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Understanding the IRS Audit Process for Your 403(b) Plan

By Kimberly A. Flett, CPA, QPA, QKA

Mention the IRS and the word "audit," and most employers become immediately concerned. For sponsors of 403(b) plans it is important to note that audits of the plans are occurring, especially with the changes to the 403(b) regulations that have transpired over the last several years. With the right amount of planning and proper administration, plan sponsors can avoid audit pitfalls and provide for an employer-sponsored plan that effectively meets IRS guidance and regulations.

Planning

A 403(b) plan, according to the summary definition in IRS Publication 571, is defined as a "tax-sheltered annuity (TSA) plan, for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers." There are primarily three types of funding options in a 403(b) plan:

an annuity contract provided through an insurance company,

a custodial account invested in mutual funds, and

a retirement income account (RIA) set up for church employees which invests in annuities or mutual funds or other investment options as selected by the church or other religious organization.

A 403(b) plan allows for employee pre-tax deferrals similar to a 401(k) plan. The funding limits are the same as the 401(k) plan in which participants can defer up to $17,500 for 2014 in either pre-tax 403(b) deferrals or post-tax Roth 403(b) deferrals or a combination of the two. Another $5,500 may be made in catch up contributions for employees over age 50.

These plans may also allow for employer matching contributions and profit-haring contributions, subject to annual IRS funding limits. The plans generally are

available to employees of tax-exempt organizations defined under Code Section 501(c)(3) and certain ministers, including those who are employed by 501(c)(3) organizations, public educational institutions, self-employed ministers and certain chaplains. The plan must be sponsored by an employer organization and that includes the denominations of self-employed ministers.

During planning it's important that the organization sponsoring the plan qualify as a public educational institution or as a Section 501(c)(3) organization. The plan must have an adopted form plan document which meets IRS conditions. All 403 (b) plans with the exception of churches as described in Code Section 3121(w)(3) (A) and (B) (which sponsor a 403(b)(1) and/or 403(b)(7) plan) were required to have a plan document by Dec. 31, 2009. The plan must be set up in a proper investment contract such as an annuity contract or custodial account.

The compliance changes also include that product providers and plan sponsors enter a contractual agreement that information shared will meet the necessary compliance requirements such as the eligibility for distributions, loans and hardship withdrawals. These are also known as "hold harmless agreements," service provider or vendor indemnification agreements.

Revenue Procedure (Rev. Proc.) 2013-22 allows for pre-approved 403(b) documents effective June 28, 2013. Under the 403(b) Pre-approved Plan Program, a 403(b) prototype plan may apply for an opinion letter, and 403(b) volume submitter plans may apply for an advisory letter.

Ongoing Administration

It is important that ongoing administration is correct and accurate to keep the plan in compliance. Annual funding limits for all source types including Roth deferrals, pre-tax 403(b) deferrals, matching and profit sharing must be followed. The plan must be following the terms of the plan document. Items such as incorrect distribution provisions, plan-imposed funding limits and other factors such as eligibility for match and profit sharing need to be followed.

Additionally, there can be no waiting period in order to make salary deferrals into the plan.
An important feature unique to 403(b) plans includes universal availability. This requires that all employees be given the opportunity to make salary deferrals unless the plan has an allowable excluded class of employees such as employees who normally work fewer than 20 hours per week or more.

Universal availability in 403(b) plans generally requires that the option to participate in a 403(b) plan be made to all employees and that the employer provide a meaningful to employees to participate or make changes. The IRS has said (in a webcast presented by IRS Audits Division Senior Staff Specialist Dan Gardner and Ellie Lowder, TGPC, consultant) that "meaningful opportunity" requires "year round activity" on the part of the employer).

Current 403(b) regulations allow certain employees to be excluded from plan participation without violating discrimination testing rules. This includes:

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employees who are participating in another 403(b) or 401(k) plan of the same employer,

nonresident aliens,

employees who are participating in a 457(b) plan, and

employees who normally work fewer than 20 hours per week.

A safe harbor can be applied to determine if employees work fewer than 20 hours a week, if beginning on the employee's anniversary date the employee will work fewer than 1,000 hours of service in a 12-month period, and for each following 12 months the employee worked fewer than 1,000 in the preceding 12-month period.

It is important to determine if the universal availability is properly considered when sponsoring a 403(b) plan especially under audit.

Plans may allow for a "15 years of service catch-up contribution." For employees with at least 15 years of service, an additional catch up contribution is allowed as the smaller of: (1) $3,000, (2) $15,000 reduced by the previous year's catch up under this rule as either Roth or pre-tax deferral, or (3) $5,000 times the number of years of service less the total deferrals in previous years.

What the IRS Is Looking for When Auditing

The IRS provides guidance in the 403(b) Fix it Guide as to which types of items it is looking for when auditing a plan. These include:

The organization is eligible to sponsor a 403(b) plan.
A plan document was adopted by Dec. 31, 2009.
The terms of the plan document were followed.
All employees who were eligible were given an opportunity to make salary deferrals.
Employee and employer contributions followed IRS funding limits.
All employees making the 15 years of service contributions were eligible with 15 years of service.
Loan amounts were proper under Code Section 72(p).
Plan hardship withdrawals were proper.

Although the timing of 403(b) deposits is regulated mainly by the Department of Labor, the IRS is also concerned about it. Similar to 401(k) withholdings, plan sponsors of 403(b) plans must deposit employee contributions no later than within a five to seven day window of time after withholding. (Referred to as a safe harbor). Generally large employers must deposit these funds within a 1-2 day period if not a shorter one. Large employers are defined as those having more than 100 participants. In general, employers of this size are deemed as utilizing sophisticated payroll systems that allow for an automatic timing of deposits.

Plan document options establish the definition of compensation used for deferral and employer contributions. Examples include compensation as reported on Form

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W-2, gross compensation less pre-tax withholding and date of entry compensation. This area is a common area where mistakes are made. In such situations, it is necessary for the employer to make the participant whole if the correct amount of compensation was not used in calculating deferral or employer contributions. A complete review of the plan definition of compensation, as well as continued communication with the payroll provider and internal personnel is vital to prevent mistakes in this area.

In general there are two types of plan document amendments: interim and operation amendments.

Interim amendments are based upon current legislation and are in effect until the next required document restatement. Interim amendments can be optional — such as a plan allowing for Roth in-plan conversions — or mandatory.

Operational amendments are by choice of the plan sponsor. These can include adjustments to a plan loan feature or a change in the entry dates from semi-annual to quarterly for employer contributions in a 403(b) plan. The timing of these amendments are critical as there cannot be a cut-back of benefits, rights and features that have been properly earned by participants under the current terms of the plan.

Whether the amendments are interim or operational, it is vital the adoption, timing and signatures are proper when audited by the IRS.

Plans that allow for auto-enrollment require special notification and an option for employees to cease auto enrollment in the plan. It is vital that all documentation related to this is proper, and where appropriate signed by affected employees, and that any auto-escalation is followed carefully in terms of the plan document and takes effect with the proper payroll period.

With the changes affecting the Defense of Marriage Act, it is important that the plan document and related operations allow for recognition of same-gender couples regarding benefits in the plan. As much of this guidance is newly on the horizon, it is important that plan sponsors communicate with their third-party administrators and legal counsel in this regard.

Required minimum distributions (RMDs) are due from the plan beginning April 1 of the year following the year in which an employee turns age 70.5 or severs employment, if later. RMDs are required for all terminated employees who have a balance, and any highly compensated employee who is more than a 5% owner (very uncommon in a not-for-profit) even if still an active employee. Subsequent RMDs are due by Dec. 31 of each year following, so a participant who waits until April 1 will be subject to two RMDs that year.

Other issues that can be of concern include:

- Failure to allow rollovers according to the plan document, following the terms for hardships, in-service distributions, loans.

Failure to satisfy the ACP test (not applicable to governmental and non-electing church plans).

Exceeding the Code Section 402(g) limit and Code Section 415 limit.

Not allowing employees the option to defer immediately upon hire.

Not following the entry requirements for employer contributions.

Not following the plan document for vesting requirements.

Items to have available for the audit include:

payroll and personnel files

Forms W2

enrollment forms

plan documents and amendments

any related notices to employees

Form 5500 for the year under audit (for ERISA plans only)

summary annual report

all information listed in the information document request (IDR)

What triggers a 403(b) audit? A variety of factors including particular items on Form 5500, participant complaints, randomness, plan type, size and region of the country.

The IRS uses its own system for addressing plan operational, compliance and document failures in a program called the Employee Plans Compliance Resolution System (EPCRS). The IRS has added a significant focus to the EPCRS correction program for 403(b) plans under Rev. Proc. 2013-12. This is available for plans after Jan. 1. 2009. Rev. Proc. 2008-50 must be used for plans before Jan. 1, 2009.

The EPCRS program allows for three types of correction depending on the plan violation: the self-correction program (SCP), the voluntary compliance program (VCP) and Audit CAP, which is used when the plan is under audit.

The results of the audit can lead to penalties, fees, make-up contributions, lost earnings and/or tax consequences at the participant level.

Kimberly A. Flett, CPA, QPA, QKA is Director of Retirement Plan Design and Administration at SS&G, Inc. She also is a member of the NTSA Communications Committee.