

403(b) PLAN EXECUTIVE SUMMARY

January 2012



We Deliver Performance

Northern California

800.952.8800

Southern California

(L.A. Area)

800.736.7090

Southern California

(San Diego Area)

800.572.4122

www.PolycompRetirementPlans.net

Table of Contents

1. What is a 403(b) plan?	1
2. Who can sponsor a 403(b) plan?	1
3. I've heard that 403(b) plans can be ERISA or Non-ERISA – what is ERISA and is there a benefit to one or the other?	1
4. When is a 403(b) plan exempt from ERISA?	2
5. What types of employees may be excluded from the plan?	2
6. What types of contributions are available?	3
7. When must contributions be made?	3
8. What is an Information-Sharing Agreement?	4
9. Do I need an Information-Sharing Agreement (ISA)?	4
10. What are the benefits of a 403(b) plan?	4
11. What are the employee contribution limits?	5
12. Do I need to worry about the ADP or ACP discrimination tests?	5
13. If I am making employer contributions, why is the ACP test relevant?	6
14. Can the ACP test be avoided?	6
15. What is a Safe Harbor 403(b) plan?	7
16. Can the plan allow employee loans?	8
17. What types of investments are available to 403(b) plans?	8
18. What events allow an employee to take a distribution from the plan?	8
19. Can I decide to contribute different matching or discretionary employer contributions to each employee?	8
20. What are the possible advantages of having the Roth option?	9
21. What are the tax benefits of having the Roth option?	9
22. Are all of the Roth investment earnings tax-free when distributed?	9
23. Can participants convert 401(k) assets to Roth assets without taking them out of the plan?	10
24. What are the additional costs of having a Roth option in a 403(b) plan?	10
25. How long can an employee be required to work before becoming 100% vested in the contributions?	10
26. What are some questions to ask before adopting a 403(b) plan?	10
Exhibit A	11

1. What is a 403(b) plan?

A 403(b) plan is a deferred compensation program offered to employees of a tax-exempt organization or certain educational organizations.

2. Who can sponsor a 403(b) plan?

403(b) plans may be maintained by governmental and tax-exempt organizations under §501(c)(3) (a.k.a. non-profit organizations), churches, or educational organizations.

3. I've heard that 403(b) plans can be ERISA or Non-ERISA – what is ERISA and is there a benefit to one or the other?

The Employee Retirement Income Securities Act of 1974 (ERISA) outlines the duties and responsibilities borne by organizations and companies that establish or maintain an employee benefit pension plan. The differences between the two types of plans are outlined below:

	ERISA 403(b) Plans	NON-ERISA 403(b) Plans
Requires a plan document	Yes	Yes
Subject to ERISA's Title I Requirements	Yes	No
Eligible organizations	Those established or maintained by a tax-exempt organization unless the plan satisfies the "limited employer involvement" criteria of the Department of Labor (DOL) non-ERISA safe harbor regulations.	Governmental employers (i.e., schools) and churches (however, churches may elect to be covered under ERISA). 501(c)(3) sponsors plans that satisfy the "limited employer involvement" criteria of the DOL non-ERISA safe harbor regulations.
Requires annual employee disclosures	Yes	Yes – particularly regarding eligibility to enroll
Subject to fiduciary responsibility	Yes	No
Have ERISA protection	Yes	No
Requires discrimination testing	Yes	No
Must file an annual Form 5500	Yes	No

Note: Many employers are finding that the effort it takes to avoid ERISA requirements for their 403(b) plan is just not worth it. With the right provider, embracing ERISA can allow you to sponsor a plan designed to benefit both your organization and your employees.

4. When is a 403(b) plan exempt from ERISA?

A 403(b) plan is exempt from ERISA only if it satisfies the following four requirements:

- Participation is completely voluntary for employees; and
- Employees, their beneficiaries and representatives can solely enforce their rights under the 403(b) investments; and
- Employer involvement in plan operation is limited to any of the following: a) Permitting vendors to publicize their products to employees, b) Requesting information; c) Summarizing or otherwise compiling the information provided; d) Collecting deferrals and remitting deferrals to vendors; e) Holding group contracts; or f) Limiting the investment products or vendors available to employees “to a number and selection which is designed to afford employees a reasonable choice in light of all relevant circumstances”; and
- Employer does not receive any direct or indirect compensation other than reasonable compensation to cover expenses in administering deferrals.

A plan is subject to ERISA when:

- Employer makes contributions other than elective deferrals (i.e., matching contributions); and
- Employer makes discretionary administrative determinations such as processing distributions, making hardship withdrawal determinations, authorizing plan-to-plan transfers, or determining eligibility for the enforcement of plan loan provisions.

5. What types of employees may be excluded from the plan?

The following employees may be excluded:

- Employees who are *expected* to work less than 1,000 hours in a 12-month period, and *actually* work less than 1,000 hours during this period;
- Employees who are eligible to defer under another plan of the employer, such as another 403(b), 457(b) governmental, or 401(k) plan;
- Students performing services for a school, college or university;
- Leased employees or independent contractors; and
- Non-resident aliens with no U.S. source income.

The following exclusions are no longer allowed:

- Effective the earlier of the date that the collectively bargained agreement terminates or July 26, 2010:
 - Collectively bargained employees (different than 401(a), 401(k));
- Effective for plan years beginning on or after January 1, 2010:
 - Visiting professors (professors can participate in original school plan);
 - Vow of poverty through religious affiliation; and
 - Employees who make a one-time election to participate in a governmental plan.

In addition, ERISA 403(b) plans have to meet other coverage rules, which may require inclusion of some of the above employees that are excludable under the Universal Availability requirements.

6. What types of contributions are available?

Roth Contributions: (a.k.a. Roth elective deferrals) Post-tax employee contributions made via payroll deduction. Gross income is not reduced by these post-tax contributions. The deferral will be subject to federal and state income taxes when made, but the entire Roth account (including all investment earnings) can be withdrawn tax-free after meeting certain distribution requirements. These post-tax Roth deferrals will be combined with pre-tax salary deferrals for all plan purposes, including the maximum contribution limits (see *question 11*), catch-up contributions (see *question 11*), and discrimination testing (see *questions 12 through 14*). For more information on Roth contributions, see *questions 20 through 24*.

Salary Deferral Contributions: (a.k.a. Employee elective deferrals) These are pre-tax employee contributions made via payroll deduction. Gross income is reduced by these pre-tax contributions. All contributions and investment earnings accrue on a tax-deferred basis.

Employer Matching Contributions: A participant needs to contribute his/her own money to receive a matching contribution from the employer. Regardless of whether a participant contributes post-tax or pre-tax money as outlined above, the employer match monies are tax-deductible and excluded from payroll taxes. There may be other requirements, such as 1,000 hours of service and/or being employed on the last day of the plan year.

Employer Discretionary Contributions: (a.k.a. Non-elective contributions) Participants do not need to contribute his/her own money to be eligible to receive an employer discretionary contribution. There may be other requirements, such as 1,000 hours of service and/or being employed on the last day of the plan year.

Safe Harbor Contributions: These are contributions made by the employer, that exempt the employer from Actual Contribution Percentage (ACP) testing requirements (see *question 13*). Contributions can be made in the form of employer matching or non-elective contributions. For more information on Safe Harbor contributions, see *question 15*.

7. When must contributions be made?

Employee contributions (post-tax and pre-tax) must be deposited as soon as they can reasonably be segregated from the employer's payroll account. The Department of Labor (DOL) has Safe Harbor guidelines for ERISA 403(b) plans:

Plans with fewer than 100 participants at the beginning of the plan year comply with the regulations if the contributions are deposited no later than the 7th business day following the day the amounts would have been payable in cash.

For plans with over 100 participants at the beginning of the plan year, the DOL has indicated that participant contributions are timely deposited on the earlier of (1) the 15th business day of the month following the month the contribution is withheld by the employer, or (2) the earliest date the contributions can be reasonably segregated from the employer's general assets. Being consistent is a primary concern. For example, if the employer was once able to segregate contributions within 3 days it will always have to deposit within 3 days.

Employer matching contributions and profit sharing contributions can be made as late as the employer's tax filing deadline, including extensions.

8. What is an ISA?

An Information-Sharing Agreement (ISA) is a written agreement between the employer and a vendor that is providing contracts in connection with the plan (such as an investment provider). The employer and these vendors must communicate with each other about participant investment activities such as:

- Whether a plan participant is employed and when a participant's employment is severed;
- Which optional provisions are selected or allowed by the plan, such as loans, hardship withdrawals and rollovers; and
- Who is responsible for administering the participant's investment activities.

9. Do I need an ISA?

If a vendor arrangement has been in place prior to September 25, 2007, the IRS assumes the vendor is eligible to receive ongoing contributions and that the employer and that vendor are already coordinating information. These vendors (sometimes referred to as "payroll slot vendors") have been "grandfathered" under the rules that applied to these types of arrangements before September 25, 2007. Because ISAs are only required for non-payroll slot vendors, an ISA would not be required for these arrangements.

10. What are the benefits of a 403(b) plan?

For the eligible employee (participant): There are four primary benefits for the eligible employee of a 403(b) plan: (1) Pre-tax employee salary deferral contributions reduce the employee's income for federal and state income tax purposes. (2) Employer matching contributions and employer discretionary contributions are not taxable to the employee until withdrawn from the plan trust. (3) Investment earnings on plan assets are tax-deferred. (4) Salary deferrals may be deducted automatically and conveniently from payroll.

In addition to reducing taxable wages, low- and middle-income participant may claim a Saver's Credit* up to \$1,000 (\$2,000 for married couples). The schedule below is our understanding of the credits and income breakdown for 2012:

<u>Joint filers</u>	<u>Single filers</u>	<u>Tax credit</u>
earning < \$34,500	earning < \$17,250	50%
\$34,501 to \$37,500	\$17,251 to \$18,750	20%
\$37,501 to \$57,500	\$18,751 to \$28,750	10%

For the employer: Employer matching contributions and non-elective contributions are tax deductible and excluded from payroll taxes. Employee **pre-tax salary deferrals are included** for both employee and employer payroll taxes.

**As with any tax matter, you are urged to discuss the tax credit with your tax advisor to verify current Internal Revenue Service (IRS) requirements.*

11. What are the employee contribution limits?

The maximum employee contribution amount (post-tax and pre-tax) for the year 2012 is the lesser of 100% of compensation or \$17,000. Participants who are 50 years old or older in 2012 may make an additional “catch-up” contribution of \$5,500. **Note:** *The \$17,000 is a combined limit of pre-tax and Roth contributions, and is inclusive of all other 401(k) contributions made to the plan of another employer.* (IRC §402(g))

The maximum annual addition contribution limit for a participant is the lesser of \$50,000 or 100% of the participant’s gross annual compensation. This limit applies to the sum of the employee contributions (post-tax and/or pre-tax) (but not the \$5,500 catch-up), employer matching contributions, employer discretionary contributions, and forfeiture allocations. (IRC §415)

Special catch-up contribution limit for employees with 15+ years of service

For employees of certain qualified organizations (educational organizations, hospitals, church-related organizations and health and welfare agencies) who have at least 15 years of full-time service with the same employer, a “special” catch-up limit applies in addition to the “regular” catch-up limit already available. The special catch-up limit equals the **lesser** of:

- a) \$3,000;
- b) \$15,000 reduced by the cumulative amount of “special” catch-up contributions made in prior years; or
- c) \$5,000 times the number of employee’s years of service for the organization, minus the total elective deferrals made for earlier years.

For example:

- 1) Mary has 20 years of service, and her elective deferrals under the 403(b) plan for her prior taxable years total \$60,000. She has never utilized any special catch-up contributions. For the 2012 plan year, Mary can put in an additional \$3,000, which is the lesser of: (1) \$3,000, (2) \$15,000, or (3) \$40,000 (i.e., [$\$5,000 \times 20$] - \$60,000).
- 2) Bob has 20 years of service, and in prior years, Bob has made \$60,000 in deferrals, of which \$13,300 were special catch-up contributions. For the 2012 plan year, Bob can put in \$1,700 in special catch-up contributions, which is the lesser of (1) \$3,000, (2) \$1,700 (i.e., $\$15,000 - \$13,300$), or (3) \$40,000 (i.e., [$\$5,000 \times 20$] - \$60,000).

For calculation purposes, compensation is limited to \$250,000 in 2012 for any individual participant.

12. Do I need to worry about the Actual Deferral Percentage (ADP) or ACP discrimination tests?

403(b) plans are not subject to ADP testing. If you are making any employer contributions (i.e. matching) to the plan, however, your plan will be subject to ACP testing. The ACP test applies only to matching contributions and any voluntary post-tax (i.e., not Roth) contributions to the plan. *If you are not making employer contributions, skip ahead to question 16.*

13. If I am making employer matching contributions, why is the ACP test relevant?

The ACP test compares the matching contribution levels of the Highly Compensated Employees(HCE) to the rest of the employees. If the test fails, either HCEs must take taxable distributions from the plan or the employer must make a 100% vested contribution for the remaining employees.

HCE is defined as any employee who:

- Is a greater than 5% owner of the company (including family members of the owner: spouse, children, grandchildren or parents) at any time during the current or preceding year; OR
- Received compensation in excess of \$115,000 in the preceding plan year, for plan years beginning in 2012.

The first step is to calculate the ACP for the Non-Highly Compensated Employee (NHCE) group. The allowable ADP for the HCEs can then be determined using the following table:

NHCE AVERAGE DEFERRAL RATE	MAXIMUM HCE AVERAGE DEFERRAL RATE
1.00%	2.00%
2.00%	4.00%
3.00%	5.00%
4.00%	6.00%
5.00%	7.00%
6.00%	8.00%
7.00%	9.00%
8.00%	10.00%
Greater than 8%	1.25 times NHCE%

Example of a failed ACP Test with the distribution to the HCE:

Participant	Wage	Match	%	Group Average	Allowable %	Allowable \$	Taxable Distribution
HCE	\$110,000	\$11,000	10%	10%	4.5%	\$4,950	<u>\$6,050</u>
Employee A	\$40,000	\$4,000	10%				
Employee B	\$40,000		0%	2.5%			
Employee C	\$40,000		0%				
Employee D	\$40,000		0%				

14. Can the ACP test be avoided?

Yes. The ACP test can be avoided if your plan qualifies as a Safe Harbor 403(b) plan. Each year, you may elect, before the beginning of the plan year, if the 403(b) plan is to be designated as a Safe Harbor plan for that year.

15. What is a Safe Harbor 403(b) plan?

A Safe Harbor 403(b) plan is a 403(b) plan where the ACP test is waived and the HCE's matching contributions are not restricted by the lack of matching contributions for the rest of the employees. However, in a Safe Harbor plan the employer must commit to making either a matching or non-elective contribution for the employees. If the employer decides to designate the plan as Safe Harbor then the plan must meet the following conditions:

- Participants cannot be required to be employed on the last day of the plan year or to work a specified number of hours to share in the contribution,
- A written notice announcing the Safe Harbor contribution must be given to participants at least 30 days **BEFORE** the beginning of the plan year,
- Employer matching contributions are required for NHCEs and optional for HCEs (subject to the plan document), and
- All Safe Harbor contributions are 100% immediately vested.

There are two types of Safe Harbor alternatives:

- 1) **Matching Contribution,**
- 2) **Non-Elective Contribution.**

- 1) **Matching Contribution:** There are several formulas available. The two most often used are:
 - a) 100% of the first 3% of the participant's compensation that is deferred, plus 50% of the next 2% deferred, or
 - b) 100% of the first 4% of the participant's compensation that is deferred.

Safe Harbor matching contributions are allocated only to those participants who have made salary deferrals to the plan. If a participant elects not to defer, they are not eligible to receive a matching contribution. From a cost standpoint, this is a good choice for plans with low participation rates.

Example of a Safe Harbor match of 100% of the first 4% of compensation that is deferred:

Participant	Compensation	Employee Deferral	4% Safe Harbor Match
HCE	\$110,000	\$17,000	\$4,400
Employee A	\$40,000	\$4,000	\$1,600
Employee B	\$40,000	\$1,600	\$1,600
Employee C	\$40,000	\$600	\$600
Employee D	\$40,000	\$0	\$0
Total			\$8,200

2) **Non-Elective Contribution:** The Safe Harbor formula is 3% of compensation for all eligible, NHCEs.

Example of a 3% Safe Harbor non-elective contribution to all eligible employees:

Participant	Compensation	Employee Deferral	3% Non-Elective
HCE	\$110,000	\$17,000	\$3,300
Employee A	\$40,000	\$4,000	\$1,200
Employee B	\$40,000	\$1,600	\$1,200
Employee C	\$40,000	\$0	\$1,200
Employee D	\$30,000	\$0	\$900
Total			\$7,800

16. Can the plan allow participant loans?

Yes. 403(b) plans may allow participant loans. The same rules that apply to other qualified plans apply to 403(b) plans.

Note: Non-ERISA 403(b) plans should be careful about the administration of the loan, as any discretionary action by the employer (i.e., determining the available loan amount) may unintentionally subject the plan to ERISA.

17. What types of investments are available to 403(b) plans?

403(b) plans must be invested in one or more of the following types of investments:

- A custodial account that holds shares of SEC-registered (U.S. Securities and Exchange Commission) mutual funds;
- An annuity contract; or
- A Retirement Income Account (for church 403(b) plans only).

18. What events allow a participant to take a distribution from the plan?

Attainment of age 59½, termination of employment, hardship condition, death, or disability. A distribution to an “alternate payee” will be permitted if pursuant to a qualified domestic relations order (QDRO).

19. Can I decide to contribute different matching or discretionary employer contributions to each employee?

Yes. For an ERISA 403(b) plan that provides for employer discretionary contributions, if the plan discrimination testing passes, then contributions may vary per employee at the employer’s discretion.

20. What are the possible advantages of having the Roth option?

(See question 6 for an explanation of Roth contributions.)

The Roth option appeals to:

- Participants who anticipate higher personal income tax rates in the future.
- High-income earning participants who are not permitted to make Roth IRA contributions because of income restrictions.
- Participants who would like to avoid the minimum distribution requirement at age 70½ by rolling Roth deferrals to a Roth IRA where minimum distributions are not required.
- Participants who want to diversify retirement accounts between pre and post-tax.

21. What are the tax benefits of having the Roth option?

For the eligible employee (participant): Post-tax employee contributions do not reduce the employee's gross income for federal and state income tax purposes. However, the employee's future earnings on these post-tax dollars will accrue on a tax-free basis so long as the account is in existence for at least 5 years. On the contrary, employer matching contributions and employer discretionary contributions, and any applicable earnings, are tax-deferred, or are not taxable to the employee until withdrawn from the plan trust.

As with any tax matter, you are urged to discuss the above with your tax advisor to verify current IRS requirements.

22. Are all of the Roth investment earnings tax-free when distributed?

Yes. If the account has been in existence for at least 5 years, beginning with the first contribution.

And once one of the following occurs, there will be NO TAXES on the distribution:

- Attainment of age 59½
- Death
- Disability

Note: If the account is less than 5 years old, all earnings on the Roth account are taxable to the participant in the year distributed. In addition, participants who are younger than age 59½ may incur a 10% federal early withdrawal penalty.

However, taxation can be deferred by rolling the plan distribution directly to a Roth IRA or to another qualified retirement plan with the Roth 401(k) option.

23. Can participants convert 403(b) assets to Roth assets without taking them out of the plan?

Yes. As of September 27, 2010, employees with 401(k) or 403(b) accounts can move money from the regular (pre-tax) account to a designated Roth account (after-tax) within the plan. **Note:** Conversions of 401(k) or 403(b) elective deferral accounts can only be made if the participant is at least 59½ years old. Other vested employer and rollover accounts can be converted at any time.

In order to make this available to participants, your plan must offer designated Roth accounts. **Note:** These Roth accounts must be available for regular contributions, as well. In addition, since this type of conversion is technically considered a distribution, your plan must allow for in-service distributions (which can be solely for this purpose).

24. What are the additional costs of having a Roth option in a 403(b) plan?

The addition of the Roth option will add administrative complexity and costs to your 403(b) plan:

- Roth accounts will require separate recordkeeping.
- Distribution processes will need to cover the use of different rollover options for Roth and non-Roth dollars, keep track of the timing of the contributions and distributions, and incorporate the changes to the 1099-R reporting requirements.
- In addition, the plan document and summary plan description need to reflect the Roth option.

25. How long can a participant be required to work before becoming 100% vested in the contributions?

Plans may utilize a vesting schedule no longer than the 6-year graduated or 3-year cliff shown below. Employee elective deferrals, employer Qualified Non-Elective Contribution (QNEC) accounts, and Safe Harbor accounts must always be 100% vested immediately.

GRADUATED	
Year	%
0-1	0
2	20
3	40
4	60
5	80
6+	100

CLIFF	
Year	%
1	0
2	0
3	100

26. What are some questions to ask before adopting a 403(b) plan?

- Should I sponsor an ERISA or non-ERISA 403(b) program?
- If I am a non-governmental, tax-exempt organization (i.e., a §501(c)(3) organization), should I sponsor a 403(b) or a 401(k) plan?
- Do I want to allow my employees to choose whichever vendor they want, or do I want to have all deferrals go to one investment provider?

Exhibit A

Comparison of 401(k) and 403(b) Plans 2012

	401(k)	403(b) <i>*If blank, same as box to the left</i>
Who can sponsor?	Any business entity, including sole proprietors, partnerships and non-profit organizations. A governmental employer <u>may not</u> sponsor a 401(k) plan unless grandfathered.	Tax-exempt organizations under §501(c)(3), non-electing church employers, and educational institutions. <i>For more information regarding who can sponsor a 403(b) plan, see question 2.</i>
Is a plan document required?	Yes.	
What are the elective deferral limits?	The lesser of \$17,000 or 100% of compensation.	
Are catch-up contributions available?	Yes - Participants age 50 or older may contribute an additional \$5,500.	Yes - Participants age 50 or older may contribute an additional \$5,500. For employees of certain non-profit organizations, a special catch-up is available in addition to the \$5,500 listed above. <i>For more information regarding special catch-ups, see question 11.</i>
Are Roth contributions allowed?	Yes.	
What are the limits on total annual contributions [§415(e)]?	The lesser of \$50,000 (\$55,500 if age 50 or older) or 100% of compensation.	
Am I required to make minimum employer contributions (i.e. non-elective, matching)?	Only if your plan is top heavy.	No.
Can an employee contribute to both a 401(k) and a 403(b) plan?	Yes. However, the \$17,000 maximum deferral limit [§402(g)] applies to all employee contributions made to all plans and employers of that employee during that calendar year.	
If an employee receives an allocation from both a 403(b) and a 401(k), are the contributions received combined for the \$50,000 annual allocation limit [§415(e)]?	Only if the employee owns more than 50% of the business maintaining the 401(k) plan.	
What are the non-discrimination requirements?	<ul style="list-style-type: none"> • ADP/ACP Test • 410(b) Coverage Test • 401(a)(4) Non-Discrimination 	<ul style="list-style-type: none"> • <u>For deferrals:</u> <ul style="list-style-type: none"> ○ Universal Availability Test • <u>For employer contributions:</u> <ul style="list-style-type: none"> ○ ACP Test ○ 410(b) Coverage Test ○ 401(a)(4) Non-Discrimination
Are there any restrictions on investments?	Assets must be held in a trust, unless fully insured (i.e., welfare benefit plans).	Must invest in annuity contracts or custodial accounts.
Can employer allocations be tiered?	Yes.	
Is IRS Form 5500 required?	Yes.	No, unless you make an employer contribution.