

Coping With IRS 403(b) Audits – A Guide for What to Expect

As the Internal Revenue Service (IRS) continues to audit 403(b) plans, it's important to **be prepared**—the IRS may request numerous documents and information relating to your 403(b) plan. Understanding what information could be requested and ensuring you have access to that information can help to make your IRS audit go smoothly.

How will I be notified that the IRS intends to audit our 403(b) plan?

The IRS will typically send a letter, or perhaps the auditor will provide a courtesy phone call, to the employer sponsoring the 403(b) plan. Contingent upon the size of the plan, the IRS auditor will provide an overview of the audit process, establish primary contacts and point persons, review types of information that will be requested, and may establish a physical location for the auditor, which could be in the employer's office. Subsequent information and data will be requested via IRS Form 4564, entitled "Information Document Request" (IDR). There may be one comprehensive IDR, or several IDRs requesting various data elements about the 403(b) plan.

How long will the audit last and how much time will I have to gather the information requested via Form 4564?

The length of the audit depends on the size of the plan and the extent of the internal controls established by the employer to oversee plan administration. For example, plans with 2,500 or less lives are considered relatively small. Plans with, say, 30,000 lives are considered large and an employer can expect an audit to continue for a year. Generally, an employer will have 30-45 days to complete an IDR.

Who should be involved with an IRS audit?

The IRS will be looking for specific documentation and explanation of processes and procedures for administration of the 403(b) plan. Therefore, your human resources and payroll employees may need to be involved in an IRS audit, as well as investment providers you have approved under the plan, and, if applicable, your third party administrator. Management is generally not directly involved in the IRS audit but should be informed of the audit. In addition, you should consider involving your legal counsel in the audit process.

In the event of an IRS audit, what should you have easy access to?

The IRS can request all documents and information pertaining to your 403(b) plan. Being proactive can help the audit go smoothly. That is, understanding what information could be requested and ensuring you have access to the following information will facilitate a well-organized and efficient audit for both you and the IRS:

- Plan document timely adopted by 12/31/2009 and any subsequent amendments to that document due to plan design changes;
- Annuity contracts and/or custodial arrangements;

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- Salary deferral agreements;
- Annual notice provided to eligible employees each year about the opportunity to defer into the 403(b) plan;
- Names and Social Security Numbers of plan participants;
- Employment records, including salary history, dates of hire, termination and rehire;
- Contribution history;
- Distribution history;
- Internal procedures used by human resources and payroll employees for operation of the 403(b) plan, including procedures for monitoring employee deferrals (including catch-up contributions) against the annual Internal Revenue Code (IRC) deferral limit, and, determining eligibility for hardship withdrawals and for transacting a permissive service credit transfer to a governmental defined benefit plan, these internal procedures should be consistent with the provisions of the 403(b) plan document;
- Participant and/or plan statements;
- IRS Form W-2s and 1099s;
- Loan data and related documents;
- Calculations and supporting documentation for employees who are making catch-up contributions to assess whether they will exceed the IRC-permitted limits; and
- Employee handbook to assess whether the 403(b) plan document reflects day-to-day operation.

Beware of IRS auditors' top issues for 403(b) plans:

- Complying the universal availability requirement (which ensures that employee deferrals to a 403(b) plan are nondiscriminatory);
- Appropriately monitoring the 402(g) elective deferral and 415(c) annual additions limits, including proper calculations for the 15 Years of Service Catch-up for eligible participants under 403(b) plans, and the Age 50+ catch-up;
- Determining whether a hardship withdrawal is appropriate under the terms of the 403(b) plan and the IRS rules, and maintaining appropriate documentation to support such a hardship withdrawal.

IRS Issue: Internal controls and documentation supporting plan operation in accordance with the plan document and IRS guidance

- ✓ Internal controls governing human resources and payroll departments and documentation supporting 403(b) plan operation in accordance with the plan document and IRS guidance

An IRS audit may also include inquiries regarding whether the employer has put “internal controls” in place – procedures designed to demonstrate a commitment to compliance and to minimize errors. An employer may be asked for documentation of the following internal controls:

- Human Resources procedures, including notifying eligible employees of the opportunity to contribute to the 403(b) plan and determining under what circumstances an individual is considered an independent contractor rather than an employee.
- Payroll procedures, including monitoring employee deferrals against the annual Internal Revenue Code (IRC) deferral limit.
- Schedule of participants showing amounts contributed as elective deferrals, matching and other employer contributions. If there is more than one investment provider, a list from each provider reconciling amounts deposited for the year to each participant’s account.

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- Calculations and supporting documentation for employees who are making catch-up contributions to assess whether they will exceed the IRC-permitted limits.

IRS Issue: Written plan and related agreements

- √ Written 403(b) plan, including any amendments, including signature of authorized individual on behalf of the employer and evidence of the date of the plan's adoption
- √ Agreements between the employer and third parties who have been delegating administrative duties under the plan
- √ Products approved under the plan
- √ Information sharing agreements between the employer and product vendors to share information for loans, hardships, and other distributions from the 403(b) plan.

Written 403(b) Plan

A 403(b) plan sponsor is required to maintain a "written plan" and operate the 403(b) plan in accordance with its terms. This written plan must have been adopted no later than December 31, 2009 to comply with the IRS 403(b) regulations. The written plan must contain all material terms, including eligibility, benefits, applicable limits, and contracts available under the 403(b) plan, and the time and form under which benefit distributions would be made. The written plan may contain certain optional features not required under Code Section 403(b), such as hardship, loans, contract to contract exchanges, plan-to-plan transfers, and acceptance of rollovers into the plan. The "written plan" may be either a plan document or a collection of documents (including the contracts, salary reduction agreements, employee handbooks, etc.).

In addition, a plan sponsor is permitted to assign administrative responsibilities to parties other than the employer, but not to participants (other than employees of the employer a substantial portion of whose duties are administration of the plan). Any administrative agreements should be kept with the written 403(b) plan documents.

Products available under a 403(b) plan

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*

Information sharing agreements

A 403(b) plan sponsor and an investment provider must share participant information on an ongoing basis for proper administration of the 403(b) plan. Some examples of sharing information include:

- Has the participant had a severance of employment?
- Does the participant have outstanding loans?
- If the participant wants to take a hardship, have the hardship withdrawal rules been satisfied?

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The plan document should require information sharing between the employer and approved investment providers if a 403(b) plan permits contract to contract exchanges (when a participant moves all or a portion of his account under one investment provider to another investment provider under the same 403(b) plan). If an employer subsequently deselects an investment provider, that provider must enter into an information sharing agreement with the plan sponsor.

IRS Issue: Excluding eligible employees from plan participation

What documentation should I have in my files?

- √ Annual “universal availability notice” and evidence that the notice has been provided to eligible employees at least annually and that eligible employees have been given a reasonable period, based on the relevant facts and circumstances to participate in the 403(b) plan
- √ Human Resources procedures regarding notifying eligible employees of the opportunity to contribute to the 403(b) plan
- √ Employment contracts, indicating whether an employee is a common-law employee or an independent contractor

In general, all common law employees of the employer are permitted to make salary reductions and designated Roth contributions, if applicable, under a 403(b) plan with some very narrow exceptions. An employer can exclude the following employees from participating in the 403(b) plan:

- Employees whose maximum salary reduction and/or designated Roth contributions under the 403(b) plan would be no greater than \$200 a year
- Nonresident aliens with no U.S. source income
- Student-employees whose compensation is not considered FICA wages
- Employees eligible to defer to another 403(b), governmental 457 plan, or 401(k) plan of the employer
- Employees “normally” working less than 20 hours/week

If a plan is operating under these permissible IRS exclusions, the exclusions should be reflected in the plan document. The IRS will compare the 403(b) plan document against administration of the eligibility requirements to compliance with both the IRS regulatory requirements and plan provisions.

Safe-harbor test for determining whether an employee normally works fewer than 20 hours per week:

New employee: if employee is expected to work less than 1,000 hours/year, the employee can be excluded from participating in the plan, even though the employee may be working for more than 20 hours a week for a period of time (such as permanent substitute teachers).

After the first year of employment: an employer would look to the actual hours worked the prior year and if the employee worked fewer than 1,000 hours in the preceding 12-month period, then that individual could be excluded under the 403(b) plan.

Universal Availability Notice

At least once each plan year, a 403(b) plan sponsor must provide notice to eligible employees informing them that they have the opportunity to make deferrals (including designated Roth contributions, if applicable), or change deferral elections, as well as information on when they can make those elections, the maximum amount permitted, and whether there are conditions on those elections. Special rules apply to certain church organizations.

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IRS Issue: Salary reduction agreements

What documentation should I have in my files?

- √ Salary reduction agreements indicating the amount each participant has elected to contribute to the plan

The IRS wants to ensure that the salary reduction agreements are valid and comply with the IRS regulatory requirements. That is, in general, the agreement to defer compensation must be in place prior to the date on which the compensation is paid.

IRS Issue: Plan contributions in excess of the Code limits, including any applicable catch-up limits

What documentation should I have in my files?

- √ Worksheets showing how much a participant is permitted to contribute to the plan for each year
- √ Salary reduction agreements indicating the amount each participant has elected to contribute to the plan
- √ Employment records including salary history
- √ Internal procedures governing the operation of the 403(b) plan
- √ Employee handbook to assess whether the 403(b) plan document reflects day-to-day operation
- √ Procedures for distributing excess contributions, including applicable tax reporting

The IRS limits the amounts that one can contribute to an employee's 403(b) account each year. For longer service employees and employees who are at least age 50, this limit may be increased by available catch-up contribution provisions. A participant who is eligible for both catch-ups must use the 15-year special catch-up *before* contributing under the age 50+ catch-up.

1. **Elective Deferral Limit:** In general, the total amount that an employee can contribute either as a pre-tax deferral and/or as designated Roth contributions to a 403(b) plan (as well as any other such employee contributions to 401(k) plans, SIMPLE retirement accounts or salary reduction simplified employee pensions) during the year is \$19,000 in 2019.
2. **15-Year Special Catch-up:** If an employee has completed at least 15 full years of service with his current employer and that employer is an educational organization, hospital, home health service agency, health and welfare service agency, church or convention or association of churches (or associated organization), he may increase the annual deferral limit by the *smallest* of :
 - \$3,000;
 - \$15,000 minus any elective deferrals made by the organization and previously excluded under the catch-up election; or
 - \$5,000 times the employee's years of service minus the elective deferrals made to plans of the organization in prior taxable years, not to exceed \$15,000 cumulatively over the 403(b) participant's lifetime.
3. **Age 50+ Catch-up:** a participant who is at least age 50 by the end of the year may contribute an additional amount up to \$6,000 in 2019.

The IRS also reviews total contributions made to a 403(b) plan under an annual additions limit. This annual additions limit provides that the total amount of employer and employee contributions (other than the age 50+ catch-up contributions) and forfeitures made to an employee's 403(b) participant account during a 12-month period (typically, the calendar year) cannot be more in 2019 than 100% of compensation up to \$56,000. Special rules apply to employees who also have an ownership interest of more than 50% in an outside business.

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IRS Issue: Loans from the plan that do not comply with Code rules

What documentation should I have in my files?

- √ Copies of loan procedures for making loan to participants
- √ Copies of loan procedures for loan defaults and applicable tax reporting
- √ Copies of participant loan application forms
- √ Loan amortization schedules;
- √ Outstanding loan amounts at the beginning and end of the plan year;
- √ Defaulted loans;
- √ Loan repayments (date and amount);
- √ Interest rates;
- √ IRS Form 1099R on deemed distributions; and
- √ Documentation that the amount of the loan was within the applicable IRC limits.

Loans from 403(b) Plans

A loan made to a participant in a 403(b) plan must meet the following requirements:

- The maximum loan amount cannot exceed the lesser of \$50,000 reduced by the participant's highest outstanding loan balance during the last 12 months or 50% of the participant's vested account balance, taking into account all plans of the employer. If the plan provides, the Internal Revenue Code permits a participant to take a loan of up to \$10,000, even though the loan is greater than 50% of his vested account balance,
- 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.
- Repayments must be made in level payments at least as frequently as quarterly.
- The loan must be repaid within five years unless the loan is used to acquire a participant's primary residence.

IRS Issue: Hardship withdrawals from the plan that do not comply with Code rules

What documentation should I have in my files?

- √ Employer's procedures for determining financial hardship;
- √ Copies of financial hardship withdrawals request, including supporting documentation from the participant evidencing the financial hardship;
- √ Documentation that the amount of the distribution was necessary to satisfy the emergency need;
- √ IRS Form 1099-R

The IRS is looking to ensure that financial hardship withdrawals meet the guidelines of both the IRS regulations and the plan document. Specifically, the IRS wants to ensure that there was an immediate and heavy financial need and the amount distributed did not exceed the amount of that need.

If the 403(b) plan requires a 6-month suspension of contributions following a hardship withdrawal, the IRS may ask to see internal controls and procedures providing for the suspension.

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IRS Issue: Distributions made to participants that do not comply with Code rules

What documentation should I have in my files?

- √ Copies of procedures for approving and making distributions to participants
- √ Copies of participant distribution forms, with supporting documentation and related tax-reporting
- √ Evidence that the plan has met the required minimum distribution rules
- √ Procedure in place to ensure required minimum distributions occur, date(s) of distribution, copies of correspondence, and IRS Form 1099R issued

Distributions under a 403(b) Plan

In general, amounts held in a 403(b) plan cannot be distributed until a participant has a hardship, severance from employment or disability, reaches 59½ or dies. Special rules apply to distributions from annuity contracts of either amounts contributed prior to 1989 and of certain employer contributions. In addition, the IRS requires that a participant begins taking required minimum distribution from his 403(b) account no later than April 1 of the year following the later of the year in which he reaches age 70½ or retires from the employer sponsoring the 403(b) plan.

IRS Issue: Employers that are ineligible to sponsor 403(b) plans

What documentation should I have in my files?

- √ If you are a 501(c)(3) sponsor, the IRS determination letter which granted that organization tax exempt status under Code Section 501(c)(3)

Employers eligible to sponsor a 403(b) Plan

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
- Tax-exempt 501(c)(3) organizations, which are organized and operated exclusively for religious, charitable, scientific, literary, educational or safety testing purposes. The organization should have a favorable determination letter from the IRS regarding its status under Section 501(c)(3) of the Internal Revenue Code.

What other information could the IRS request?

- Payroll procedures to monitor annual deferral limits. If there are excess deferrals, amount of excess annual deferrals, date(s) of distribution, copies of correspondence and IRS Form 1099R issued;
- Procedure in place to ensure that transfers among 403(b) plans can only be among other 403(b) plans;
- Evidence that these transferred amounts are subject to the same withdrawal restrictions as amounts deferred to the plan receiving the transfer; and
- Individual, including title, who has primary responsibility for plan administration.

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Are there additional items other than the list above that may be required because you sponsor a plan which is subject to ERISA?

If your 403(b) plan is subject to ERISA, in addition to providing a summary plan description, including any summary of material modifications, you may be asked to provide copies of the IRS Form 5500 Annual Return/Annual Report and, as a 501(c)(3) employer, if the plan contains employer contributions, documentation that any applicable nondiscrimination testing has been performed.

403(b) plans and ERISA

All 403(b) plans are subject to Title I of ERISA unless an exemption applies. The following 403(b) plans are exempt from ERISA:

- Plans sponsored by a governmental entity (including public schools)
- Plans sponsored by a church or church organization unless the sponsor made a voluntary irrevocable election to have the ERISA provisions apply, or
- Plans that are administered with limited employer involvement, subject to the following requirements:
 - Participation is voluntary for employees (e.g., no negative election or automatic enrollment provisions)
 - It is a salary reduction-only plan – no employer contributions
 - All rights under the plan are enforceable only by the employee, beneficiary or authorized representative of the employee or beneficiary
 - There is limited employer involvement in the plan as outlined in the Department of Labor's Field Assistance Bulletins 2007-02 and 2010-01
 - The employer cannot receive compensation for performance of its duties under the plan other than compensation to cover reasonable expenses

How can my 403(b) vendor/investment provider assist?

It is prudent to check with your vendor/investment provider to obtain information about the servicing and recordkeeping of your plan. While your vendor/investment provider will not be able to supply all the information that the IRS may request (such as plan document, employment contracts, compensation or participation agreements), your investment provider can generally provide such items as plan-level and participant-level statements, contribution and distribution information and IRS tax reporting information.

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