

## INITIAL IRS CONTACT LETTER

### School District 403(b) Plans Subject to IRS Scrutiny

By: Fred Reish and Bruce Ashton

*In the last few months, the IRS has targeted the 403(b) plans of public school districts to determine their level of compliance with Internal Revenue Code requirements. They are specifically looking at the "universal availability" requirement, which requires that all employees (other than those who may be specifically excluded by class) are given an opportunity to participate in the plan. We are providing for your review, initially without analysis, copies of the first contact letter, the questionnaire that accompanies it and a follow up letter the IRS is sending out if the response from a school district indicates a problem. We will send out another bulletin in a few weeks with our analysis of what this means to public school districts and other sponsors of 403(b) plans.*

*The first letter from the IRS (they refer to these as "soft contacts") asks the district to complete a questionnaire about the employees eligible to participate in the plan and return it to the IRS. While the response is voluntary, the IRS does indicate that a failure to respond could lead to an examination of the plan.*

*If you have any questions regarding this matter, please contact any of us.*

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District Identification Number:

Name of District:  
Person to Contact/ID Number:  
Contact Telephone Number:  
Fax Number:  
E-mail Address: [epcu.403b@irs.gov](mailto:epcu.403b@irs.gov)  
Return Reply to: IRS/EPCU

Dear Sir or Madam:

This letter is being sent to you because your school district maintains a section 403(b) plan. This letter constitutes a compliance check. A compliance check is not an audit or investigation under section 7605(b) of the Internal Revenue Code or an audit under section 530 of the Revenue Act of 1978.

Among the requirements imposed by the Internal Revenue Code (IRC) on employers who offer section 403(b) plans to their employees are the nondiscrimination provisions of IRC section 403(b)(12)(A)(ii). To meet these provisions, in general, all employees must be provided the opportunity to defer a portion of their compensation pursuant to a salary reduction agreement. This is commonly referred to as the "universal availability" requirement. To assist us in assessing your compliance with this requirement, please provide this information on the enclosed Section 403(b) Questionnaire.

You may also furnish any other documents or clarifying material that you believe will be helpful for us to review. Failure to provide this information could result in further action or examination of your plan.

If you would like someone else to represent the plan during this compliance check, you must submit a written power of attorney. Form 2848, Power of Attorney and Declaration of Representative, may be used for this propose.

Please fax, send or e-mail your reply within 15 days from the date of this letter using the contact information referenced above. If you have questions, please contact me at the above telephone number.

Thank you for your cooperation.

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SECTION 403(b) QUESTIONNAIRE

Please provide the following information (including the EIN in the space above):

- 1) Specify the requirements for any employee to participate in your §403(b) plan, including whether participation is contingent upon the deferral of a mandatory minimum amount.

\_\_\_\_\_
\_\_\_\_\_
\_\_\_\_\_
\_\_\_\_\_

- 2) Which if any employee or group of employees, are excluded from participating in your §403(b) plan:

Substitute or part-time teachers Bus drivers Cafeteria workers Janitors

Others (specify)\_\_\_\_\_ No exclusions

Reason for exclusion(s)\_\_\_\_\_
\_\_\_\_\_
\_\_\_\_\_

- 3) Indicate whether the following groups of people are employed by the school district and if so, whether they are permitted to make deferrals to your §403(b) plan.

a) Employees regularly scheduled to work less than 20 hours per week.
Permitted Not Permitted

b) Employees regularly scheduled to work at least 20 hours per week
Permitted Not Permitted

c) Employees covered by a collectively bargained agreement (union)
Permitted Not Permitted

- 4) Does your plan provide for a one time, irrevocable election to make salary deferrals? Yes No

- 5) Does your school district maintain any other plans with salary deferrals, such as:

§401(k) - Date established \_\_\_\_\_ §457

Other (specify)\_\_\_\_\_

- 6) Describe how the opportunity to make deferrals is communicated to employees to ensure that they are aware of their right to participate in the §403(b) plan. If the method differs by groups of employees, explain that as well.

\_\_\_\_\_
\_\_\_\_\_
\_\_\_\_\_
\_\_\_\_\_

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## FOLLOW UP LETTER

District Identification Number

Person to Contact/ID Number:

Contact Telephone Number:

Dear Sir or Madam:

Recently, the Employee Plans Compliance Unit sent you a compliance check letter that addressed the issue of whether your public school's section 403(b) plan complies with the "universal availability" requirement of section 403(b)(12)(A)(ii) of the Internal Revenue Code ("Code"). The universal availability requirement provides that if any employee is given the opportunity to make salary reduction contributions to the plan, then all employees must be given that opportunity, with certain specified exceptions. Based upon our review of your response to our compliance check, it appears that your public school's section 403(b) plan may not satisfy this requirement.

A violation of the universal availability requirement puts a section 403(b) plan at risk for losing its tax-favored status, resulting in the loss of the retirement savings and tax benefits provided to its participants.

In the interest of preserving the tax-favored status of your plan, the Internal Revenue Service is offering a period of relief to enable sponsors of section 403(b) plans to correct for failing to satisfy the universal availability requirement and bring their plans into compliance. This period of relief begins immediately and will end 240 calendar days after the date of this letter.

To correct a violation of the universal availability requirement, the public school should provide to each eligible employee the opportunity to participate in the plan for the current and future years. It may also need to make a contribution to the plan on behalf of each eligible employee for each year the employee was improperly excluded from participating in the plan.

### **How can you tell if your plan has violated the universal availability requirement?**

As noted above, to satisfy the universal availability requirement, all employees of the public school (with certain exceptions discussed below) must be provided the opportunity to make salary reduction contributions, or deferrals, to the section 403(b) plan if any employee of the public school is offered the opportunity to make salary deferrals. This means that certain employees may not be excluded merely by virtue of belonging to a certain classification of employee, such as nurses, substitute teachers, bus drivers, maintenance workers, and part-time, temporary and non-contract employees. Employees who may be excluded from participating in the plan include:

1. Employees who participate in an eligible governmental plan under Code section 457(b);
2. Employees who have made a one-time irrevocable election not to make salary deferrals to the section 403(b) plan at the time the employee, was initially eligible to participate in the plan;
3. Employees who are non-resident aliens with no U.S. source income;
4. Employees who are students performing certain services;
5. Employees who normally work fewer than 20 hours per week;
6. Employees who wish to defer less than the minimum deferral amount of \$200 annually; and
7. Employees covered by a collectively bargained agreement (union).

You may want to consider contacting the custodian or trustee of your section 403(b) plan to assist in making this determination and with any correction necessary to be eligible for the relief.

### **What should you do?**

If, after considering the above information you believe your section 403(b) plan has satisfied the universal availability requirement, to be eligible for the relief provided in this letter, your public school should make a fully vested contribution for each otherwise eligible employee for each year the employee was improperly excluded from making a salary deferral to the section 403(b) plan. A fully vested contribution is one in which the employee is entitled to the full amount of the contribution,

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whether or not the employee leaves the service of the employer. Additionally, if the employee would have been entitled to a matching contribution, then the public school should make an additional contribution to make the employee whole.

There were various ways in which the make-up contribution to the employees may be calculated. We provide two common methods here. Both of these methods utilize the concept of “lost opportunity cost,” which represents the benefits lost to the employee. Generally, the lost opportunity cost represents the loss of the tax benefit to the employee for having paid income tax on salary that could have been deferred and the loss of the ability of the salary deferral to grow tax-free in the section 403(b) plan. The Service has determined that the lost opportunity cost is equal to approximately fifty percent (50%) of the amount of the salary deferral the employee could have made to the section 403(b) plan.

The first method for calculating the contribution for the excluded employee is based on the average deferral rate of similarly situated employee. The employer determines the “average deferral percentage” (ADP) of the affected employee’s group (i.e., highly or nonhighly compensated). Refer to the enclosure for additional information concerning this test. Once the appropriate average deferral percentage is determined for each year affected, each excluded employee is entitled to a fully vested contribution equal to fifty percent (50%) of the employee’s compensation multiplied by the average deferral percentage for that year. If the employer matched the salary deferrals made under the plan, the employee is also entitled to any related matching contribution attributable to salary deferrals. For purposes of determining the amount of salary deferral to be matched, one-hundred percent (100% and not 50%) of the missed salary deferral is used.

Example: Employee A was a nonhighly compensated employee who was incorrectly excluded from participating in a school’s 403(b) plan. The ADP for the nonhighly paid group was 10%. The amount the employer must contribute on the employee’s behalf equals \$2,500 (10% multiplied by Employee A’s compensation of \$50,000, or \$5,000 multiplied by 50%). The Plan also provides for a matching contribution equal to 10% of the salary deferred. The corrective contribution for the matching portion equals an additional contribution of \$500 (10% X \$5,000). Thus, the total required corrective contribution equals \$3,000 (\$2,500 + \$500) plus an adjustment for earnings. Refer to Revenue Procedure 2006-27 for additional correction information.

The Service recognizes that it is not always possible to make a precise calculation as to what the average deferral percentage would be for a particular year. In that case, reasonable estimates may be used. Even if it is possible to make a precise calculation, where the probable difference between the approximate and the precise calculation is insignificant and the administrative cost of determining the precise calculation would significantly exceed the probable difference, reasonable estimates may be used.

In addition, in lieu of calculating the average deferral percentage, an employer may deem the average deferral percentage to be equal to three percent (3%) of compensation. Under this second method, the employer would make a fully vested contribution for the excluded employee equal to one-and-a half percent (1.5%) multiplied by the employee’s compensation for each year of exclusion. Again, if the employer matched the salary deferrals made under the plan, the employee would be entitled to any related matching contribution attributable to salary deferrals. For purposes of determining the amount of salary deferral to be matched, the average deferral percentage would be considered to be 3%, not 1.5%.

There may be other ways to correct a failure to comply with the universal availability requirement. If you would like to suggest an alternative method of correction or would like to discuss this compliance check further, please contact the person whose name and telephone number are shown above.

It is important to us that your employees are able to continue to enjoy the benefits of maintaining and participating in a 403(b) plan. For more information on 403(b) plans, including the universal availability requirement, please go to the IRC 403(b)/457 Online Resource Guide web page at <http://www.irs.gov>.

Sincerely,  
Manager EP Compliance Unit

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

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