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403(b) Plan Compliance with the Annual Additions Limit: IRS Expects 403(b) Plan Sponsors to Collect Information About Employees' Outside Employment

by Samuel J. Baldwin on December 2, 2021

**Updated September 27, 2022*

In a recent Issue Snapshot about how the annual limit on retirement plan contributions under Section 415(c) of the Internal Revenue Code ("Code") applies to 403(b) plans, the IRS revealed that it expects 403(b) plan sponsors to maintain procedures to inform employees about Section 415(c)'s special aggregation rule for 403(b) plans and to collect information from employees about outside employment and retirement plan contributions.

Tax exempt employers that sponsor 403(b) retirement plans are likely aware that Code Section 415(c) limits the annual contributions that may be made to an employee's 403(b) plan account, including amounts deferred by the employee (other than age 50 catch-up contributions) and employer matching and nonelective contributions. But tax exempt employers may not be aware of Code Section 415(c)'s special aggregation rule for 403(b) plans, and how contributions to other qualified retirement plans – including plans maintained by unrelated employers – can limit the amount of contributions that may be made to an employee's 403(b) plan account.

According to the Issue Snapshot, IRS examiners auditing a 403(b) plan for compliance with the Code Section 415(c) limit are instructed to review the employer's procedures for informing employees about the Code Section 415(c) aggregation rule and to review the information the employer collects from employees about outside employment and retirement plan contributions.

Code Section 415(c)'s aggregation rule for 403(b) plans

Generally, Code Section 415(c) requires aggregation of contributions made by on or behalf of a participant to all defined contribution plans sponsored by the employer and other employers in the same controlled group[1] to determine whether the total amount of contributions made by or on behalf of the participant exceeds the Section 415(c) annual limit for the year.[2] So, if an employer sponsors a 401(k) plan and a separate profit sharing plan, contributions to both plans must be combined to determine whether an employee's contributions exceed the Section 415(c) annual limit.

The regulations under Code Section 415(c) also include a special rule for 403(b) plans. Unlike other defined contribution plans, for purposes of Section 415(c), an employee's

account in a 403(b) plan is treated as controlled by the employee, rather than the employer. This unique rule has two important effects:

1. If a tax exempt employer sponsors a 403(b) plan and a qualified defined contribution plan, such as a money purchase pension plan, contributions to the two plans generally are not aggregated. This means an employee may receive contributions up to the Section 415(c) limit under each plan. This significantly increases the total annual retirement plan contributions employees can receive if they are eligible to participate in both the 403(b) plan and the qualified defined contribution plan sponsored by their employer.
2. If an employee with a 403(b) plan account at a tax exempt employer is in control of an employer that sponsors a qualified defined contribution plan, the contributions to the employee's 403(b) plan account must be aggregated with contributions to the qualified defined contribution plan for purposes of the Section 415(c) limit. This means that the total contributions for the employee to both plans must not exceed the Section 415(c) annual limit.

The second point is illustrated by an example provided in the IRS's Issue Snapshot. The following excerpt has been edited for space and clarity:

University X provides a 403(b) plan covering all employees. The 403(b) plan provides for elective deferrals and nonelective employer contributions.

Professor Y, who participates in the 403(b) plan, controls their own separate consulting business. Professor Y's business sponsors Plan Z, a defined contribution plan to which contributions on behalf of Professor Y are made.

For 2021, Professor Y elected to defer $19,500 under the University X 403(b) plan, and University X made a nonelective employer contribution of $35,000 on behalf of Professor Y. In 2021, Professor Y contributed $24,000 to Plan Z.

The Code Section 415(c) limit for 2021 as applied to Professor Y is $58,000. The total elective and nonelective contributions on behalf of Professor Y to the University X 403(b) plan equals $54,500 ($35,000 + $19,500). Thus, the contributions to Professor Y's account in the 403(b) plan do not exceed the Code Section 415(c) limit when tested Separately from those made to Plan Z.

Because Professor Y controls the employer that maintains Plan Z, the Code Section 415(c) limit applies on an aggregated basis. The combined contributions of $78,500.

($24,000 to Plan Z + $54,500 to the University X 403(b) plan) exceed the Section 415(c) limit by $20,500 ($78,500 - $58,000). The excess annual addition is attributable to the 403(b) plan.

As a result of the special aggregation rule, tax exempt employers that sponsor a 403(b) plan must be aware of their employees' outside employment, including prior employment for an employee that is hired during a taxable year. Because contributions that exceed the Code Section 415(c) limit are attributed to the 403(b) plan, if contributions to a qualified defined contribution plan sponsored by an employer controlled by an employee cause the Section 415(c) limit to be exceeded, the tax exempt employer is responsible for correcting the excess contributions that have been made to the 403(b) plan.

Employer procedures to comply with the Code Section 415(c) limit

In its Issue Snapshot, the IRS identifies several items that examiners should ask for when auditing a 403(b) plan for compliance with the Code Section 415(c) limit.

Notably, the IRS instructs examiners to review the employer's policy regarding outside employment. If a tax exempt employer does not have a policy prohibiting outside employment, the examiner is instructed to review the employer's procedures for informing employees about the special aggregation rule and to review any notices, forms, or written communications containing that information. The examiner is further instructed to review any information the employer collects from employees about their outside employment and plan contributions.

These instructions provide an important takeaway for tax exempt employers: the IRS expects 403(b) plan sponsors to routinely communicate with its employees about the Section 415(c) limit, explain to employees how contributions to retirement plans at unrelated employers may affect their 403(b) plan contributions, and collect information about outside employment and retirement plan contributions at unrelated employers.

403(b) plan sponsors should review participant notices to confirm they include information about the Code Section 415(c) special aggregation rule and consider formalizing a process to collect information about outside employment (and prior employment) and retirement plan contributions.

Taking these steps is not only beneficial to the sponsor of a 403(b) plan because they facilitate its ability to effectively administer the 403(b) plan in compliance with Code Section 415(c), but implementing effective procedures and documenting these processes will also put the plan sponsor in a strong position during an IRS audit of its 403(b) plan.

What Does it Mean to "Control" an Employer?

As described above, Code Section 415(c) requires contributions to an employee's 403(b) plan account to be aggregated with contributions to a qualified retirement plan sponsored by an employer that is "controlled" by the employee. The regulations under Code Section 415(c) provide a definition of "control" for purposes of determining when an employer is controlled by a 403(b) plan participant. The details of the rule are complicated, but generally a participant in a 403(b) plan is treated as "controlling" an employer if, for purposes of Section 415, that employer would be considered part of a controlled group with a hypothetical employer 100% owned by the 403(b) plan participant.

For example, if a doctor employed by a tax exempt hospital also owns 75% of the stock in a private medical practice, a hypothetical company 100% owned by the doctor would be considered part of a controlled group with the private medical practice for purposes of Code Section 415. Therefore, the doctor is treated as "controlling" the private medical practice for purposes of Code Section 415(c), and contributions to a qualified defined contribution plan sponsored by the medical practice must be aggregated with contributions to the doctor's account in the hospital's 403(b) plan.

But it is often unclear how to use this rule to determine whether an employee is in "control" of a tax exempt entity. Tax exempt entities typically lack the sort of formal ownership structure of a for-profit company. They generally do not issue stock or have defined percentage ownership. For this reason, tax exempt entities have their own rules for determining when they are treated as members of a controlled group. And, under those rules, it is not always clear when a hypothetical company 100% owned by an employee would be treated as part of a controlled group with the tax exempt employer.

Further guidance from the IRS would be welcome, but smaller tax exempt entities where a single individual may appear to be in control of the organization should tread with caution when applying the Code Section 415(c) limit to contributions for the executive director or another employee whose role involves traditional indicia of control over the operations of the organization – particularly with respect to compensation and retirement plan contributions.

If you have questions about how the Code Section 415(c) limit applies to a 403(b) plan or would like assistance developing procedures for complying with the special aggregation rule or other aspects of Code Section 415(c), please contact a member of Verrill's Employee Benefits & Executive Compensation Group.

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[1] For purposes of applying the controlled group rules to Code Section 415, "more than 50%" ownership is substituted for "at least 80%" ownership.
[2] For 2021, the annual limit is generally the lesser of $58,000 ($61,000 for 2022) or 100% of the participant's compensation for the year.

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