IRS Targets School Districts for 403(b) Review

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Over the next eighteen months, the Internal Revenue Service (IRS) will be contacting public school districts in every state to determine whether the districts' 403(b) plans are complying with the "universal availability" rule. von Briesen & Roper's school law and employee benefits law attorneys have significant experience in this area and frequently work with the IRS when 403(b) plan compliance issues arise.

Under the "universal availability" rule, if the district allows at least one employee to make elective contributions to a 403(b) plan, it generally must allow all employees of the district to do so. However, the following classes of individuals may be excluded from 403(b) participation:

- Employees who will make an annual contribution of $200 or less
- Employees participating in a 401(k) plan, a 457 plan, or another 403(b) plan
- Non-resident aliens
- Employees who normally work less than 20 hours per week
- Students performing certain services District employees often improperly excluded from 403(b) plan eligibility include: school nurses, substitute teachers, bus drivers (if district employees), maintenance workers, and other non full-time, non-permanent employees.

Failure to comply with the "universal availability" rule may result in the district's 403(b) plan losing its taxdeferred status. That is, contributions to the plan and, in many cases, the earnings on the contributions would be subject to income tax immediately.

What School Districts Should Do If Contacted by the IRS

If a school district is contacted by the IRS, the district must provide the information requested in the IRS's correspondence. The district may also include any other documents that it believes will assist the IRS in its review. If the district fails to fully comply with the IRS's request, then the IRS may institute a full audit of the district's 403(b) plan.

If the IRS determines that the district's plan has failed to comply with the "universal availability" rule, the IRS will allow the district to correct the failure within 240 days of the date it notifies the district of the failure. The IRS has approved two methods of correction:

1. The district makes a fully vested contribution for each excluded employee equal to 50% of the employee's compensation multiplied by the average deferral percentage of the plan for each year the employee was improperly excluded. Further, if the district made matching contributions for other employees, then the excluded employees would be entitled to any related matching contributions attributable to the district's contribution.
2. The district makes a fully vested contribution for each excluded employee equal to 1.5% of the employee's compensation for each year the employee was improperly excluded. Again, if matching contributions were made for other employees, the excluded employees would be entitled to any related matching contributions attributable to the district's contribution.

The method chosen by a district to correct its failure may be restricted by labor contracts. There are no additional costs, fees or penalties imposed on the district if the failure is corrected within the applicable time period.

Conducting an Internal Audit

Even if a school district is not contacted by the IRS, it is prudent for the district to complete an internal audit of the eligibility criteria of its 403(b) plan to ensure compliance with the "universal availability" rule. A district that finds eligibility errors may participate in the IRS's voluntary compliance program and correct the eligibility errors using one of the two approved methods described above. The district would also be required to pay all fees, if applicable, associated with the voluntary compliance program. To protect the confidentiality of the audit process, we recommend completing an internal 403(b) audit through the use of counsel.

Final Regulations Eliminate Two Employee Exclusion School Districts May Be Using

The IRS recently released final regulations for 403(b) plans. The final regulations, which generally become effective on January 1, 2009, eliminate two exclusions from the universal availability rule that school districts may have utilized in the past.

1. A school district was previously allowed to exclude an employee from participating in the district's 403(b) plan if the district offered – and the employee made – a one-time election to participate in a governmental plan in lieu of participating in the school district's 403(b) plan. The plan is permitted to maintain this exclusion until taxable years that begin after December 31, 2009.
2. If a plan currently excludes from 403(b) plan participation employees who are covered by a collective bargaining agreement, the plan is permitted to maintain that exclusion until the later of: (1) the first day of the taxable year that begins after December 31, 2008; or (2) the earlier of: (a) the date the agreement terminates; or (b) July 26, 2010.

If the district's 403(b) plan may only be amended by a legislative body that meets in a legislative session, the plan is permitted to maintain the above referenced exclusions until the earlier of: (1) the close of the first regular legislative session of the body with the authority to amend the plan that begins on or after January 1, 2009 or (2) January 1, 2011. Any employee previously excluded from a 403(b) plan based on either a one-time election to participate in a governmental plan or coverage under a collective bargaining agreement must be allowed to make elective deferrals on and after the applicable effective date. However, the school district does not have to make matching contributions on behalf of these individuals.

Extra Monitoring is Required

In light of the IRS's focus on school district 403(b) plans and the recent release of the final regulations, it is important that school districts pay close attention to the operation of their 403(b) plans and their plan documents to ensure continuing compliance with the statute and IRS regulations. We will provide additional guidance regarding the final 403(b) regulations in a *Legal Update*.

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