compensation” includes deferrals to 403(b) plans as well as deferrals made to IRC Sec. 125 and IRC Sec. 457 plans.

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## 403(b) Salary Deferral Plan

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- **Written plan document:** The plan must have a written plan document adopted by the employer. This document must include eligibility, contribution, distribution, loan and hardship provisions and list the funding vehicles offered. The employer must operate the plan in accordance with these written plan provisions.
- **Ongoing administrative responsibility:** The employer must be responsible for the plan's administrative functions. While many functions may be outsourced to the plan providers, the employer is responsible for the coordination of these functions.
- **Employer as fiduciary:** The employer has a fiduciary duty to ensure the plan operates in the best interests of plan participants by selecting and monitoring service and fund providers and investment options, as well as the fees charged for these services.
- **Expanded Form 5500 reporting and independent plan audit:** The new 403(b) regulations expand the information 403(b) sponsors must report to the federal government, on Form 5500. Further, many non-profit organizations with more than 100 eligible participants will be required to hire an accounting firm to prepare an audit of the plan to accompany Form 5500. These requirements do not apply to sponsors exempt from ERISA, such as governmental organizations and churches.
- **Plan must be universally available to employees:** The plan must be "universally available." If one employee is eligible to make contributions, all employees must be eligible, with limited exceptions.

403(b) plans must meet the same coverage requirements as 401(k) plans. If the employer makes contributions to the plan, these employer contributions must satisfy the same non-discrimination requirements as 401(k) plans. (Governmental entities are exempt from the non-discrimination rules). 403(b) plans are exempt from the Actual Deferral Percentage (ADP) test applicable to 401(k) plans. This is a significant advantage, as highly compensated employees<sup>1</sup> do not have to worry about having excess contributions refunded to them.

The IRS will treat two or more non-profit entities as a single employer if there is at least 80% overlap of directors or trustees (a controlled group). This means that such commonly controlled entities will have to meet the IRS coverage and availability rules for all involved entities. Special rules apply to churches and qualified church-controlled organizations.

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<sup>1</sup> "Highly compensated" employees generally include 5% or more owners and those earning more than \$150,000 (2023 value) in the prior year.

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### Fee Disclosure Requirements

If a plan gives participants the right to direct any investments, plan sponsors must provide participants with expanded, standardized investment fee and performance information. This additional information is intended to aid plan participants in making better-informed investment choices. The failure by a plan sponsor to meet these ERISA requirements may result in a breach of fiduciary duty to plan participants and the loss of ERISA Section 404(c) protection (meaning the plan fiduciaries may be held responsible for the results of the participants' own investment choices).

### Other 403(b) Plan Features

- **Roth 403(b) contributions:** If the employer permits, and the written plan so provides, plan participants may choose to have some or all of their salary deferral contributions treated as contributions to a designated Roth account, commonly referred to as a “Roth 403(b).” Unlike normal 403(b) contributions, which are made *before-tax*, Roth 403(b) contributions are made on an *after-tax* basis. If certain requirements are met, distributions from the Roth 403(b) are received income tax-free. Contributions to a Roth 403(b) account are subject to the same employee elective deferral limits as the 403(b) plan itself.
- **When to setup a 403(b):** A 403(b) plan may be set up at any time during the year. However, salary-reduction agreements must be entered into before the reduced salary amounts are available to the employee. An employee can later modify the deferral amount, but only with respect to future income.
- **Investment options:** 403(b) plans may offer investments in annuities (fixed or variable and individual or group)<sup>1</sup> or custodial accounts invested in mutual funds.

### Withdrawing 403(b) Funds

- **When withdrawals are permitted:** Distributions from 403(b) plans are typically limited and cannot be paid until separation from service, death, disability, termination of the plan, or attainment of age 59½. Some plans may permit hardship distributions. Some 403(b) annuity contracts may have different withdrawal provisions.

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<sup>1</sup> Under IRS final regulations, life insurance was permitted only if the policy was issued before Sept 24, 2007.

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- **Distributions taxed as ordinary income:** Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging<sup>1</sup> or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- **Early withdrawal penalties:** Taxable distributions from the plan before a participant reaches age 59½ are subject to a 10% federal tax penalty for “early” withdrawal. The 10% penalty may not apply if one of a number of exceptions applies (See IRC Sec. 72(t)). All taxable distributions are included in the participant’s gross income in the year of distribution from the plan.
- **Required minimum distributions (RMDs):** Plan assets are usually withdrawn at retirement. To avoid income-tax penalties, distributions must begin by April 1 of the later of (a) the year following the year the participant reaches age 72, or (b) the year following the year the participant retires.<sup>2</sup>
- **Participant loans:** Participants can borrow funds from their 403(b) and later repay the loan without incurring a tax if certain requirements are met regarding maximum loan amount, amortization requirements, time period for repayments, etc.
- **Financial Hardship:** The salary-reduction amount (but not the earnings) is available for financial hardship; e.g., an immediate and heavy financial need which cannot be met with other sources. Hardship distributions are included in the participant’s taxable income in the year of distribution.
- **Coronavirus-related distribution (CRD):** One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a “Coronavirus-related distribution,” or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed \$100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse

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<sup>1</sup> Those born before 1936 may be able to elect 10-year income averaging or capital gain treatment.

<sup>2</sup> The age 72 “trigger” date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs. If the first distribution is delayed until April 1 of the following year, *two* distributions will be required in that year.

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financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

### The Death of a 403(b) Participant

When a participant dies, 403(b) proceeds become part of his or her taxable estate for federal estate tax purposes. For federal income tax purposes, plan proceeds are generally treated as ordinary income to the beneficiary, except for any “pure” insurance proceeds provided by a 403(b) life insurance contract.<sup>1</sup>

### Changing from One 403(b) to Another, Rolling Over to IRA

The transfer of funds from one 403(b) investment to another will not be considered a taxable distribution if the funds remain subject to the same distribution restrictions as on the prior investment, and the employer has an agreement in place with the new investment provider to permit the new investment. If proceeds from a 403(b) are rolled directly into a traditional IRA, it will defer taxation. A rollover to a Roth IRA is a taxable event. If a distribution is paid directly to the participant first, it will be subject to the mandatory 20% income tax withholding rule.

### Federal Bankruptcy Impact

Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

### Counting Deferred Amounts as Current Compensation

Deferred amounts can be counted as current compensation in computing benefits under a separate qualified pension plan, if the qualified plan so provides.

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<sup>1</sup> For insurance policies purchased prior to September 24, 2007.

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### End Result

- Except for payroll taxes (e.g., FICA, Medicare), the employee avoids current income taxation on the deferred amount.
- The earnings on the accumulating funds are not taxed until they are distributed, usually at retirement.

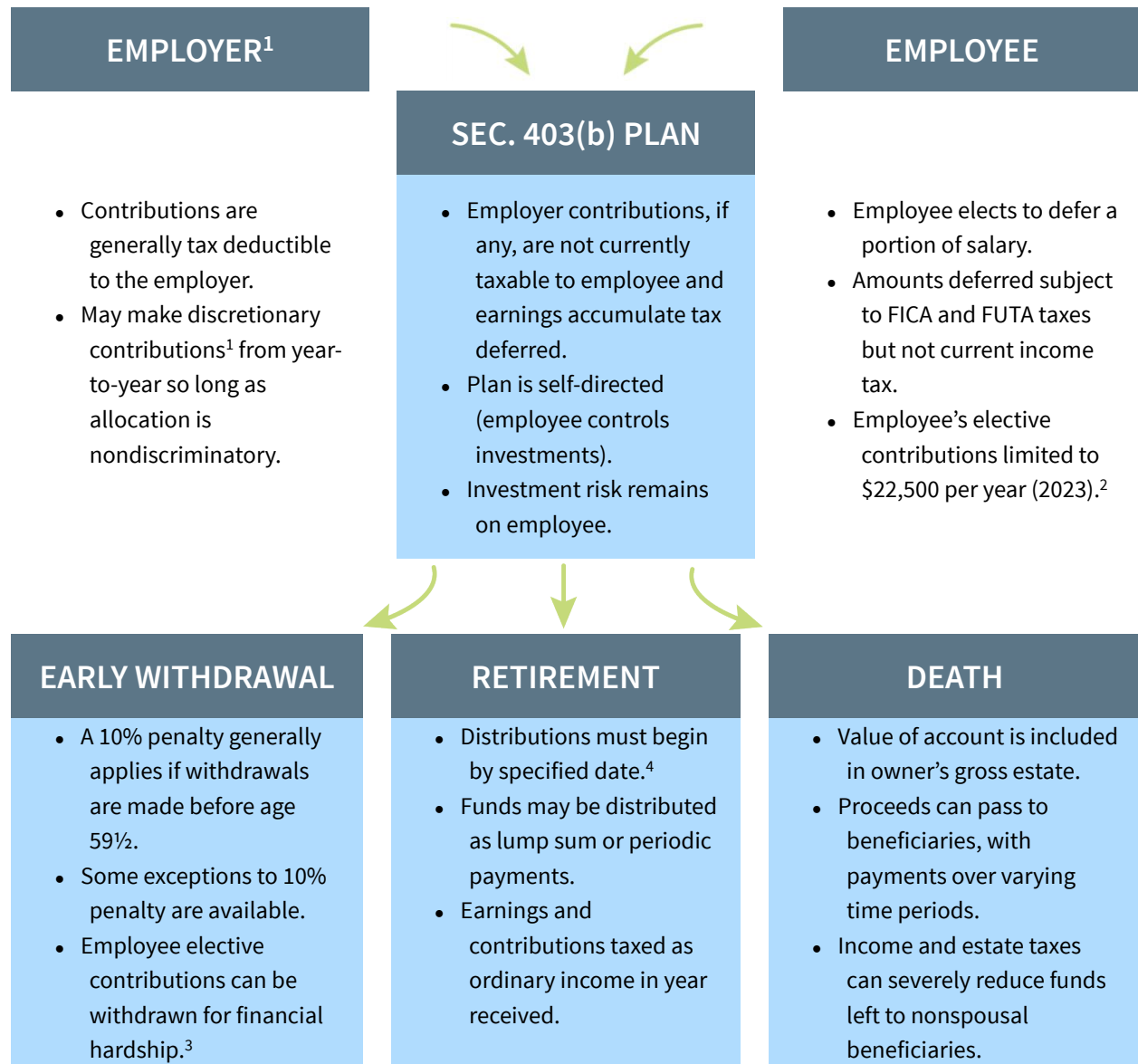
### Comparison of Federal Income Tax Payable<sup>1</sup>

| Without 403(b) Plan                            |                         | With 403(b) Plan               |                      | Benefit                      |
|------------------------------------------------|-------------------------|--------------------------------|----------------------|------------------------------|
| Taxable Income Before \$5,000 Salary Reduction | Tax Due Without Annuity | Taxable Income After Reduction | Tax Due with Annuity | Current Income Tax Reduction |
| \$25,000                                       | \$2,589                 | \$20,000                       | \$2,000              | \$589                        |
| 40,000                                         | 4,389                   | \$35,000                       | 3,789                | 600                          |
| 60,000                                         | 6,789                   | \$55,000                       | 6,189                | 600                          |
| 80,000                                         | 9,189                   | \$75,000                       | 8,589                | 600                          |
| 100,000                                        | 13,234                  | \$95,000                       | 12,134               | 1,100                        |

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<sup>1</sup> Based on 2023 federal income tax rates, married filing jointly, and using the standard deduction.

# How a 403(b) Salary Deferral Plan Works



<sup>1</sup> If there are employer contributions, the arrangement must generally satisfy the minimum participation requirements as well as the nondiscrimination rules applicable to employer-sponsored qualified plans.

<sup>2</sup> For those age 50 and older, additional "catch-up" contributions of \$7,500 may be made.

<sup>3</sup> If provided for by the plan. Under Treasury regulations, financial hardship is defined as "immediate and heavy financial need where funds are not reasonably available from other sources."

<sup>4</sup> Distributions must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 72, or (b) the year following the year in which the participant retires.