

## IRS Announces Universal Availability Project: Focus on School District 403(b) Plans

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In a recent bulletin, we alerted you that the Internal Revenue Service is sending out letters to public school districts regarding their 403(b) arrangements. (See our May 2007 Bulletin available at <http://www.reish.com/publications/pdf/initialirs.pdf> for a copy of the first IRS letter, the questionnaire that accompanies it and a follow-up letter the IRS is sending out if the response to the questionnaire indicates a problem.) Initially the IRS sent letters to districts in three states, but in an announcement released on June 21, 2007 it expanded the project (called the 403(b) Universal Availability Project) to cover all fifty states. The project is slated to last through 2008. Commenting on the expansion of the compliance project, the Director of the IRS Employee Plans division indicated that the data collected so far has revealed "fairly widespread noncompliance by schools with the universal availability requirement for 403(b) plans."

The IRS's first contact letter invites the recipient school district to complete a "compliance check" questionnaire in order for the IRS to determine whether or not the district is complying with the universal availability rule under section 403(b)(12)(A)(ii) of the Internal Revenue Code (the requirements of this rule are discussed below). While responding to the inquiry is voluntary, the IRS does indicate that a failure to respond could lead to an IRS audit.

In our experience, the IRS initiates these types of programs to gather a statistical sampling to determine whether the issue merits a formal audit program. With that in mind, and in light of the expansion and extension of the project to the entire country, all school districts should be concerned about whether they satisfy the universal availability requirement in their 403(b) plans, regardless of whether they receive an IRS letter.

### Universal Availability

The universal availability requirement states that once a plan sponsor gives any employee the opportunity to make an elective salary deferral, all employees must be given that same opportunity, with limited exceptions. Those exceptions allow the following categories of employees to be excluded from participation:

- Employees who participant in an eligible governmental plan under Code section 457(b);
- Employees who have made a one-time irrevocable election not to make salary deferrals to the 403(b) plan at the time the employee was initially eligible to participate in the plan (that is, the employee irrevocably opted out of plan);
- Employees who are non-resident aliens with no U.S. source income;

- Employees who are students performing certain services;
- Employees who normally work fewer than 20 hours per week; and
- Employees who wish to defer less than a minimum deferral amount of \$200 annually.

The IRS expanded this list in Notice 89-23, allowing the following additional categories of employees to be excluded:

- Employees who make one-time elections to participate in a governmental plan under section 414(d) (that includes plans maintained by the U.S. government, the government of any state or political subdivision of any state or by any agency or instrumentality of any state or the U.S. government) instead of the 403(b) plan;
- Employees covered by a collective bargaining agreement whose retirement benefits were the subject of good faith bargaining between the representative of such employees and the employer;
- Visiting professors for up to one year under certain circumstances; and
- Employees affiliated with a religious order who have taken a vow of poverty.

If any employee in an excludable category is given the option to make elective deferrals, then all employees in that category must be permitted to participate.

We are aware of a number of situations in which school districts have improperly excluded otherwise eligible employees from participation. Common categories of employees that are improperly excluded from school district plans are substitute teachers, bus drivers, maintenance workers, and employees who are not full-time. Those employees could be excluded if they fit into one of the excludable categories, noted above. But, if they do not, the universal availability rule requires that those employees be allowed to participate in the 403(b) plan.

In late 2004, the Treasury Department issued proposed regulations under section 403(b). The proposed regulations are expected to be finalized this summer and possibly effective as early as January

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1, 2008. The proposed regulations do not adopt the Notice 89-23 exclusions, but they provide a delayed effective date for a 403(b) maintained pursuant to a collective bargaining agreement that is in effect when the final regulations are issued. Once the proposed regulations become final, districts will need to review their eligible categories carefully to ensure that they are not excluding otherwise eligible employees.

### **What Happens if Your District's Plan Does Not Meet the Universal Availability Rule?**

The failure to meet the universal availability rule results in the loss of 403(b) status, which puts the 403(b) plan, and most importantly, employee salary deferrals, at risk of losing tax-favored status. That is, violation of the universal availability rule could mean that contributions to the 403(b) plan and the earnings on those contributions are immediately subject to income tax.

The IRS letter invites school districts to correct the failure to comply with the universal availability rule by bringing their plans into compliance. As explained in the letter attached to our prior bulletin, once a school district completes the questionnaire and the IRS determines that the school district has failed to comply the school district will receive a letter "inviting it" to correct the failure. The school district is given 240 calendar days from the date of receipt of the letter to correct the failure.

Interestingly, the IRS does not indicate in its letter whether the school district needs to provide proof of correction or what happens if the school district fails to correct within the 240-day period. The omission of guidance on the consequences for failing to correct does not mean the IRS is not serious about compliance. In fact, we have been informed of one instance in which the IRS has imposed a penalty on a government agency for failure to properly administer a plan. Nonetheless, if a school district intends to correct the failure to comply with the universal availability requirement, it is in the district's best interest to correct within the 240-day period. That is because the availability to correct under this program is more favorable than other voluntary correction programs offered by the IRS. In order to use the correction programs offered by the IRS, the school district would have to pay a filing fee along with any fees associated with compiling and drafting the application, whereas compliance by "invitation" through an IRS letter does not.

### **Methods of Correction**

The IRS proposes two methods of correction in the letter. The methods of correction are designed to make up the contributions to the employees who were improperly excluded from the plan for each year the employees were excluded from making deferrals.

The first method requires the school district to calculate the contribution for the excluded employee based on the average deferral rate of similarly situated employees. Under this method, once the average deferral percentage is determined, each improperly excluded employee is entitled to a fully vested contribution equal to 50% of the employee's compensation multiplied by the average

deferral percentage for that year plus an adjustment for earnings. In addition, if the school district matches salary deferrals under the plan, that employee is also entitled to receive any related matching contribution attributable to that period. In contrast to the calculation of the corrective deferral contribution, the employee is entitled to a matching contribution based on 100% of the missed salary deferral and not 50%.

The second method of correction authorized in the letter is for the school district to use a deemed average deferral percentage of 3% of compensation. Under this method, the school district would make fully vested contributions to the improperly excluded employees equal to 1.5% multiplied by the employee's compensation for each year of exclusion plus an adjustment for earnings. In addition, if the school district made matching contributions, the improperly excluded employees would be entitled to any related matching contributions on those salary deferrals. As noted above, the matching contribution is based on 100% of the missed salary deferral (i.e., matching contributions will be made on 3% of compensation).

Finally, in addition to the two methods suggested in the letter, the IRS indicates that it would be amenable to alternative methods of correction. We are aware of at least one alternative method of correction. However, based on our experience in handling hundreds of plan correction proceedings, in order for a district to use an alternative method, the district would have to negotiate with the IRS.

### **Practical Issues**

Correcting a failure to comply with the universal availability requirement in accordance with the methods outlined above may involve considerable costs to a district. However, before making any correction, school districts would be well-advised to retain counsel to determine whether there are any contractual restrictions on using the methods suggested by the IRS (e.g., restrictions imposed under a current memorandum of understanding with union employees).

In addition, it appears that school districts that do not receive the letter are unable to correct a universal availability failure without participation in a formal correction program. As a result, districts that do not comply with the universal availability requirement and do not receive a letter should seek the advice of counsel and correct under the IRS's voluntary correction program. Indeed it might be prudent for the district to conduct an internal audit to determine the level of compliance of its plan, especially once the final 403(b) regulations are published. In order to protect the confidentiality of the process, such an internal audit should probably be conducted by or through the district's counsel.

### **Conclusion**

The IRS letter provides school districts the opportunity to correct failures to satisfy the universal availability rule. With the finalization of regulations under 403(b) and the IRS's focused efforts on 403(b) compliance, public school districts should be increasingly diligent about operational compliance for their 403(b) plans. This will, in some cases, require a more pro-active approach to managing the plan.

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