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PROFESSIONAL ACTUARIAL SPECIALTY GUIDE

U.S. TAX-SHELTERED ANNUITIES

Overview

Although tax-sheltered annuities (TSAs) had previously been available to employees of certain tax-exempt organizations, Public Law 85-866 added Section 403(b) to the Internal Revenue Code to limit the exclusion from gross income of employees of Internal Revenue Code Section 501(c)(3) employers of the cost to purchase TSAs. The TSA exclusion allowance is $(a \times b - c)$, where a is 20% of compensation includible in gross income, b is years of service, and c is prior contributions. Section 501(c)(3) employers include any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, for testing for public safety, for fostering national or international amateur sports competition, or for the prevention of cruelty to children or animals.

The earnings of Section 501(c)(3) organizations may not inure to the benefit of any private shareholder or individual; Section 501(c)(3) organizations may neither lobby nor participate in political campaigns. As of January 1, 1958, Public Law 87-370 extended coverage to employees of educational institutions (as of January 1, 1976, "educational organizations") under states and political divisions of states.

Not every TSA arrangement is an employee benefit plan under the Employee Retirement Income Security Act (ERISA). ERISA added to 403(b) custodial accounts that are invested in regulated investment company stock (mutual funds). ERISA also included TSA contributions under the limits on contributions and benefits in the new IRC Section 415.

As of January 1, 1978, Public Law 95-600 allowed rollover contributions and transfers between 403(b) annuities and IRAs. Churches that maintained defined-benefit 403(b) plans were allowed to keep them by Public Law 97-248.

The Tax Reform Act of 1986 (TRA 86) included TSA salary deferrals under the new Section 402(g), with a special \$9,500-per-year limit in place of \$7,000. For 1996, the indexed \$7,000 limit is \$9,500; from now on, both limits will increase in \$500 increments. TRA 86 made 403(b) annuities subject to the required minimum distribution rules (age 70½) and the premature distribution rules (before age 59½, death, disability, separation from service, or, for employee deferrals only, hardship). TRA 86 also set nondiscrimination requirements for 403(b) plans.

In Revenue Procedure 95-24, the Internal Revenue Service (IRS) established a voluntary correction program for Section 403(b) plans. The tax-sheltered annuity voluntary correction program combines aspects of both the voluntary compliance resolution (VCR) program and the closing agreement program (CAP) for plans qualified under Section 401(a).

The Small Business Job Protection Act of 1996 extended some 401(k) plan rules to TSAs. Participants now may make more than one salary reduction agreement each year. The salary covered is the same under 401(k). In 1996, the IRS included TSAs in the Administrative Policy Regarding Self-Correction (APRSC), a new voluntary program for operational defects.

The Retirement Systems Professional Education and Development Committee of the Society of Actuaries provides this Specialty Guide for continuing education purposes. It is intended to provide the user with a summary of representative sources of current general knowledge. Neither the Society of Actuaries nor the Committee intends or represents this Specialty Guide to be complete or its use necessarily required or sufficient for meeting continuing education requirements or any other professional competency standards of any organization.

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Role of the Actuary

Consulting actuaries serving 501(c)(3) and public educational organizations must be aware of the uses and potential problems of TSAs as they help plan, develop, and manage employee benefit programs. A TSA arrangement may be an employee benefit plan subject to ERISA. Consulting actuaries help individual taxpayers with planning for and complying with TSAs. For example, actuaries may be called upon to help with the complex calculations needed to estimate the exclusion allowance when the employees participate in other benefit plans. The TSA may be the last of multiple layers of retirement benefits.

Life insurance company actuaries who manage TSA products want to know how the product is used by the consumer. TSAs may be the key component of a life insurance company's annuity business, with ramifications throughout every section of the business: administration, finance, investment, taxation, Securities and Exchange Commission (SEC) compliance, and actuarial reserving. Actuaries develop and manage products, manage investments, plan tax strategies, prepare financial statements, and set reserves for TSAs.

I. Introduction

The Bureau of National Affairs Inc.'s *Tax Management Portfolios* cover tax-sheltered annuities comprehensively. One *Portfolio* is devoted entirely to Section 403(b), and another covers employee benefits for tax-exempt organizations. These loose-leaf *Portfolios* are continuously updated.

Kenty, David E. and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of the use of TSAs to fund pension arrangements for employees of public educational organizations and certain other tax-exempt organizations. The text covers the historical development, eligibility, coverage, and nondiscrimination requirements; contribution limitations; funding vehicles; uses; tax incentives; and distributions.

Appendixes include: Department of Labor (DOL) letters, a sample TSA plan document, and IRS publication 571 "Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations."

Level: Intermediate

Pages: 79

Wolff, Carolyn G. and Schwartz, Daniel J., "Employee Benefits for Tax-Exempt Organizations," *Tax Management Portfolios*, Bureau of National Affairs, 373 T.M.

Wolff and Schwartz comprehensively cover deferred-compensation arrangements for tax-exempt organizations and include plans that use TSAs. The text surveys TSA plans in context with qualified plans, Section 457 plans, individual retirement accounts (IRAs), and simplified employee pensions (SEPs). It covers the types of organizations that may offer TSAs, eligibility, funding vehicles, life insurance, vesting, nondiscrimination requirements, salary reduction procedures, in-service distributions, limits on excludable contributions, income and excise taxes on the employer and employee, Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes, private letter rulings, and ERISA coverage.

Appendixes include the following: Worksheet 1, IRS Notice 89-23, 1989-1 C.B. 654; Worksheet 2, IRS Notice 90-73, 1990-51 IRB 17; worksheets for determining individual limits on tax-deferred contributions to Section 403(b) annuities; and charts of federal income tax rules.

Level: Intermediate

Pages: 86

The *Pension Answer Book Series* covers Section 403(b) in a single volume together with Section 457 and church pension plans. The publisher's "mission is to provide practical, solution-based 'how-to' information to business professionals."

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy provides a practical handbook in question and answer format. The text is organized in chapters dealing with: eligibility, coverage, and nondiscrimination requirements; contribution limitations; investment management; ERISA and distribution requirements; loans; life insurance; plan terminations; qualified domestic relation orders (QDROs); and plan design.

Appendixes include finding lists of Internal Revenue Codes; Treasury regulations; IRS publications, opinions, procedures, and rulings; ERISA sections; DOL Regulations; other statutes; and miscellaneous items.

Level: Basic

A similar guide to TSA program administration is the *Section 403(b) Manual*.

Mortenson, Arvid L. *Section 403(b) Manual*, 9th edition, Chicago, Ill., Dearborn Financial Publishing Inc.: 1994.

Mortenson's *Manual* is a step-by-step guide through the history, law, and practical administration of 403(b) programs, including instruction in the calculation of the basic exclusion allowance and alternative elections. The *Manual* contains sample documents and copies of government forms useful in the establishment and administration of a TSA program. The texts of relevant private letter rulings are presented.

Level: Intermediate

Pages: 420

II. Law and Regulations

The answers to questions about TSAs are found in federal tax law, which is the most active area of federal law, and in federal labor law (ERISA).

The Internal Revenue Code is published as Title 26 of the U.S. Code. Subsection 403(b) is found under Subtitle A—Income Taxes, Chapter I—Normal Taxes and Surtaxes, Subchapter D—Deferred Compensation; Part I—Pension, Profit-Sharing, and Stock Bonus Plans.

Revenue acts amending the Code are published first as slip laws, then in the Internal Revenue Service's *Bulletin* and thereafter in the semi-annual Internal Revenue *Cumulative Bulletin* for the year of enactment. The tax services provide up-to-date loose-leaf and paperback editions of the Code. LEXIS® and WESTLAW® provide on-line access to the Code.

Level: Basic

Government Printing Office. *Code of Federal Regulations*, Title 26, Washington D.C.

Treasury decisions (TDs) explain provisions of the Internal Revenue Code and are published in the *Federal Register*. Usually, they are published first in proposed form and then in final form with amendments. Eventually, each TD becomes part of the internal revenue regulations. Preambles to TDs may contain explanatory material that is not included in the regulations. The preambles are published in the *Bulletin* and *Cumulative Bulletin*. The tax services generally note any significant material in preambles.

Level: Basic

Government Printing Office. *Bulletin* and *Cumulative Bulletin*, Washington, D.C.

IRS interpretations of the provisions of the Internal Revenue Code and Regulations as they apply to particular factual situations are summarized in revenue rulings, that are published in the *Bulletin* and *Cumulative Bulletin*. IRS acquiescence and nonacquiescences in tax court decisions are announced in the *Bulletin*.

Level: Basic

Government Printing Office. IRS Notice 89-23, 1989-1 C.B. 65, Washington, D.C.

Notice 89-23 provides nondiscrimination rule safe harbors for employer TSA plans.

Level: Intermediate

Pages: 11

Government Printing Office. Department of Treasury, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*, IRS publication 571, updated annually, Washington, D.C.

Publication 571 explains the tax provisions that apply to TSAs. It is designed for employees who participate in TSAs. It includes worksheets and tables to compute the exclusion allowance and other limits.

Level: Basic

Pages: 19

ERISA is published as Title 29 of the U.S. Code.

The tax services provide up-to-date loose-leaf and paperback editions of ERISA. Committee reports may be included to support understanding of legislative intent.

Government Printing Office. *Code of Federal Regulations*, Title 29, Washington, D.C.

Department of Labor regulations explain provisions of ERISA and are published in the federal *Register*. Usually, they are published first in proposed form and then in final form with amendments.

Level: Basic

III. Deferred-Compensation Plans for Employees of Public Educational Organizations and Tax-Exempt Organizations

Employees of public educational organizations and tax-exempt organizations have always had the right to defer taxation of salary through TSAs. Section 403(b) of the Internal Revenue Code is one of many limitations and complications in tax and labor law affecting that right. Some, but not all, of these deferred-compensation arrangements meet the definition of "employee benefit plan" and are subject to ERISA. As with other deferred-compensation plans, design and implementation involve eligibility, contributions, funding vehicles, and distributions. A clear perception of risks, returns, and values is needed to responsibly advise sponsors and employees regarding TSAs as an alternative or supplement to qualified plans and Section 457 plans.

Wolff, Carolyn G. and Schwartz, Daniel J., "Employee Benefits for Tax-Exempt Organizations," *Tax Management Portfolios*, Bureau of National Affairs, 373 T.M.

This is a summary of the rules for TSAs and other deferred-compensation plans for tax-exempt organizations, with footnotes and bibliography.

Level: Intermediate Pages: 86

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy provides an overview in answers to six questions. He provides answers to 22 questions on TSA plan design. The text also covers Section 457 and church plans.

Level: Basic

IV. Eligibility

Not all employees of organizations that are exempt from federal income tax are eligible to defer compensation under Section 403(b) of the Internal Revenue Code.

Kenty, David E. and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of eligibility, with footnotes and bibliography.

Level: Intermediate Pages: 79

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy answers five questions defining an employer that is eligible to maintain a TSA and three questions defining an employee who may defer his or her salary under a TSA.

Level: Basic

V. Funding Vehicles

TSA arrangements may be funded through individual annuity contracts owned by the employee, group annuity contracts, or mutual funds held in a custodial account. Consideration of funding vehicles from the consumer perspective involves issues of compliance as well as of effective management of pension assets.

Kenty, David E. and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of the technical aspects of funding vehicles, including rules for contributions and distributions, with footnotes and bibliography.

Level: Intermediate Pages: 79

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy covers investment vehicles, fiduciary issues, investment management, participant direction and communication, investment advice, and record-keeping in 45 questions on funding.

Level: Basic

VI. Employer-Sponsored Plan

If certain basic criteria are met, a TSA arrangement is an employer-sponsored plan subject to ERISA. For employer plans, there are additional compliance requirements, including nondiscrimination and eligibility rules; reporting, disclosure, and funding requirements; fiduciary standards; and vesting.

Kenty, David E., and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of the use of TSAs in employer-sponsored plans. Appendixes include: DOL Opinion letters; a sample TSA plan document; and IRS publication 571, "Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations; for Use in Preparing 1992 Returns."

Level: Intermediate Pages: 79

Government Printing Office. IRS Notice 89-23, 1989-1 C.B. 65, Washington, D.C.

Notice 89-23 provides nondiscrimination safe harbors for employer TSA plans.

Level: Intermediate Pages: 11

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy covers ERISA requirements for TSAs, government, and church plans in 47 questions dealing with the circumstances under which a TSA is subject to ERISA; joint and survivor annuity requirements; death benefit beneficiary designations; amendments; bonding and plan assets; disclosure; reporting; and fiduciary matters.

Level: Basic

VII. Tax Incentives

Contributions to a TSA for account of an eligible employee are excludable, within limits, from the employee's gross income. There are primary limitations applied each year. However, for employees near retirement, there is an option to elect to use a catch-up provision to increase deferrals for three years. Special rules apply to certain church employees. The accumulation of investment earnings is free of tax until distributed. In addition to employee salary deferrals, the employer may contribute to the accounts of employees.

Kenty, David E. and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of tax incentives.

Level: Intermediate Pages: 79

VIII. Distributions

TSA distributions generally are subject to the premature distribution and minimum-required distribution rules in the Internal Revenue Code. Distributions are taxed under Section 72, the same as distributions from qualified plans. Loans are permitted, and the rules may differ from the rules for qualified plans. Distributions may be rolled over to another TSA or an IRA. It is possible to transfer assets directly from one TSA to another.

Kenty, David E. and London, Jeffrey L., "Tax-Deferred Annuities—Section 403(b)," *Tax Management Portfolios*, Bureau of National Affairs, 388-4th T.M.

Kenty and London provide an overview of distributions from TSAs.

Level: Intermediate Pages: 79

Levy, Donald R. *403(b) Answer Book*, New York, Aspen Publishers, Inc.: 1995.

Levy answers 128 questions in a chapter on distributions. The topics include: requirements governing timing and amount of distributions; calculation and distribution of grandfathered amounts; distributions after death of participant; designated beneficiaries; minimum-distribution, incidental-benefit requirements; taxation and investment in the contract; withdrawal restrictions; hardship distributions; excise taxes on excess distributions; death benefits; rollovers; transfers; tax withholding; and reporting.

Level: Basic

Publishing and Ordering Information

For publications referenced, please contact the publishers directly for books or reprints of articles.

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