RECORD, Volume 22, No. 2*

Colorado Springs Meeting
June 26–28, 1996

Session 73L
Section 403(b) and 457 Plans

Track: Pension
Key words: Employee Benefit Plan, Legislation and Regulation, Pension Plans

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Summary: This session addresses current issues pertaining to employers who sponsor Internal Revenue Code (IRC) 403(b) plans. Special attention will be given to the increased Internal Revenue Service (IRS) focus on these plans. The effect of recent legislation, particularly with respect to 457 plans, will be discussed. Topics also include participation, contributions, nondiscriminatory testing, distributions, and the maximum exclusion allowance (MEA).

Mr. Peter A. Gold: I'm the national practice director of 403(b) plans for Buck Consultants out of Stamford, Connecticut. Paul Carlevato is the manager of the western region of Metropolitan Life on the service center for 403(b) and 401(k) plans. We're going to talk about many things. We assume a limited basic knowledge of 403(b) plans. We tend to ignore church plans. There are a whole set of special rules for church plans.

Mr. Paul Carlevato: The 403(b) plans have become increasingly complex over the last several years. In 1994 the IRS began to take a serious look at 403(b) plans, and after an initial study, the IRS determined that the overall noncompliance level for 403(b) plans could be as high as 90%. I think that points to many opportunities.

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Peter is going to touch on that quite a bit more when we touch on the tax-sheltered voluntary corrections (TVC) program and the audit guidelines, which I think were developed as part of this initial study.

Our experience has been that many tax-sheltered annuity (TSA) sponsors have unknowingly created qualification problems in enhancing their programs, such as the addition of employer contributions. We're going to touch on that a little bit, as well. We're also going to talk about some of the contracts that are used to fund 403(b) plans. With the increased scrutiny from the IRS, TSA plan sponsors will need knowledgeable professionals to guide them through the compliance regulations. We're hoping to give you at least a little information on several subjects.

As Peter mentioned, many of the topics we're going to talk about are probably worthy of 90 minutes of discussions themselves. We talked about church plans, which is a very complex area. Our hope is to point out some issues in several different areas of TSAs.

One experience I had in the market helps to set the stage. About five years ago I came out to Denver to start up a 403(b) recordkeeping operation, mostly dealing with ERISA plans. At that time we acquired an ERISA 403(b) marketing group, and we started going out and looking at some of these plans that they were bidding on. I talked to one particular plan who had added employer contributions several years prior to our meeting with them, and was referring to ERISA throughout the presentation. I got a fax when I went back to my office and they wanted to know what ERISA was. Here was a plan that had employer contributions, which was clearly an ERISA plan, and did not even know that the code section existed or applied to the plan that they were operating.

I had an opportunity to read over a Buck survey. Peter gave me the copy to take a look at, and I was pleased to see that most of the sponsors had indicated they had an ERISA plan, or at least were now completing Form 5500s and had a plan document, which I don't think was the case five years ago when we were getting started with this.

Mr. Gold: It's over 70% now in the respondents that say they have these things.

Mr. Carlevato: One of the things we were talking about was whether these people really understand these questions and really understand if they have an ERISA plan or not.

I know the session was intended for people with experience, but I think we'd like to start out with a little bit of an overview, particularly on 457 plans, because a majority of our presentation is going to be with 403(b) plans because that's where there's a great deal of legislative activity right now. At the end of 1995 one study that I was taking a look at in preparation for the conference estimated 403(b) assets to be at about $270 billion in June 1996. They also have a projected growth rate of 8.9% through the year 2000, which is quite a bit of assets and much growth. That's a higher growth expectancy than exists in the 401(k) market. The 457 plans, on the other hand, estimated assets of $45–50 billion with about a 12% expected growth rate through the year 2000. There is a great deal of activity here, many new plans starting up, and many people are getting into these types of arrangements.

The 457 plans generally cover government employees, 501(c)(3) organizations and other nonprofits. The 403(b) plans generally cover public educational systems, commonly referred to in the business as K through 12, 501(c)(3) organizations. They also have special rules for churches and certain educational institutions.

Mr. Gold: The thing what's important to remember is not all tax exempt organizations are 501(c)(3) organizations. Only your basic charitable, educational, literary, or testing for public safety organizations are 501(c)(3). Anybody else who's tax-exempt is under 501(c) or something else, and can only have a 457 plan; they cannot have a 403(b) plan. The IRS has found a number of non-501(c)(3) tax-exempt organizations with 403(b) plans and they currently don't know what to do with them. There's no way to correct because they shouldn't have 403(b) plans. Brokers, especially, go out and sell these things, and people ask, "Are you tax exempt," and they say yes. They never ask what are you tax exempt under, and employers can get themselves into a great deal of trouble if they are not careful about that distinction.

Mr. Carlevato: The plan may be subject to ERISA, if certain features or restrictions exist. For example, if employer contributions are made, which was pointed out earlier, it generally subjects a 403(b) plan to Title I of ERISA. The 403(b) plans subject to ERISA are also subject to increased administrative and reporting complexities. That may not be clearly understood in the 403(b) market, because of the development of certain regulations over time and the failure to keep up on those. Many tax-exempt organizations are so used to just the annuity programs they established where individuals go out and get annuity contracts, they never really were concerned about Title I of ERISA, or the reporting that goes along with that. That's a big area in the market right now. Peter will talk about this when we get into audit guidelines.

The IRS has recently proposed or enacted legislation to help guide 403(b) plan operations. This will be a big part of our presentation as we go along.

A comparison of 457 plans is included. I'm not going to go through each of these different topics, but they are compared to a 401(k) plan. Some of the major things to point out is that there are 457 plans that are classified as eligible or ineligible, and there are some funding restrictions as far as contributions. They are a little bit different. I'll talk about those a little bit later. They are not subject to nondiscrimination rules.

These 457 plans can be either eligible or ineligible. Both types are unfunded. Eligible 457 plans enable benefits to be taxable when distributed and are subject to age 70½ minimum distribution rules and the deferral limitations. Ineligible plans can provide unlimited benefits, but are subject to substantial risk of forfeiture. These plan benefits are subject to taxation when a substantial risk of forfeiture lapses. Both types of plans will sometimes use a rabbi trust to help secure the benefits. Deferral limitations on eligible 457 plans are the lesser of $7,500, or one-third the participants' includable compensation. There is also a special catch-up election for the employees for the last three tax years. It's important to note that this limit is reduced dollar for dollar by contributions to 401(k) and 403(b) plans.

Some of the 457 issues include determining the intent of establishing the non-qualified plan. It's important to understand why the sponsor is establishing the plan. What do they expect to get out of this? Funding requirements may be too great if many covered employees have a short period until retirement. Other plans may better meet the needs of employees, such as welfare benefit or qualified plans. So something else to consider is looking at other arrangements.

Mr. Gold: Even if you can meet the funding needs, you're limited to $7,500 and a relatively older employee who can't be funded with the $7,500 limit might have to go to the ineligible 457 plan, which does not have a limit. So even if you are bumping up against that $7,500 limit, you can still manage to do a 457 plan. Personally, I don't like 457s, but that's my personal opinion.

Mr. Carlevato: That's why it's good to consider other options as well, or even a combination of options. As a result of the substantial risk of forfeiture, the plan sponsor will want to structure 457 plan provisions on forfeiture form and timing of benefits to meet the individual needs of the people that will be covered by the plan.

Mr. Gold: The rest of the presentation will be on 403(b) plans.

What is a 403(b) plan? The way these things have been traditionally done is employees have individual contracts or the employer will say we're acting exactly as a conduit; we're going to withhold your money, and we'll send it anywhere you want. We've seen 403(b) arrangements where they send the money to a dozen or two dozen providers. There are some states that have the any-willing-provider rule. You have to send the money to anybody they want. It can get to be a real mess, depending on what the plan is. The IRS has basically taken the position that they don't really care. They just want it done properly, and they don't care how you allocate the responsibility among the employer, the employee, the third party administrator (TPA), the insurance company, the mutual funds, or anyone else. As long as it's done properly, they say you can rack it up however you want.

The thing to be aware of is that the IRS looks at the employer to be a controlled group. That becomes important when we talk about testing. In a plan maintained by the employer, since the employer is doing the salary reduction, anybody that salary reduction is going out for is an employee in that plan and anybody who is in the controlled group of an employer doing the salary reduction is in the same plan. You might have a hospital system that has a hospital in San Francisco and another hospital in Los Angeles and believe it's a controlled group. The two hospitals might think they're in separate plans because they never deal with each other, but the IRS will say it's one plan, and it's a controlled group. They will allow you, in that case, to desegregate the discrimination tax pay on a geographical basis if you've historically treated the geographical units separately for benefits purpose, and they operate independently on a day-to-day basis. The one restriction is that you can't be in the same standard metropolitan statistical area (SMSA). You couldn't have a hospital in San Francisco and one in Berkeley and desegregate because they're in the same standard metropolitan statistical area. San Francisco and Los Angeles could be desegregated.

The IRS doesn't care if the 403(b) plans cover different groups of employees, have different benefits for employees, or use different providers to provide those benefits. It's all the same plan. They don't care. The only break you get in treating it as an employee plan (and this is for 415 testing purposes) is you don't have to aggregate it with your qualified plan for 415 testing. The IRS does treat it as plans for the individual in that case, unless the individual controls the not-for-profit that has the 403(b) plan. This is highly unlikely, though possible, especially in some of the smaller cultural not-for-profits, like a theater group or something like that. Or perhaps the employee has selected the alternate limit under 415(c)(4)(C). The problem with that is that 415(c)(4)(C) selection made by the employee on the tax return is not made by checking a box; it is made if you need to use it, you've deemed to use it, and it's irrevocable and it follows you for life. So if you work for Company A in California and made this 415(c)(4)(C) election, and then you move across the country to New York, to an entirely unrelated employer, that 415(c)(4)(C) election follows you, and that new employer won't know about it. In fact, the employee probably doesn't even know about it, but he has made it. The plan design approach you may wish to consider is limiting contributions to the plans to those that could be made without the need to make any alternate elections under 415(c). It makes life a whole lot easier if you don't know they've been made anyway. If some employee doesn't get the maximum he can get, at least you know he's qualified. You are not going to lose your tax default.

The Department of Labor (DOL) takes an entirely different view as to what is a plan. The DOL says if you do anything more than take employee contributions from their pay, and remit them to the insurance company or the custodial account or the mutual fund, you have a plan for the ERISA offices. You basically can't get involved in the administration. They came out with a recent letter ruling that said an employer who determined whether or not the employee had a hardship withdrawal was involved in the plan and that made it an ERISA plan. There's a whole long testament of regulations, but basically it comes down to, you shouldn't do anything but take the money out of the employee's pay. You can limit the number of providers of services to the employees; limit them to a reasonable number to give them a reasonable choice. Where's the break point on that? Obviously, you can limit it to less than ten. Can you limit to only two? You know that's a hard question to answer, because there's no real guidance. It is a facts-and-circumstances situation.

An interesting issue related to that is you can now find TPAs or insurance companies or mutual funds that will let you invest in not only their own products, but also in products of all the other mutual fund carriers out there. Do you really need to have more than one provider in there now? That's something you really have to think about, especially in light of becoming an ERISA plan.

What are the consequences of being an ERISA plan? Frankly, they are not particularly onerous. You have to file a Form 5500. It takes about ten minutes, because you only fill out the first page, which basically has information on the plan and who the plan sponsor is. You also have to give a summary plan description (SPD). Most people give them out anyway. In fact, most of the TPAs or insurance companies of custodial accounts provide them for you. You are definitely subject to joint-and-survivor (J&S) annuity rules if you have an annuity plan. There is a question as to whether or not you are subject to them if you have a plan funded solely through mutual funds. You can certainly argue that the 403(b) could be set up with an employee contribution and a company match just like a 401(k) plan, and then it is not subject to the rules of joint-and-survivor annuities, so we'll make this a profit sharing 403(b) as opposed to a money purchase 403(b) and not be subject to the joint-and-survivorship annuity rules.

I spoke to the DOL about that since it is a DOL regulation, and they said, "We gave that to the IRS under the Bureau Organization Plan Number 1. It should be an IRS rule." I called the IRS and they said, "We don't regulate that, that's a DOL thing; it's 403(b)." So there's really no definitive answer, but we're trying. The other rules on vesting would apply to an ERISA plan; they are in ERISA but are not onerous. You have to be bonded to handle plan assets. You're probably bonded for your qualified plan, anyway, so it shouldn't cost anything additional.

The advantage to being an ERISA plan is that it allows you to take a proactive role in centralizing the data. One of the big mistakes, or one of the causes for the mistakes that people make in 403(b) plans is due to the data not being centralized. There's no control over who does what. Typically, if you have two or three providers, the employee can call any one of them directly, and if he does so, the employer doesn't know what's going on. A classic case would be a loan. You're limited to loans of $50,000 reduced by the highest outstanding balance in the last 12 months. Let's say you have three providers. An employee calls up provider one and says, "Give me a loan." Provider one says, "Sure," and gives him a loan. He has an account balance there, but hasn't put money in for ten years. He does the same thing for provider two and provider three. Now you have $150,000 worth of loans because nobody centralized it, and nobody is looking at this thing as a whole.

Let's discuss the maximum exclusion allowance (MEA). The MEA calculation requires you to reduce the amount you put in by prior year's excludable amounts. Ten years ago I put it into that provider and five years ago I put it into that provider and two years ago I put it into that provider, and the providers don't talk to each other. So the current provider who is doing the MEA testing for you for the current year, because that's where the money's going, doesn't have a clue as to how this is going to work out. And if it's coming out right, it's by luck. Paul will get into that more. So I really think that you have to take a proactive role and make this an ERISA plan.

You're going to get the blame if this goes wrong, so you might as well get the credit for making it go right. Make sure everything is done right and make sure the data are coordinated. Make sure that there is one central point that everybody has to go through, whether it is you or one TPA that is deemed to be the lead TPA, which will record the activities of all the other TPAs. You can set it up any way you want in the contract. Just make sure this is centralized somehow, so the stuff works; otherwise, it's never going to work.

TPAs can be funded either from annuity contracts or custodial accounts with mutual funds. There are advantages and disadvantages.

Mr. Carlevato: Generally, on the annuity side, a contract can be written either as a group annuity or as an individual annuity. I'm going to focus on group annuity contracts, because that's mostly what we're doing now. It seems to be the trend in the industry, especially with the ERISA plans because it enables the insurance company to tie the contracts through one sponsor together to overcome some of these issues. Another thing that we do at Metropolitan and what some other sponsors are also doing, is call it a common remitter program to overcome some of those issues with the MEA. We will get into it in more detail later. We're having all funds flow through Metropolitan Life and then we'll farm them out, even if they are not part of one of our annuity contracts. That helps us to keep a better handle on the MEA. You'll see some of that in the industry coming along, as well.

Group annuity contracts, in general, can be either variable or fixed in nature. A fixed annuity contract provides a single guaranty. The account is usually backed by the general reserves of the insurance company. Variable annuity contracts consist of the fixed component, as well as several separate accounts. They can be funded through either the insurance company's investments, or as Peter pointed out, other companies. Mutual fund companies, for example, have set up some separate accounts through some of the major mutual fund providers so that people can get into a single annuity contract and transfer between funding options without some of the 403(b)(7) issues, which we will talk about next.

Interest crediting methods are interesting in annuity contracts and they vary from carrier to carrier. Some of the issues with the interest crediting method is that many of the annuity contracts have two or three or even more tiers in the interest credit, which makes it very difficult for a TPA to replicate the interest credit method. So other accounting has to be very closely tied into the insurance company's contract reports.

A common interest crediting method is a two-tier method in the 403(b) market, where new markets in a given year have one rate and old money deposited in prior years has another rate. The recordkeeping for this may create the need to have two different buckets—one for old money and one for new money—so that can be tracked properly in an ERISA environment. Annuity contracts generally carry surrender charges to cover acquisition costs, sales charges, and commissions. Those also have to be monitored very closely; especially if an outside administrator is used. Generally, a seven-year surrender charge is applied on annuity contracts, and that can either be from the date of the deposit, or from the date the contract is issued.

There are several different methods of applying surrender charges to annuity contracts, as well. Another distinguishing factor of the 403(b) annuity contract is that there is a mortality and expense (M&E) charge because it is an insurance contract. Because of the annuitization feature, there is a charge for mortality in the contract. That's worked out by the actuaries of the insurance company based on how many payments they expect to make. Annuity payments are guaranteed for the life of the participant. Once a contract is annuitized, at retirement, or earlier, the participant gets a portion of interest and principle through their life expectancy. If they live past the life expectancy the insurance company insures those benefits and continues to provide the same level of payment throughout the participant's lifetime. That could also be a J&S arrangement, as well. Most annuity contracts are issued by insurance companies, although other companies are now marketing insurance contracts.

From the Floor: Why would I use a group annuity as opposed to individual annuities?

Mr. Carlevato: A group annuity contract has benefits both to the plan and to the insurance company. It enables them to issue certificates, as opposed to individual contracts to each of the people participating in the 403(b) plan. If individual annuities are used, a contract has to be issued to each participant in each individual annuity account. In a group annuity contract, one group annuity contract is issued to the plan sponsor and the individuals are issued certificates.

From the Floor: Do you tend to get better rates on the group annuities because there are less contracts issued?

Mr. Carlevato: No. At Metropolitan Life, we do not have a different rate structure based on the group or individual annuity contract, but the group approach does enable the employer to get consolidated reports. So there are some advantages, especially to the insurance company, with group annuity contracts.

Let's discuss custodial accounts under 403(b)(7). Prior to 1974 when ERISA was enacted, annuities were the only way to fund 403(b) plans. With the advent of ERISA, 403(b)(7) was introduced, which allowed mutual fund shares or unit investment trusts to be offered through the bank custodian or nonbank custodian. This requires that if mutual fund shares are to be used, a custodial account must be established, and the custodial account can be established with the bank or nonbank custodian. The important thing is that the custodian must be a person who demonstrates, to the satisfaction of the IRS, that the manner in which he will handle the assets will be consistent with the requirements of the code. The key here is to find a single custodian capable of handling multiple products and vendors to minimize administrative complexity as Peter pointed out earlier. If you have a different custodian for each funding organization that you have in your plan, there's an issue of whether they will be communicating with each other about MEA limitations, loans, and other things. If you have a single custodian to handle all of the funding vehicles that you're offering, it can help to minimize those complexities.

Mr. Gold: Think of it as a 401(k) plan. You wouldn't have separate trustees for each investment option of the 401(k) plan. There is no reason you should have separate custodians or separate insurance companies for every investment option under the 403(b) plan. You'll drive yourself nuts.

Mr. Carlevato: To be accepted as an investment vehicle for a 403(b)(7) plan, mutual fund shares must be issued through a regulated investment company as defined in Code Section 851A. These companies must be registered with the SEC, under the Investment Act of 1940, as either a management company or unit investment trust. Are there any questions on the annuity or mutual funds side? One of the issues is that 403(b)(7) and 401(a) contracts have different withdrawal restrictions. The availability of funds prior to age 59½ is different for annuity contracts than for custodial accounts. One special feature of this regulation is that once money is placed into a 403(b)(7), contract, it has to retain that identity even if it's transferred at a later date into an annuity contract. What you have is administrators who may not know where this money is coming from, and therefore, are unable to identify that money as 403(b)(7) and as a result allowing distributions prior to age 59½ that probably shouldn't have occurred. So it's important that the identity of 403(b)(7) money continue to be retained even if it's placed into an annuity contract at a later date.

Loans are another issue. Loans are covered under 72P, as introduced by TEFRA in 1982 and these rules are generally the same as qualified plans in that there's a $50,000 cap. Peter pointed out one of the issues before. If you have different custodial accounts and somebody has a large balance, they could be taking $50,000 or a combination that results in exceeding the $50,000 from several different contracts and nobody knows about it. Some insurance companies transfer assets to the fixed account; Metropolitan Life is one of them. We issue all of our loans out of the fixed account, so, there can't be any issue with results of the collateral on the loan.

Let's discuss collateralizing the loan. In a 403(b)(7) account we have run into some mutual fund companies that are just not issuing loans out of the contract because the value of the contract would fall below the 50% level and that could be an issue under 72P. These limits have to be monitored carefully so that there is not a compliance issue, especially in an ERISA environment. Another distinguishing fact is that 403(b)(7) accounts are subject to a 6% excise tax under Code Section 49-73 if you exceed the MEA calculation, or you exceed contribution limitations. The 403(b)(1) plans or annuity contracts are not subject to this 6% excise tax. Are there any questions on annuities or mutual funds on 403(b)?

From the Floor: Why aren't plans designed so that you just have the choice of buying an annuity or not buying an annuity?

Mr. Gold: Historically, it always had to be funded through an annuity contract. It's just historic.

Mr. Carlevato: That's a good point because the distribution strategies with the advent of 403(b)(7) are changing as we speak. Insurance companies in the past have always marketed 403(b) contracts like life insurance. Metropolitan Life is one of those. We send people out to campuses of colleges, universities, school districts, and hospitals. They actually sit on site and visit people and enroll them in individual or certificate 403(b) contracts. Mutual fund companies are coming into the market, and they're distributing products in a much different manner. They are relying on name recognition and direct mail campaigns. We're also putting, as are other companies, kiosks at these organizations and on the campuses so they can actually go to a machine and sign up for these contracts. The whole marketplace is changing as far as distribution, but I believe that a lot of companies are still relying on the annuity contracts, because that's what they are comfortable with. They have that hands-on distribution that has always been there and they're slow to move over. But the mutual fund companies are definitely changing the distribution strategy in the 403(b) market.

Mr. Gold: A related question is why do 403(b) plans exist at all? Why don't we just allow not-for-profits to have 401(k) plans and do away with 403(b) plans? That would make the most sense. I don't think that's ever going to happen, due to the lobbying strength of some of the 403(b) providers who don't want to face the competition of the mutual funds in their areas. It certainly should happen.

Mr. Carlevato: You will run into nonprofits that have 401 plans because, in the past they were allowed to have 401(k) and profit-sharing plans. Money purchase plans are still being issued to nonprofit organizations. Many school districts have money-purchase plans supplementing their 403(b) programs. That brings in a whole other degree of complexities as far as MEA calculations, 415 and other things we can touch on a little bit later.

What's going on with these things in the real world? The IRS is auditing them like crazy. There is a series of quotes from various IRS officials starting from 1994 through October 31, 1995. Basically the IRS has been auditing 403(b) plans, and they still had this elevated enforcement program about a year-and-a-half ago. They have just brought a whole bunch of agents into Washington to be trained in 403(b) audit techniques. They sent them back out into the field to do two things: (1) to audit 403(b) plans, and (2) to train other agents to audit 403(b) plans.
There will be stepped-up auditing of 403(b) plans. The IRS has made it quite clear that every subsequent audit of a not-for-profit organization will include an audit of its 403(b) plans. Under guidelines, the IRS has said that in proposed form they will not finalize those audit guidelines until they are significantly used in the field. The only way to get that is to actually go out and audit, so that's the case. They are going to audit because they want experience to finalize those guidelines. This is something that is getting a much higher profile than it ever has in the past. It was even mentioned in *The New York Times*, and for it to make *The New York Times*, you know it is a real issue.

What's the response to the problems the IRS is finding? What have they been saying you should do? They've been talking a great deal to try to educate both the employers and the employees because the burden of noncompliance basically falls upon the employees, not the employer. A penalty for noncompliance of course, is all the amounts we thought were tax deferred and all the earnings on those amounts are really taxable income for you as far back as the statute of limitations is open. The IRS has a funny view of the statute of limitations.

In the qualified plan area, which extends to the 403(b) plan area, once there is a defect, it takes the plan forever and the years are never closed, at least as far as the plan is concerned. So there's some education going on. They've issued the audit guidelines and have begun to audit the plans seriously. Most importantly they thought that the Tax-Sheltered Voluntary Compliance Annuity Program (TVA) would allow you to go in and look at your plans, look at your client's plans, and find out what was wrong and take steps to correct it. You would go to the IRS and say, "We've sinned, we're guilty; before you come and audit us and throw the roof down on us, let's negotiate a deal." The deals that they are negotiating are, so far, pretty lenient. They've closed out three cases and we'll get to those later.

Why do we care? We care because they'll audit us. If I'm going to be audited, I want to pass the audit. To the extent you're an ERISA plan, you might have a fiduciary duty to operate the plan correctly. Plans have to be operated in accordance with their terms under ERISA to the extent my plan has the correct terms in it, such as MEA limits and 402(g) limits, and if I'm not a plan in accordance with its terms, I must have a fiduciary liability issue. The same issue may arise under non-ERISA plans since state law is not pre-empted. If the non-ERISA plan state law is not pre-empted, they can possibly sue me for breach of contract or breach of duty under state law, if I operate the plan indirectly. What's most important is my clients are going to be very unhappy if they find out we have these back taxes and have to redo their tax returns for all those back years. They would be unhappy with me. A doctor might say to me, "It's the employer's responsibility to do this. I'm just an employee, what do I know? I assumed you were taking care of it. What's MEA? I'm just a doctor. I know heart surgery, I don't know MEA from a hole in the wall." If you're going to get the blame, you might as well take the responsibility and do things correctly. Give yourself a pat on the back and take some credit. Put out some nice employee communication about this great thing we're doing.

Finally, there's a potential liability to the employer as well in two areas. One is for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes on employer match contributions which turn out to be made to a non-403(b) plan. If it were made to a non-403(b) plan, it would be subject to FICA and FUTA and you will not have withheld upon it because you thought it was being made into a 403(b) plan, and they weren't subject to FICA and FUTA. There's a failure to withhold income tax at the source. Say an employee puts his money into a 403(b) plan and you haven't withheld on it. Since it is not a 403(b) plan you should have withheld on it, so you're liable for failure to withhold and the interest in penalties for failure to withhold at the source. And that can add up to a surprisingly large amount. The University of Minnesota was subject to an audit, and I think that their liability was somewhere around $60 million. Duke University came in somewhere around $30 million. Of course, these are big organizations. The reason the University of Minnesota's plan was disqualified was because they had all these residents and interns running around. They said they were not employees, but independent contractors. The IRS said they were employees and the university didn't allow them to contribute; therefore, the plan is discriminatory and it's disqualified. One suspects that those cases will be settled for significantly less than those amounts. But they did not use TVC, and were audited. So bear that in mind.

Proposed audit guidelines were in Announcement 95-33 which came out May 1995. They cover a great many points and are perhaps one of the better sources to find out what a 403(b) is and how it operates. The rules are so poorly written elsewhere. The audit guidelines are a great help in understanding the rules. They provide specific steps the agent should take to audit the plan, give a list of the materials we should look at, talk about the tax consequences and failing.

There are basically three types of tax consequences. One disqualifies the entire 403(b) program, and remember this is on a controlled group basis, so if you have one individual in one of your operations who makes a minor slip and puts more than $9,500 in, everybody's 403(b) contributions in the entire organization are going to be affected, if it's not corrected. So you're going to get many angry employees who will say, "I didn't put in more than $9,500, why am I being penalized?"

Then there are defects that affect only individuals, and those defects can be broken down into two further types: those that affect the entire account balance and those that affect only the amount of the mistake. The audit guidelines don't cover every possible issue. Frankly, I don't think the IRS could think of every possible issue.

There are some comments that came out from the American Council of Life Insurance (ACLI) and from some of the actuarial organizations on the audit guidelines which point out some of their problems. It's very interesting reading. They are not going to make any changes in them until they get audit experience. We're stuck with them for the time being.

There are three types of defects. One is those that cause the entire plan to lose it's tax-favored status. Obviously an employer is not eligible to make a 403(b) plan if he's not a public educational institution, is not a 501(c)(3), the whole plan is taxable if the plan's not funded. What does it mean not to fund a 403(b) plan? What some people do is take the money out of the employee's pay, and instead of sending it over to the insurance company or the custodian of the mutual funds, they just put it in the bank account. When the guy actually retires, they go to take the money out of the bank account, with interest, and go out and buy the annuity at that time. That's a no, no. The money hasn't been put into an insurance contract or a custodial contract since the guy has been working. So the entire plan is deferred.

Another defect that caused the entire plan to lose tax-favored status is uncorrected excess deferrals over the $9,500 limit. If you don't correct them, the entire plan is disqualified. Discriminatory contributions, minimum participation rules, and inadequate coverage are other defects that cause the plan to lose its tax-favored status.

The second type of defect is that which affect only a portion of the employee's account, such as contributions over the MEA limit or excess 415 contributions; only those portions that exceed these limits are taxable to the employee. The treatment for an improper loan under 403(b) is the same as it would be under a 401(k) plan—it's a deemed distribution if it's not paid back properly or if it's too large initially. Other examples are incidental violations of the minimum distribution rules (which is a 70½ rule) and taking more than one election per year. If you make two elections, the second election doesn't count, and anything over the amount that's taken out of your pay because of that second election is going to be deemed taxable to you. The third defect is that which affect the employee's entire account.

Now we look at the situation where pay is earned when the services are performed, which gives rise to the pay. I earned the sick leave over the past 15 years and I'm making the election, but I can't apply the accumulated sick leave. The same applies to accumulated vacation. Severance pay is another possible problem area. There are also window plans. Teachers are becoming increasingly subject to window plans, especially in my school district. You have to be very careful how the window is structured, and how it's applied through the 403(b) plan. If you're giving them the window, additional benefits because of prior service, we're going to give you an extra 2% in pay for each year of service, that's prior to the election and it's no good, unless the teacher's election has been in effect for a long period of time. If it's a flat-dollar amount, we're going to give you an extra $1,500 or $5,000 to leave, whatever it is. Then it will be covered by the 403(b) election. Facts and circumstances have to be looked at very carefully.

From the Floor: I'd like to ask about more than one deferral election for a year. What if that deferral election is to reduce a referral?

Mr. Carlevato: It's still a change.

From the Floor: It's still a change, but what will the IRS want you to do to correct that? Will the employee have to come up with additional cash to deposit?

Mr. Carlevato: They will say that any amounts taken out because of a second deferral election, even if it's less than the amounts taken out because of the first one, would be taxable to you. It's the whole thing, it's not the incremental amount. You can cancel it at any given time, which raises other problems. If you cancel it, you can't re-elect in the same year. Also, if you made a deferral election in January of one year to withhold 8% of your pay, and you terminate employment in February and you're rehired in March, you can't make another deferral election, because it would be done within the same year. It often happens with teachers. Their school year is not the same as their tax year. A teacher misses a deferral election in January, quits and then gets rehired again as a substitute teacher the following September. He or she can't make another deferral election because he or she has already made one in the same taxable year. It's a real problem.

There are other defects that affect the employers' entire account. There are inadequate deferral elections and impermissible investments. Say you don't put the money into an annuity contract or into a custodial account, and you put it into something else. You violate the incidental death benefit rule on life insurance in the TSA. You can buy life insurance on an ineligible employee. What's an ineligible employee? Basically it's an employee who's not employed by a company allowed to have the 501(c)(3), for example, like an independent contractor. He or she comes in, working for the school on an independent contract basis, but he or she is not covered. The head of the Board of Education is probably not covered, although the Superintendent of Schools would be. The head of a school board, because he's an elected official, would not be covered.

Mr. Gold: Hospitals with for-profit create all kinds of other problems, because a for-profit hospital will certainly have a 401(k) plan, and you will almost certainly transfer people back and forth, at one point or another, between the for-profit and the not-for-profit piece of the hospital. You have to be very careful when you do your limits that you look at both pieces of the pie—the 401(k) piece of the transferred guy and the 403(b) piece of the transferred guy. As Paul will point out, the 401(k) piece will affect your MEA election, and it will affect the $9,500 limit on the deferrals because you aggregate them. Transfers can create a problem in cases like that. Even transfers in from the outside can be a problem.

There can be no direct rollovers under the Unemployment Compensation Amendments (UCA) Act of 1992; 403(b) plans were subject to the same direct transfer rules as the qualified plan, and the language has to be in the annuity contract. If you have individual annuity contracts with an insurance company with each of your employees, each of those individual contracts has to be amended to put it in. In other words, if you have a group contract, you only have to amend it once. The insurance company will almost certainly do it for you, but you have to check to make sure it's done and make sure it was sent out. Hopefully they won't slip, or be late, or be sloppy, but it happens.

One or two violations of the minimum distribution rules are fine, but if I'm sending half and I consistently don't take my money out, then it will disqualify my entire account.

So what is the IRS going to look at when it comes in and audits your plan? Basically, anything they can think of. They'll ask for a copy of the plan document, which you may or may not have, because if it's an individual arrangement, you may not have a plan document. They will ask for anything else that would make up a plan document like copies of the information describing the plans given to the employees. They will want copies of insurance contracts, all the insurance certificates, any grievances between you and the custodial agent, the mutual fund agreement, a list of all the funds that are there or that are available, and a list of the people that are participating in them. They will ask for copies of any correspondence between the insurance company, the TPA, the custodial account employees, and any reports you get back. They especially like payroll procedure manuals so they can see if you're doing the withholding correctly and violating the $9,200 limit or the 415 limit as well as FICA procedure manuals (to see if you are withholding FICA properly) and internal audit reports.

If you're not going to use TVC, don't do an internal audit. If they come to you, they'll ask for it. You might be giving them a road map. The alternative is, if you are going to do an audit of your plan, use an outside counsel, even if he doesn't do the audit. Even if you're going to hire a consulting firm or somebody else to do the audit, have the attorney hire the consulting firm to do the audit, and that way it will be the attorney's work product. It will be privileged and the IRS won't be able to get it. That's not to say you can't know what's going on, but just be careful. If you're going to do an audit, you really have to be prepared to correct the defect defined in the audit. If you do the audit and don't correct the defects, and you are eventually audited, you can't plead ignorance anymore. Now it's willful because you did the audit, and you continued the defect. Penalties for willful noncompliance are much harder than penalties for inadvertent noncompliance. If you're going to do an audit, make sure you're going to at least take steps to correct going forward even if you don't use TVC. Again, they are going to ask for records showing how the reduction amounts are handled, for FICA and FUTA records, and for a list of all the participants who were currently employees. They will also ask for employees that were not participants, and an explanation of why they were not participants. They will want to see if they're subject to one of these exclusions when not participating, or if they just didn't know about it, or knew about it but didn't want to participate, which is OK.

How do you do your MEA tests? Most people do their MEA test at the beginning of the year on a projected basis, which is fine if nothing is different from your projections, but that's probably not going to be the case. They need copies of 1099s to see that all taxes are properly recorded and paid. They also need a list of loans and calculations that prove compliance with the 401. They also need copies of your procedures and in-service distributions and copies of Form 5500s if you've filed them. They need all the normal stuff that you can think of.

From the Floor: If you have a plan that's strictly an employee contributions type plan, are you subject to discrimination testing?

Mr. Gold: You are not subject to the 401 discrimination testing. There are separate discrimination tests for the employee contribution; you have to allow every employee to contribute.

From the Floor: When employers consider matches, why don't they just consider salary adjustments and let the employee defer more or less?

Mr. Carlevato: It's not that hard to pass 401 impasse.

From the Floor: Then why bother?

Mr. Carlevato: Employees talk on the assembly line, in the classroom, or in the cafeteria. They don't understand why someone gets a pay raise. But they can understand matches. If someone doesn't get a match, it's because he or she didn't contribute, and that's understandable.

Mr. Gold: There are also many unions involved in many school districts, and they are negotiating their benefits. They want their plans to look like the private sector plans, so they're negotiating these benefits in many cases.

Mr. Carlevato: It's a little hard for a union to negotiate different salary levels for different employees. There are possibilities—you could do something for nurses but not for physicians, or something like that. There are approaches you could take. Hospitals are complex, too. You have a nonprofit and a for-profit section. Once again, people in nonprofit hospitals see that the for-profit hospitals have a 401(k) and the match and they want the same. The perception by the participant is that if he or she gets a salary increase, it's still not the same as what is being done at the for-profit hospital.

Mr. Gold: I guess I have what's called a bias. That is, there are well-established systems out there that are administering 401(k) plans that have all the appropriate checks and balances in them. If I can piggyback on those systems for my 403(b) plans, why don't I? The software is out there to test 401(m); it's simple. People do it every day for 401(k), and if I can piggyback on an existing administrative system, why involve something totally new unless there is a good reason or there are plan design reasons for doing that? I don't think avoiding testing is a reason. If I needed to do the salary adjustments for some other reason, that's fine, but I wouldn't do that just to avoid the testing.

Mr. Carlevato: That brings up a good point about the audit guidelines. What we've seen in the market at Metropolitan Life is that many of these sponsors are relying on the statements that are produced by the product system, the annuity or the mutual fund system to provide their recordkeeping. We feel that there needs to be more than that. A product system is just issuing annuity contracts. The employer is sending in a lump sum of money and not distinguishing between employer, employee, rollover, 403(b)(7) or 403(b)(1). It might be also that the employer or the sponsor splits the money out by source of money, but the insurance company's contract recordkeeping system does not have the capability to identify different sources of money under the contract reporting. We are really seeing the need for different systems as in a 401(k). If you have a 401(k) with a mutual fund contract in it, you almost always will hire that company, another third party vendor, or a consulting firm to do the wrap-around recordkeeping. You don't rely strictly on the product statement.

The same thing is true in the 403(b) market. Unfortunately, I don't think people are recognizing the need for that account, as they add these more complex features. They are relying on these product statements, and they're just not going to do it for them. That's creating some of these issues. The IRS doesn't have to look hard to find a problem with a 403(b) plan. At this time they're looking at MEAs and very easy things to find, but I would presume that after this initial go around they are going to start looking for more revenue, they're going to start getting into more detail and that's probably going to be attracting the sources of funds.

Mr. Gold: Let's focus on six issues: (1) satisfying nondiscrimination rules, (2) exceeding the limits of lawful contributions, (3) noncompliance with restrictions and distributions, (4) noncompliance with the required beginning dates of contributions, (5) inadequate reduction agreements, and (6) failure to file a full Form 5500. There's one more issue that's starting this year: company matching contributions are subject to a $100,000 limit on compensation. That gets factored into employer-matching contributions. That's something else they will be looking at. We can go through most of these things one by one.

The daily assessment and nondiscrimination rules. There are different rules for pretax elective defaults, nonelective defaults, matching contributions, and after-tax contributions. In fact, you can have a 403(b) with after-tax contributions on it. They are rare, but they do exist. In a nonelective default, contributions are made by the employer on a nonmatch lump-sum basis.

Prior to this year you could rely on reasonable good-faith interpretations of the IRS safe harbors. They've extended the reliance to 1997 on the good-faith rules for which they haven't issued the appropriate regulations. What are those rules? On the pretax elected defaults, all employees must be able to make elected defaults, but there are certain exceptions. If you normally work less than 20 hours per week, and if you are covered under another 401(k) plan, you could be grandfathered under a Section 457 plan or another 403(b) plan; if you're a union employee, then you're excluded. You can't exclude people from salary reduction contributions because of age and service. People do, but it's not permissible. You can exclude the employer matching contributions, but not the elected employer contributions for age and service. You cannot exclude them from salary reduction contributions because of age and service.

What does it mean to be regularly scheduled to work 20 hours a week? I might work 21 hours in some weeks but not in others because the employer has more of a need for me. Have I blown it? The IRS has indicated, yes. The safest thing to do is let all employees make a pretax salary deduction contribution. You don't have to match them, you can keep them out if they don't have a year of service or if they don't meet some other rule, but at least you won't have messed up on the nondiscrimination for the pretax contributions. It doesn't cost you anything really, because it's their own money. That's something to bear in mind. Also, if you let any employee working less than 20 hours per week default, you must let all employees working 20 hours a week or less default. For example, you may have, in a hospital situation, nurses who work less than 20 hours per week, but since they're nurses they are going to be in the 403(b) plan and they can defer. However, you may have custodial employees or attendants or transportation people who wheel you around the hospitals on the gurneys, who work less than 20 hours per week who you don't let defer. If you let anybody who makes less than 20 hours per week defer you have to let them all defer. Hospitals are very difficult because they have all these different crews of people that they treat differently. It falls under what kind of revocable electives are not subject to these rules. I've never seen one. Basically, before you were first eligible to participate in a plan you were allowed to make a one time irrevocable election for the rest of your working career with this particular employer for a set amount. If you do that for the rest of your working career with that employer, he will take out that amount of your pay, and that is not an election under a 403(b) plan for pretax deferrals. I've never seen it done.

Independent contractors can be another problem. When you exclude employees because they are independent contractors, make sure they are, in fact, independent contractors. I know it's hard to determine what is and is not an independent contractor, but you don't want to be in the University of Minnesota position and exclude people who you think are independent contractors and find out that they are not. They are making this a little bit easier. They are working on a new set of rules for employee classification to replace the 20-step test that they used to have, so that will make your life a little easier.

Nonelective deferrals, matching and after-tax contributions. What rules are they subject to? They are basically subject to the same rules as qualified plans are—401(a)(4) on compensation—and if you have employer matching contributions you better cover at least 50 employees or 40% of your work force. The 410(b) coverage rules can't discriminate in coverage. A matching contribution is subject to 401(m) average contribution percentage (ACP) tests that you used in the 401(k) plan. You are all familiar with what they are. Again, prior to 1997 you can comply with these rules on a good-faith basis or with the safe harbors. There are three alternative safe harbors for the nonmatching contributions that are a nonsalary default elective.

Good faith really means having a logical explanation for what you're doing. These things were in existence before the 401(a)(4) general test came out. I don't think you have to go through the general test. I suppose you could, but it's a lot of work, especially if you don't pass the average benefits test. It's easier to use the safe harbors than to go through the general test. Good faith means to have a reasonable motive for what you are doing based on a legislative history of what's in there. If you think it's reasonable and you can support it by something that's in the legislative history, you'll be fine. The IRS is not going to focus much on this at this time. They realize there's no real guidance. The IRS or the guidelines made that quite clear. They said they have good-faith compliance. We're not going to let it slide, but unless it's egregious we're not going to jump on it either. You really have to be discriminating, perhaps saying none of your nonhighly compensated employees can ever participate; only highly compensated employees can participate. The safe harbors that are set out in the IRS announcement are all relatively similar.

I'll go through the maximum permitted disparity safe harbor. Basically under the maximum permitted disparity safe harbor the highest percentage of compensation deferred for the highest compensated employees cannot be more than 180% of the lowest percentage of compensation deferred from the nonhighly compensated employees. And at least 70% of all nonhighly compensated employees must accrue a benefit of the plan, and at least half of the nonhighly compensated employees must be accruing benefits. For the lesser permitted disparity they just change the percentages from 180% to 140% and from 50% to 30% and from 70% to 50%. The same applies to no permitted disparities; they just change the percentages. I've never seen 403(b)s integrated with Social Security.

Mr. Carlevato: I've seen money purchase plans at nonprofits integrated but not 403(b) plans.

Mr. Gold: What you tend to see in 403(b) plans is solid reduction contributions and employer matching contributions; that's pretty much it. You wouldn't integrate the employer match. Occasionally you will see other employer contributions that I guess you could integrate, but it can't be very common. I suspect you could cross test it.

Mr. Carlevato: What you might have are different levels of match. Someone deferring a certain percentage would have a higher match, in a tiered matching structure, but you'd have to get into cross-testing on it.

Mr. Gold: Well the tiered matching structure also sets up a problem with the benefits rights and features. Each different benefit level is a different benefit level future and you have to test to make sure each benefit level future was not discriminatory. You can probably do what you want. I'm not sure, unless it's really important. There are probably other ways to get there, other than using 403(b). Set up a 457 and give them cash or something.

From the Floor: Do any of these 403(b) plans offset anything?

Mr. Gold: With the default benefit plan? I guess you could. I've never seen it, but I guess you could. Paul, have you seen that?

Mr. Carlevato: I know they're out there. I've never worked with one but I know that they are being issued. They are coordinating 403(b) plans with defined-benefit plans.

From the Floor: Why would you possibly want to do that?

Mr. Gold: In this case, we're talking about an employer contribution. You have a nonmatching employer contribution. You wouldn't do that offset on the employee salary defaults; that wouldn't make sense. The employee just wouldn't defer anything. You'd have to pick it up on the defined-benefit side.

Mr. Carlevato: We're going to get into the MEA calculation now. Maybe after we're done, you'll realize why many participants in these plans refer to MEA as "maximum exclusion agony." I'm going to give you a little bit of history on this. I attended a conference in 1995 that identified five areas of concern. Three of them dealt with MEA-type taxation: 415, 402(g) and MEA errors, and 403(b) plans. It's certainly an area where the IRS is going to place some scrutiny in any audit of any 403(b) plan. They are most definitely going to look at these areas.

In 1958 403(b)(2) set annual limits on the amount that can be excluded from income, also known as the maximum exclusion allowance. In 1974, ERISA was enacted and imposed additional limits under 415(c), and in 1986, a third set of limits governing elected deferrals also called salary reduction contributions, or the 402(g) limit was added. So there has been significant evolution in this area with the IRS regulations. Let's take a look at a simple MEA calculation. This is extremely simple. One thing about the MEA is that it's verbally addressed in the regulations, and it's much easier to look at it as a mathematical scenario. Somebody who is not an actuary or not in the business, who reads this material is not going to have a clear understanding of how the calculation needs to be performed.

Basically, there are several components that need to be considered. Among them are compensation, contributions for the year, and prior years' contributions and years of service.

In the first step, under the maximum exclusion allowance, you are determining the includable compensation and subtracting from that the contribution for the year, and then multiplying the includable compensation by 20%. Then you multiply the step two result times the year of service. You subtract five years of contribution, so you can see what the MEA limit would be. Then you have a 415 limit, which is definitely 25% of includable compensation, or a $30,000 maximum. You have the 402(g) limit, which is probably the simplest and that is $9,500 currently.

This calculation becomes much more complex as the years go on, and if you're including employer contributions, it is especially complex if there is a vesting schedule involved. We'll touch on that after we go through all the calculations when we discuss these issues. The next one is 402(g), which is basically $9,500. The 415 is the more complex of the calculations. Peter you can jump in at any time on this.

Mr. Gold: There is a catch up for 415. You have to be aware of that. For certain employees who have 15 years of service or more, there is a catch that is the least of three alternative limits; $3,000, $15,000 less catch-up contributions, or $5,000 times years of service less previous contributions. That's available to anybody at an educational institution, a hospital, or health organization. Most other 501(c)(3) plans are not eligible for that, so the 402(g) limits can get into problems. You have to keep records for that, too, because they can eat up this catch up over a series of years.

The 415 limits are relatively simple. You have your standard 25% of pay or $30,000. However, as I mentioned earlier, there are three alternative 415 limits that you can elect inadvertently. Since there is not even a check box on your form, they are irrevocable, and they follow you for life. They are complicated, and that's all I'm going to say about them. They are also limited, by the way, to the same people who can get the 402(g) catch-up elections, except you don't need the 15 years of service.

Mr. Carlevato: The 415 alternatives are known as alternatives A, B, and C. Just to give you a feel for when each one of these would be elected, Alternative A is generally used for terminated employees, that would probably permit the greatest tax-deferred annuity compensations, although it is available only if no other alternative was previously selected. Once again, that could be by default. Alternative B sets three limits, the least of which is the maximum that can be put into a tax-deferred annuity. One limit is the maximum salary reduction under 403(b). If the individual has a number of years of service and has not made extensive use of 403(b) contributions in the past, then this would probably be a good election to take. Alternative C may provide the largest tax-deferred contribution possibilities for people who have many years of service and have made the maximum contributions to a 403(b) plan in the past. This just gives you a little idea of when these alternatives may be used. There is also the 15-year catch-up.

From the Floor: When someone first begins the 403(b) plan, do they make an election?

Mr. Gold: No, they don't make it when they first get into the plan. They make the election when they first need to use it to avoid violating a limit. You may never make it, but if you have excluded amounts from you, and if you have contributed amounts to the 403(b) plan that would exceed the standard 415 limit of 25% of pay or $30,000, but it would not exceed one of the A, B, or C elections; you are deemed to have made the A, B, or C election such that you don't violate the limit.

From the Floor: Is the $9,500 the pretax elected deferral? Twenty-five percent of $30,000 includes the employer's contributions?

Mr. Gold: Yes.

From the Floor: Is that true if there are no employer contributions included in the catch up?

Mr. Carlevato: Yes.

Mr. Gold: Or the MEA could be less than $9,500, so there is really three different aspects to the MEA and this is just one of the issues we are going to talk about at the end of your presentation. These are really all interrelated and that's a good question because that's the confusion that school teachers and other people who happen to do these calculations face. I mean, they're not in the business and here you have three different limits, one of them has three different alternatives, and all of them are very complex formulas. If anybody is interested, I do have an article from an American Society of Chartered Life Underwriters (ASCLU) publication, that was written by an actuary, that goes through some of these calculations in detail. And there are several pages of detailed analysis of these calculations. If you put this in front of somebody that's just trying to figure out how much they can put in their 403(b) plan, it's extremely confusing.

Mr. Carlevato: Do you want to know if the amount you can put in, a salary-reduction-only 403(b) plan, is the lesser of the MEA calculation or $9,500? It's a lesser of those two. If you have employee contributions, it's the lesser of the three. It's the lesser of the MEA or the 415, but no more than $9,500 plus the catch up can be on a pretax basis.

From the Floor: What about a scheme where a plan sponsor wants to contribute?

Mr. Gold: Section 403(b) monies can only be coming in with other 403(b) monies or an IRA. You can't cross between 403(b)s and 401(a)s.

Mr. Carlevato: If the money is moving from a 403(b) plan that has already been contributed to another contract, that's not included in the MEA calculations. Those were included in previous years when they were actually made for that contract.

Mr. Gold: I look at this differently than Paul does. I think the MEA formula is exceedingly simple. It's 25% of pay times the use of service minus the prior years excludable amount. Anybody can do that, even my third grader. The problem lies in finding what all those terms mean. The only one that's clear is the 25%.

Mr. Carlevato: One of the issues in this is, how do you determine what the years of service are? How do you determine what includable compensation is? If it's an ERISA plan, these things could be defined in the plan, and what the plan says it is may be different than what the employee thinks it is. For example, includable compensation or it could be certain forms of compensation. At Metropolitan Life, 403(b) marketing people have a computer program that allows them, when signing somebody up in an annuity contract or mutual fund, to actually do an MEA calculation for them. It's based on the information that the employee gives to the representative. So we will guarantee that calculation only if the information that we got was correct.

Mr. Gold: This is another reason why you need to take some control over your data. Again, it's 20% of includable compensation. What is includable compensation? Includable compensation is basically 415 compensation, taxable earnings. So includable compensation does not include amounts in the spending account, and it does not include amounts we have not yet performed services for because includable compensation is just compensation for the most recent one-year period of service. So if I've accumulated sick pay in the year, that's not includable compensation for that year. Problems come up when somebody does an MEA calculation based upon a person's rate of pay. His rate of pay is not his includable compensation because his rate of pay has to be reduced by the amount he contributes to the 403(b) plan, which is not taxable pay. He has to be reduced by his flexible spending account (FSA) contribution. If, through the course of the year, the employee makes his one change per year in his salary reduction, that's going to change his includable compensation rate. It will increase it or reduce it, depending on which way he changes his election. Maybe he has a change in family status and changes his pay election. He has a child, and now puts $5,000 in the dependant care spending account. That's going to change his includable compensation. That all has to be taken into account.

What's a year of service? Everybody has at least one year of service, even on a person's first day of employment. Basically, a year of service is defined in the regulations as the period of time an employee in a similar position works in a year. That's not real clear and the only way to clarify it is by example. Take a doctor at a hospital. A typical doctor in a hospital will work 30 hours a week, 48 weeks a year. Now if he or she works 30 hours a week, 48 weeks in a year, that's a year of service. You have another doctor who is also working in the hospital, who is only part time. He or she is working 30 hours a week, but he or she only works 24 weeks out of the year. He or she has half a year of service in the same calendar year. He or she has to work two full calendar years to have one full year of service. What is the includable pay? His or her includable pay is his pay for the most recent one year of service. The includable pay would be his pay for two calendar years added together. Who's going to know this? Nobody. You must sit down, set up systems, and attract this data so that when you do MEA calculations, the data will be correct, because the typical TPA is just going to work off what the employee tells him, and he's going to work off what you feed him in terms of data.

From the Floor: Where is the IRS going to be coming down on the penalties? They are not going to find very much from the employees.

Mr. Gold: That's right, that's why they came up with TVC. The problem with doing it incorrectly is, who pays? The employee pays. The nice thing about TVC is it shifts the burden to the employer. There, of course, are the deep pockets. That's why the IRS loves the TVC. We'll get to that later.

Mr. Carlevato: It lets the people go to the IRS rather than having the IRS having to find them.

Mr. Gold: If you go to TVC and correct all these defects and promise to sin no more going forward, the IRS will excuse the employees from the back taxes. They'll hit the employer with some penalty in the TVC. And it's a way to clean it up, but you must do it correct going forward. It's not impossible, but it's difficult.

From the Floor: You expressed a preference for imposing some sort of uniform, simplified limits on the elective term.

Mr. Gold: I think simplified limits are great.

From the Floor: I have a couple of things included. Do you have any survey data showing how many employers have actually done this?

Mr. Gold: Probably none. We haven't asked that question specifically in our survey, but my guess is that probably none have done it because probably no employers, or very few employers, have sat down and actually written plan documents. They actually take what's given to them by the insurance companies and the TPAs and they have all these alternatives. So nobody has actually sat down, with the exception of one of my clients, for whom we did a plan document. It's a hospital out in Oklahoma that has actually said we're not going to be bothered with this garbage. We can't track it, we can't administer it, and we don't know what's going on. We're going to make it nice and simple, and that's what they've done. They made it look as much like a 401(k) plan as they possibly can.

From The Floor: Is there any body of survey of data that lead to that?

Mr. Gold: Not that I know of. I don't know of any survey data that speaks to it. Just based upon my experience, I would think it's very rare because people take what they give them in preprinted documents from TPAs and custodial accountants.

Mr. Carlevato: Yes, we do the same thing.

From the Floor: It seems to me that unless an organization adopts the simplified approach that you were just talking about, that the IRS could come in every three to five years and penalize them; they're never going to get it right.

Mr. Gold: That's probably true. It's not that hard to get it right. It sounds worse than it is. You need to have a good data system.

From the Floor: Well, your example is a hospital. Some of these hospitals are just never going to get it.

Mr. Gold: Right. Hospitals are a real tough case because of the years of service.

Mr. Carlevato: Many employers are not even involved. They're just leaving it up to the vendor that is in there; if it's a mutual fund company, an insurance company, or whatever, they are asking that when employees are signed up, they should have an MEA form, and then they can be out of the picture. They don't even know what is going on.

Mr. Gold: It's really hard to come up with a simplified approach for the years of service, though. What are you going to do if everybody has one year of service? Well, that won't work for some people. They'll have less. Do you say everybody has less than one year of service? Most people will have a year of service, so it's going to be hard to come up with some kind of safe harbor rule. Presumably, you would track hours. You have to track their hours for pay purposes somehow. Maybe you can figure out a year of service based upon somebody who makes at least $50,000 per year of service. If someone only earns $25,000, that same person will have half a year of service. You prorate it in some way.

Mr. Carlevato: Or you could use equivalencies or lapse time methods.

Mr. Gold: I think the IRS would let you use anything that is reasonable in tracking this. I don't think they're going to nail you to the wall as long as you come up with a reasonable method of determining a year of service. It also works for part-timers. If a typical nurse in a category of nurses works 20 hours a week, 50 weeks a year, it takes two calendar years for him or her to have a year of service. However you could say he or she has a year of service in one year. What about another nurse in the same position who works 40 hours a week for the same number of weeks? Does he or she have two years of service for the same calendar year? The IRS would probably say no. They will probably say you can't get more than one year of service in a calendar year, but you can look at more than one calendar year to get a year of service. It's not logical because if it can go one way, it should be able to go the other, but the IRS probably wouldn't see that.

The other part of the test that creates difficulties are prior year's excludable amounts. You have to track the prior year's excludable amounts. Again, if you have multiple vendors out there, a vendor doesn't know what somebody else put in somebody else plan in prior years. What does a prior year excludable amount include? It includes pretax elective deferrals and employer contributions, and qualified defined-benefit plan accruals have to be factored in. The plan actuary should be giving your clients, each year, their accruals for their pension plan so they can track the MEA calculations. There's a formula in the regulations for determining what they are. Fortunately I'm not an actuary so I don't have to deal with it. Also included in the prior year excludable amount is Section 457 deferrals, nonqualified retirement plan deferrals, and employer contributions to the prior year in excess of the 415 limits. Even though they were included in the employee's pay because of the excess of the 415 limits, they still count as excludable compensation to the MEA.

You should include vesting with the MEA. A popular trend now, which is something we really wanted to get into, is to have employer matching contributions be subject to a vesting schedule in 403(b). One of the issues there is that the matching contributions, are included in the MEA calculations in that risk. This further complicates the MEA calculation, especially if its a graded vesting schedule. You want to be very conscientious of vesting schedules and plans. As a result, many employers who would have liked to put a vesting schedule in decided not to.

Mr. Gold: There's one more trick with the vesting schedule. The IRS has made it quite clear that amounts come into the MEA calculation when they vest, but they come into the 415 calculation in the limitation year in which they contributed, whether or not they vest. So they're not making life easy for you.

Mr. Carlevato: Another issue is that there are, as Peter pointed out, other regular plans, or 401(a) plans, and the impact of those on 415 calculations have to be considered, as well.

Mr. Gold: Or, if you transfer from hospital A in New York to hospital B in San Francisco, you only get one $9,500 limit per year per employee. I don't care how many employers you work for; you have to aggregate that.

Let's discuss taxing on TVC. The IRS has come up with this procedure to get you off the hook for all these problems that we are now discussing that exist. Basically, what it will let you do is come in and say, "I've sinned, here's how I've sinned, and this is how I propose to correct it." You can pay a sanction to get off. The program is set to expire sometime in October 1996, but they are probably going to extend it. The upside of TVC is that the IRS will not pursue recitation of identified defects. They will not pursue recitation of a plan's exclusion for identified defects, and the employees will not have to amend their prior year's tax returns. The employers will love TVC.

The downside of TVC is the IRS wants you to disclose the defects. If you don't disclose them all, the IRS can come back to you and still get you. One nice thing is the IRS may excuse employees from having to amend their prior year's tax returns. If there is any state tax liability, the states have not signed on to TVC, so they still might have state tax liability if the stuff is really not excludable from their income, and the states piggyback on the federal system somehow. You have to pay a sanction. The sanction is up to 40% of the amount and could apply to the defects.

Believe me, it's much less than it would be if the IRS came in to audit you. There's an initial up-front fee. Not all defects are covered by TVC, but most of the good ones are. It says technically you have to correct them going back to cover former employees, as well. Good luck in finding them.

What do you do if you don't have the data? The IRS realizes you can't get blood from a stone, and it will let you make reasonable projections of past pay, and past contributions, as long as it's reasonable and you can prove to them that it's reasonable.

What's the sanction? Basically, it's going to be up to 40% of the total sanction amount set by the correction fee. The correction fee, which is an up-front fee for going to TVC, is $500 if you have less than 25 employees, and up to $10,000 if you have more than 10,000 employees. It's graduated in between. Basically, the sanction amount is described in here. What has the IRS done with this? They've actually settled three TVC cases recently, and the maximum penalty that they've come up with so far is 20% of the total sanction amount. That's close to 40% of the total sanction amount. In one of the cases, it was 10% of the total sanction amount. What was the correction mechanism they asked for? The correction mechanism was do it right in the future and don't worry about the past. Go ahead and correct, but don't sin anymore. If you fail to file Form 5500s, the DOL has a correction program called the Delinquent Filer Voluntary Compliance Program (DFVC), which offers reduced penalties for filing.

There are two pieces of pending legislation that are important, and two points that are important because they are in several of the bills. One is that they are going to allow 403(b) plans to have more than one election per year. They are going to allow not-for-profits to have 401(k) plans, and they are going to make 457 plans fund their benefits because they are all concerned about Orange County, California. All those people who had 457 plans in Orange County lost their money when the county went bankrupt. They are now going to say you have to fund 457 plans. Will this pass? Funding 457 plans will pass. There is no loss of revenue for the IRS because these are all tax-exempt organizations anyway. I don't know if the rest will pass. I would certainly think that more than one change in a year has a good chance of passing. The IRS has put all regulation projects on hold, except for the 401(m) regulations, pending what happens. If it is corrected by legislation they haven't wasted their time writing regulations.

From the Floor: How about the impact of the written law on plan loans? You may have a number of different loan fees. Some may charge a flat $50 while others charge 3% of the loan.

Mr. Carlevato: Really? I would change carriers; that's exorbitant.

From the Floor: We get down to a substantial, fairly flat percentage fee. My question is, if you see those two different approaches within a plan, is that going to be an ERISA problem?

Mr. Carlevato: No. There's no problem in terms of two different approaches in charging for loan administration as long as the providers talk to each other and not give out more than $50,000. That's where the problem comes in. You can charge however you want. However, I think you would have an employee relations problem in that case. If you have two providers, one of which is charging 3% of the balance on a loan, and the other one is charging $50, and you don't tell the employees, this is an issue and something to be thinking about when you decide where to put your money. You better make sure that the investment return on the contract that is charging 3% of the outstanding loan balance has been superior to the other one for a long enough period to make up that difference in the higher administration fee. I think you have, as plan sponsor or employer, some kind of a duty to try to do something about that.

Mr. Gold: And if that was the situation, I would certainly recommend to the employer that they include language in their loan program indicating that the loan fees will be established based on the contract. Because that would clarify the issue as far as the fact that the loan program includes some note disclosure that there are different loan fees based on the contract situation.

Mr. Carlevato: Yes, that should be disclosed clearly.