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The Contribution Limitations for I.R.C. 403(b) Tax Sheltered Annuities after ERISA

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COMMENTS

THE CONTRIBUTION LIMITATIONS FOR I.R.C. § 403(b) TAX SHELTERED ANNUITIES AFTER ERISA

Since so few taxpayers can take advantage of section 403(b) annuity plans, these plans have received little attention from commentators and have occupied a remote, oft-neglected niche in the Internal Revenue Code (I.R.C.). Congress, however, did not overlook section 403(b) annuities in its enactment of the Employee Retirement Income Security Act of 1974 (ERISA). As with everything else it touched, ERISA left its intricate mark upon section 403(b) annuity plans.

After ERISA, the limitations placed upon the amount that can be annually deferred from tax income and contributed to a section 403(b) annuity have become quite complicated. Those who have previously undertaken to explain the contribution limitations for these annuities have been thwarted by the imprecise wording of the governing section, I.R.C. § 415. In late 1976 Congress clarified a key subsection of section 415 and the Internal Revenue Service issued temporary regulations regarding the alternative contribution limitations available to selected section 403(b) annuitants. Perhaps now, therefore, an accurate explanation of the calculation of the contribution limitations of section 403(b) annuities can be safely attempted.

This Comment will consider the contribution limitations imposed upon section 403(b) annuities before ERISA and then proceed to examine the present contribution limitations in depth. A grasp of the mechanics of calculating an employee's contribution limitations is indispensable to an understanding of the concepts involved. Examples will therefore be used throughout this Comment to illustrate the determination of these limitations.

I. SECTION 403(b) ANNUITIES BEFORE ERISA

Section 403(b) annuities are available only to certain employees. In order to qualify an employee must be employed by a tax-exempt organization, a state sponsored educational institution, or an educational institution.

1 I.R.C. § 403(b) annuities are often referred to as "tax sheltered annuities" and at times this Comment will use the terms interchangeably. "Tax sheltered annuity," however, is something of a misnomer. In the strict sense of the word, a "tax shelter" generates losses that can be used to offset other income. A section 403(b) annuity provides a means for tax deferral, it does not shelter other income.


5 As defined in I.R.C. § 501(c)(3).

6 As defined in I.R.C. § 151(e)(4).
tional institution of a political subdivision of a state. A section 403(b) annuity allows these employees to set aside a certain percentage of their yearly compensation and place it into an annuity. The amount that goes toward such an annuity is not included in the employee's taxable income in the year he earns it. Instead, the employee is taxed when the annuity proceeds are later distributed to him, presumably when he is in a much lower tax bracket. Traditionally, section 403(b) annuities have been especially attractive to doctors and other professionals who offer their services to hospitals and educational institutions on a part-time basis. These professionals can often more easily defer current income and, since they are usually in high tax brackets, they also have a large incentive for tax deferral.

For some employers section 403(b) annuity plans are an especially attractive method of rewarding key employees since the employer can offer these annuities selectively. For other employers, like educational

7 I.R.C. § 403(b)(1).
8 Before ERISA I.R.C. § 403(b) permitted the tax deferred amounts to be invested only in annuity contracts. ERISA, however, added I.R.C. § 403(b)(7) which allows these amounts to be invested in one additional medium — mutual funds, provided the funds are held in a custodial account. To avoid confusion this Comment refers only to section 403(b) annuities; but it should be borne in mind that section 403(b) does allow this one additional investment possibility.
9 I.R.C. § 403(b)(1), (c) provides that upon distribution of the annuity contract's proceeds an employee shall include them in his gross income in accordance with I.R.C. § 72. When an employee retires and begins receiving his annuity proceeds in yearly payments, section 72 instructs that a percentage (the "exclusion ratio") of each yearly proceed payment that represents an employee's investment in the annuity contract is to be excluded from the employee's gross income in the year of such payment. Since section 403(b) deems all amounts originally contributed to an employee's annuity that were within the permissible contribution limits to be employer contributions, an employee's investment in a section 403(b) annuity contract is usually zero (thereby making his "exclusion ratio" zero), and all of a given year's annuity proceed payment would normally be included in an employee's gross income for that year. Any contributions that exceeded the limitations, however, would have been included in the employee's gross income in the year in which the contribution was made. So when the annuity proceeds are distributed to an employee in a later year, the excess contributions that were taxed in an earlier year are the employee's investment in the annuity contract and are not taxed upon distribution. In section 72 terms, a percentage (the "exclusion ratio") of each yearly proceed payment that represents these excess contributions will be excluded from the employee's income each year.

Section 403(b) annuity proceeds do not qualify for capital gains treatment but they can be averaged in accordance with I.R.C. §§ 1301-05. In addition, both the estate tax exclusion of I.R.C. § 2039(c) and the gift tax exclusion of I.R.C. § 2517(a) apply to some section 403(b) annuities. See Rev. Rul. 68-294, 1968-1 C.B. 46 (exclusion not available for employees of colleges, public schools, universities, or hospitals that are integral parts of state and local governments). Those proceeds that represent employee contributions (i.e. contributions that exceed the allowable limitations), however, do not qualify for the estate and gift tax exclusions.

10 Often it is a borderline question whether the professional is an employee or an independent contractor. This question usually arises in the case of a doctor who works part-time at a hospital. Resolution of this problem depends on a careful evaluation of the facts on a case by case basis. The Internal Revenue Service has, however, attempted to give some guidance in borderline instances. See Rev. Rul. 66-274, 1966-2 C.B. 446. See also Hoffman, Achieving employee status for a Section 403(b) tax sheltered annuity, 29 J. Tax. 24 (1968) (fifteen considerations given to determine employee/independent contractor status).
11 ERISA does not prevent employers from discriminating in their selection of employees who are offered section 403(b) annuity plans. For a good summary of ERISA's
institutions that may regard the cost of establishing and administering a qualified retirement plan as prohibitive, section 403(b) annuity plans afford a simple and easy to maintain retirement program that can be offered to all employees.

Basically there are two types of section 403(b) annuity plans, wholly employer funded plans and salary reduction plans. In a wholly employer funded plan the employer pays the employee a nominal salary and, in addition, puts an amount towards the purchase of an annuity for the employee. The total compensation package for the employee equals his nominal salary plus the amount contributed to the annuity; but the employee's salary is viewed as being supplemented by the amount put towards his annuity. Therefore, the employee includes only his nominal salary in his yearly gross income.

By comparison, in a salary reduction plan an employee enters into an agreement with his employer whereby the employee agrees to a reduction in his present salary, or agrees to forego a future increase in salary, and the employer agrees to contribute the corresponding amount towards the purchase of an annuity. The Internal Revenue Service has sanctioned the use of such salary reduction plans by deeming the amounts contributed under such plans to be employer contributions. Such amounts therefore qualify for section 403(b) treatment and are not included in an employee's yearly gross income. The employee's salary, however, is reduced by the amount contributed towards the purchase of his annuity. Therefore, the employee will include in his gross income an amount equal to his salary minus the annuity contribution for that year. Quite frequently, an employee will combine a salary reduction plan with an employer funded plan in order to maximize his opportunity to defer compensation.

The significant difference between a salary reduction plan and an employer funded plan is in the computation of the amount that is included
in an employee's yearly gross income. The effect this difference has upon an employee's yearly contribution limitation is best demonstrated by an examination of the "exclusion allowance" formula.

A. Contribution Limitations Before ERISA:
The "Exclusion Allowance"

Before the Technical Amendments Act of 1958\(^\text{13}\) there was no limitation on the yearly amount that could be tax deferred and put towards a tax sheltered annuity. Prior to then, it was possible for an employee of a qualified organization to have his entire yearly compensation placed into such an annuity. In 1958 Congress became aware that certain qualified organizations were paying selected part-time employees all, or almost all, of their compensation in the form of contributions to tax sheltered annuities.\(^\text{14}\) To curb what Congress viewed as an abuse of tax sheltered annuities, Congress added section 403(b) to the Internal Revenue Code as part of the Technical Amendments Act of 1958.\(^\text{15}\) Section 403(b) introduced the "exclusion allowance,"\(^\text{16}\) which places a limitation upon the tax deferred amount that can be contributed into an employee's annuity per year. An employee's exclusion allowance is determined by multiplying twenty percent of his "includible compensation" by the number of "years of service" to his employer. The product is then reduced by the amount of employer contributions to the employee's annuity that were excluded from the employee's income in prior years.\(^\text{17}\) The computation of the exclusion allowance is best demonstrated by the following formula:

\[
E = \text{exclusion allowance} \\
I = \text{includible compensation} \\
Y = \text{years of service} \\
A = \text{employer's prior contributions} \\
(20\% I \cdot Y) - A = E
\]

Section 403(b) and the regulations promulgated thereunder define all the formula's components. "Includible compensation" means the amount received from a qualified employer which is included in the employee's gross income in the year for which the exclusion allowance is being computed.\(^\text{18}\) "Includible compensation" does not, therefore, contain any amount contributed by the employer for the employee's an-


\(^{16}\) I.R.C. § 403(b)(2).

\(^{17}\) Id.

\(^{18}\) I.R.C. § 403(b)(3); Treas. Reg. § 1.403(b)-1(e), -1(g) (1966). When determining includible compensation, gross income is computed without regard to I.R.C. § 105(d) (wage continuation plans) and I.R.C. § 911 (income earned in foreign countries).
nuity;\textsuperscript{19} nor does it contain any compensation paid to the employee by other employers. The factors considered in the sometimes complicated “years of service” determination are treated thoroughly in the regulations.\textsuperscript{20} To summarize, one year of service is counted for each year an employee was employed full time, and the fractions of years that part-time employees work are added together to determine total years of service.\textsuperscript{21} Also, when computing the exclusion allowance for a given year, that given year’s service is included when determining “years of service.” As for the aggregate of the employer’s contributions that were excluded from the employee’s gross income in prior years, although the statute refers only to amounts contributed by the employer for annuity contracts,\textsuperscript{22} the Internal Revenue Service has taken the position that any amounts contributed by the employer to any plan for the employee must be used to reduce the exclusion allowance.\textsuperscript{23}

The policy reasons behind the exclusion allowance formula are easy to discern. Congress wanted to limit the amount that could be put into a tax sheltered annuity in a given year. To have imposed a flat twenty percent exclusion allowance, however, would have disadvantaged long-time employees who had not taken full advantage of these annuities earlier in their employment. Congress recognized that many of the employees to whom these annuities were available (part-time professionals aside) had patterns of low income during their early years of employment. Only in later years, when their incomes had increased considerably, could these employees afford to put substantial amounts of current income away for retirement. To provide for these employees, Congress added the “years of service” calculation to the exclusion allowance formula.\textsuperscript{24} This allows a long-time employee who has had relatively low contributions in prior years to put in substantial amounts during the later years of his employment. This process is called “backloading.” But since the exclusion allowance is reduced each year by the past years’ contributions, “backloading” can only be done successfully for a few years. Eventually the prior contributions will substantially reduce the employee’s exclusion allowance.\textsuperscript{25}

B. Illustrations: The Mechanics of the “Exclusion Allowance”

Two employees will be used in the following discussion to illustrate how the exclusion allowance is computed. One is a professor at a state

\textsuperscript{19} If the employer’s contribution exceeds an employee’s exclusion allowance, even though the employee must include the excess contribution in his gross income, that amount is not included in the employee’s “includible compensation” because section 403(b)(3) specifically excludes such amounts. Treas. Reg. § 1.403(b)-1(e)(2) (1966).

\textsuperscript{20} I.R.C. § 403(b)(4); Treas. Reg. § 1.403(b)-1(f), -1(g) (1966).

\textsuperscript{21} At no time, however, may years of service ever be less than one. An employee who has worked less than one year will still be deemed to have one year of service for the computation of his exclusion allowance. Treas. Reg. § 1.403(b)-1(f)(6) (1966).

\textsuperscript{22} I.R.C. § 403(b)(2)(A)(i).


\textsuperscript{24} See note 14 supra.

\textsuperscript{25} See Rev. Rul. 70-243, 1970-1 C.B. 107 (computation illustrates how excessive backloading could reduce an employee’s exclusion allowance to zero).
educational institution who participates in an employer funded annuity plan; the other is a doctor employed part-time at a hospital (which qualifies as a section 501(c)(3) organization) where she participates in a salary reduction annuity plan.\textsuperscript{26}

1. The Professor's Employer Funded Plan

By the end of 1977 the professor will have 15 years of service with his employer. He has had an employer funded annuity with his employer since he began work, but in the past has managed to put only $14,000 into his annuity. His salary for 1977 will be $30,000. Using the formula set out in section 403(b)(2), the professor's exclusion allowance for 1977 is a hefty $76,000.

\[
(20\% \cdot Y) - A = E \\
(20\% \cdot 30,000 \cdot 15) - 14,000 = 76,000
\]

To illustrate how excessive backloading would eventually exhaust the professor's high exclusion allowance, assume an unlikely situation. Assume the professor's employer was willing to put $20,000 a year into the professor's employer funded annuity in addition to paying him his current salary. Assume further that the professor's salary remained $30,000 a year for the next five years. By 1981 the professor's exclusion allowance would be $20,000 \([(20\% \cdot 30,000 \cdot 19) - 94,000 = 20,000]\). His exclusion allowance would just cover his employer's yearly $20,000 contribution so that all that year's contribution would escape tax in 1981. By 1982, however, the professor's exclusion allowance would be $6,000 \([(20\% \cdot 30,000 \cdot 20) - 114,000 = 6,000]\) and $14,000 of his employer's yearly contribution (the excess of the $20,000 contribution over the exclusion allowance for 1982) would have to be included in his gross income for 1982.

2. The Doctor's Salary Reduction Plan

By the end of 1977 the doctor will have 15 years of service with the hospital.\textsuperscript{27} She has had a salary reduction annuity plan with the hospital since she began work, and in the past had chosen to put only $14,000 into her annuity. Her salary from the hospital for 1977 will be $30,000. Because an employer funded plan and a salary reduction plan differ in their respective determinations of "includible compensation," the computation of the doctor's exclusion allowance is not as straightforward as that of the professor's in the earlier example. Even though section 403(b) treats contributions made pursuant to a salary

\textsuperscript{26} It should be kept in mind that these two examples are only concerned with the "exclusion allowance." They assume that the exclusion allowance is the only contribution limitation in effect for section 403(b) annuities. See notes 81-110 infra and accompanying text for a discussion of the present contribution limitations.

\textsuperscript{27} Although it is immaterial for purposes of this illustration, a part-time employee would have to work considerably more than fifteen years in order to gain fifteen years of service. See Treas. Reg. § 1.403(b)-1(f), -1(g) (1966).
reduction plan as employer contributions,\(^2^8\) technically the doctor has made the annuity contributions out of her own salary, thereby reducing her salary by the amount of her annuity contribution. This reduction from the doctor’s salary that goes toward the purchase of an annuity cannot be included in the “includible compensation” ingredient of her exclusion allowance formula.\(^2^9\) The doctor’s nominal salary, therefore, is not her “includible compensation” for purposes of section 403(b). Under a salary reduction plan, her nominal salary \textit{minus} her annuity contribution equals her “includible compensation.”

To illustrate, assume the doctor has a salary reduction agreement with her employer that calls for a $1,000 annuity contribution for 1977. Using the formula set out in section 403(b)(2), her exclusion allowance for 1977 is $73,000.

\[
I \text{ (includible compensation)} = \$29,000 \text{ (salary - 1977 annuity contribution)} \\
(20\% \cdot Y) - A = E \\
(20\% \cdot \$29,000 \cdot 15) - \$14,000 = \$73,000
\]

The doctor has had quite low contributions to her annuity in prior years: she would therefore be allowed to “backload” her annuity as the professor had in the earlier example. In fact, she probably has an even greater incentive to backload. Her hospital employment is only part-time, so presumably she has other income that would enable her to take a large cut in her hospital salary. Also, her high tax bracket would make a substantial tax deferral especially appealing. Since salary reduction agreements can be renegotiated every year,\(^3^1\) the doctor would want to know the maximum amount she could contribute tax-free into her annuity in 1977 so she could renegotiate her salary reduction agreement accordingly. The formula set out in section 403(b)(2), however, cannot be used to calculate the doctor’s 1977 maximum exclusion allowance. In order to use the section 403(b)(2) formula, the doctor’s “includible compensation” for 1977 must be known, and her 1977 “includible compensation” will be known only when she is able to determine the amount by which her salary will be reduced. A mathematical equivalent of the section 403(b)(2) formula must therefore be used to determine the doctor’s maximum allowable exclusion allowance for 1977. This substitute formula is not nearly as complicated as it might first appear:

\[^{2^8}\text{Treas. Reg. § 1.403(b)-1(b)(3) (1966); see note 12 supra and accompanying text.}\]

\[^{2^9}\text{I.R.C. § 403(b)(3) (last sentence).}\]

\[^{3^0}\text{Since the “exclusion allowance” decreases proportionately with “includible compensation” (and “includible compensation” equals salary minus the annuity contribution), the higher the doctor’s 1977 annuity contribution is, the lower her 1977 “exclusion allowance” will be. Because of this inverse relationship there is a point at which the doctor’s 1977 annuity contribution will equal her exclusion allowance. That point is $19,000. This is the largest amount the doctor could contribute to her annuity in 1977 and still stay within her exclusion allowance. For an explanation of how that point can easily be computed see note 33 infra and accompanying text.}\]

\[^{3^1}\text{Treas. Reg. § 1.403(b)-1(b)(3) (1966); see note 12 supra.}\]
E = exclusion allowance  
I = includible compensation  
Y = years of service  
S = salary  
A = employer contributions in prior years

(Since the regulations deem employee contributions made under a salary reduction plan to be employer contributions, by definition, A equals prior employer contributions plus prior employee contributions)

\[
\frac{(Y \cdot S) - [5 \cdot A]}{Y+5} = E^{33}
\]

\[
\frac{(15 \cdot $30,000) - [5 \cdot $14,000]}{15+5} = $19,000
\]

Now that the doctor's salary reduction for 1977 ($19,000) is known, her includible compensation is ascertainable ($11,000), and the section 403(b)(2) formula can be worked as a check on the accuracy of the substitute formula's computation of the exclusion allowance:

\[
(20\% \cdot I \cdot Y) - A = E
\]

\[
(20\% \cdot $11,000 \cdot 15) - $14,000 = $19,000
\]

One final example should serve to complete the illustration of the computation of the exclusion allowance when a salary reduction plan

---


33 When a salary reduction plan is in effect and the employee wishes to determine the maximum allowable annuity contribution, "includible compensation" (I) equals salary (S) minus the maximum allowable annuity contribution (which in this case would be the "exclusion allowance" (E)). I = S - E. By substituting S - E for I in the exclusion allowance formula, therefore, a substitute formula can be derived:

\[
(\cdot20 \cdot Y) - A = E
\]

\[
[15 \cdot (S - E)] \cdot Y - A = E
\]

\[
[.20S - .20E] \cdot Y - A = E
\]

\[
[.20SY - .20EY] - A = E
\]

\[
[SY - EY] - 5A = 5E
\]

\[
[SY - EY] - 5E = 5A
\]

\[
SY - [EY + 5E] = 5A
\]

\[
SY - EY + 5 = 5A
\]

\[
SY - 5A = E[Y + 5]
\]

\[
SY - 5A = E
\]

\[
\frac{SY}{Y+5} = E
\]

This formula is just one of many possible alternatives to the section 403(b)(2) formula that can be derived through algebraic manipulation. No particular one has ever been adopted by the Internal Revenue Service.

Variations based upon the section 403(b)(2) formula can be very useful. For example, prior to ERISA, an employer could determine how much of the total compensation available to compensate an employee might be deferred in that employee's first year of service. The formula was one-sixth of the total compensation available, derived by substituting total compensation available for salary (S) in the formula set out in the text.

Some of the most helpful variations of the section 403(b)(2) formula were those used to afford employees the full benefit of the tax deferrals then available to them. These formulae were used to calculate the maximum level annual premium that could be contributed by an employee until his retirement, thereby providing uniform tax deferral for each year until retirement. For a sampling of some of these formulae see Green, Tax-sheltered annuities: an analysis of the new final regs and the tax-savings potential, 22 J. TAX. 142, 144-45 (1965); Hinckley, Annuities for Employees of Religious, Educational
is in effect. Assume the doctor in the previous example had both an employer funded and a salary reduction annuity plan in existence prior to 1977. Assume further that in addition to the $14,000 that had been contributed to her annuity pursuant to her salary reduction plan, $14,000 had also been contributed by her employer pursuant to an employer funded annuity plan. Using the same substitute formula as before her maximum allowable exclusion allowance for 1977 would be $15,500.

(recall that A = employer contributions, + employee contributions)\(^{34}\)

\[
\frac{(Y \cdot S) - [5 \cdot A]}{Y + 5} = E
\]

\[
\frac{(15 \cdot $30,000) - [5 \cdot ($14,000 + $14,000)]}{15 + 5} = $15,500
\]

Much to the disappointment of any number-shy taxpayers and attorneys who have to work with the exclusion allowance, ERISA did not do away with it. In fact, much to their dismay, ERISA superimposed its own complex contribution limitations upon section 403(b)'s exclusion allowance. After ERISA, the exclusion allowance is just one of three possible limitations normally placed upon yearly contributions to section 403(b) annuities.

II. SECTION 403(b) ANNUITIES AFTER ERISA

In general, ERISA divided qualified retirement plans into two broad sub-categories — defined benefit plans\(^ {35}\) and defined contribution plans.\(^ {36}\) These two categories of plans have separate contribution limitations that are set out in I.R.C. § 415.\(^ {37}\) This wonderfully complex section was added to the Internal Revenue Code by ERISA. It reflects Congress' belief that it is against the public interest to allow highly paid individuals to make extremely large yearly contributions to their qualified plans. Congress not only felt it was inappropriate to allow individuals to finance extremely large benefits at public expense through the use of special tax treatment, but also, that it was discriminatory to

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\(^{34}\) See text at note 32 supra.

\(^{35}\) In its pure form a defined benefit plan is a classic pension plan. In a defined benefit plan distributions are determined by means other than the amount in the individual's account. Usually the amount is determined by reference to length of service or the level of pre-retirement pay. Once the benefit is determined, contributions to provide this benefit are computed and made by the employer over the service years of the employee.

\(^{36}\) In its pure form a defined contribution plan is a classic profit sharing plan. In a defined contribution plan each participant has a separate account maintained in his own name. The amount available for ultimate distribution is strictly determined by the amount in this individual account.

\(^{37}\) I.R.C. § 415(b) (defined benefit plan limitations); I.R.C. § 415(c) (defined contribution plan limitations).

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restrict the contributions of the self-employed and not restrict those of the highly-paid employees under qualified plans.

A. The Contribution Limitations of Section 415(c)

For limitation purposes, ERISA classified section 403(b) annuity plans as defined contribution plans and subjected them to the contribution limitations of section 415(c)(1). Section 415(c)(1) limits yearly contributions to defined contribution plans to the lesser of $25,000 or twenty-five percent of a participant’s compensation for that year. This is not to imply that the limitation found in section 403(b)(2), the exclusion allowance, has been done away with. Both the section 403(b)(2) limitation and the section 415(c)(1) limitation apply to section 403(b) annuity plans. A given year’s contribution to a tax sheltered annuity cannot exceed either of these limitations. An annuitant’s yearly contribution therefore must equal the lesser of the two following limitations:

1. the exclusion allowance or
2. the lesser of (A) $25,000 or (B) 25% of compensation

A brief illustration, using the two examples employed earlier, should demonstrate the operation of these post-ERISA limitations.

1. Employer-Funded

The university professor had a $30,000 salary and a $76,000 exclusion allowance in 1977. Since the professor has an employer-funded plan his compensation (for purposes of section 415(c)(1)) is the same as his salary, $30,000. His contribution limitation for 1977, therefore, would be $7,500 — the lesser of the two following limitations:

1. $76,000 (exclusion allowance)
2. the lesser of: (A) $25,000 or (B) $7,500 (25% of $30,000)

38 Even prior to ERISA, contributions to H.R. 10 (or Keogh) plans had a yearly limitation of only $2,500 (or 10% of income). ERISA raised that limitation to $7,500 (or 15% of income). I.R.C. § 404(e)(1).


41 This $25,000 limitation is subject to an annual cost of living adjustment. I.R.C. § 415(d). For example, this limitation has been adjusted to $28,825 for 1976. Temp. Treas. Reg. § 11.415(c)(4)-1(c)(1) (1976). For the remainder of this Comment, however, the $25,000 figure will be used to avoid confusion.

42 I.R.C. § 415(c)(1)(A)-(B).

43 See note 40 supra.

2. **Salary Reduction**

The doctor had a $30,000 salary and a $19,000 exclusion allowance in 1976. Since the doctor has a salary reduction plan, her compensation (for purposes of section 415(c)(1)) is not the same as her salary. Her 1977 compensation will equal her salary minus her 1977 annuity contribution. Compensation, therefore, cannot be determined until the contribution is known. Consequently, when a salary reduction plan is in effect and the employee wishes to contribute the maximum allowable amount, an algebraically derived alternative for twenty-five per cent of compensation must be used to determine the second of the two limitations contained in section 415(c)(1). Using this alternative (twenty per cent of salary), the doctor’s 1977 contribution limitation would be $6,000, the lesser of the two following limitations:

(1) $19,000 (exclusion allowance)
(2) lesser of: (A) $25,000 or (B) $6,000 (20% of $30,000)

**B. Special “Elections” for Special Employees**

While ERISA did put a general $25,000 ceiling on yearly contributions to section 403(b) annuities, certain employees are allowed to exceed this limit under the “catch-up” provisions found in section 415(c)(4). Like the eighty-fifth Congress before it, the ninety-third Congress recognized that certain employees have a pattern of low annuity contributions in the early stages of their careers (due to low current income), and that late in their careers they make relatively high contributions to their annuities in order to “catch-up” on the retirement benefits the law affords them. Recognition of this low early contribution pattern prompted the eighty-fifth Congress to add the “years of service” component to the exclusion allowance formula, thereby enabling long-time employees to “backload” their annuities. Recognition of this pattern by

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45 See note 44 supra.

46 When a salary reduction plan is in effect and the employee wishes to determine the maximum allowable annuity contribution, “participant’s compensation” (C) equals salary (S) minus the maximum allowable annuity contribution (A). (C = S - A). The maximum allowable annuity contribution under the section 415(c)(1)(B) limitation equals 25% of C. By substituting S - A for C in the section 415(c)(1)(B) limitation, a substitute limitation can be derived:

\[
\begin{align*}
A &= .25C \\
A &= .25(S-A) \\
4A &= S-A \\
5A &= S \\
A &= \frac{S}{5} \\
A &= .20S
\end{align*}
\]

47 As the preceding section explained, the yearly contribution limitation for a section 403(b) annuity would be the lesser of (1) the exclusion allowance, (2) $25,000, or (3) 25% of compensation. Absent the special elections therefore, an annuity contribution could never exceed the fixed dollar limitation of $25,000. But see note 41 supra.


49 See note 14 supra.
the ninety-third Congress resulted in the addition of section 415(c)(4)’s “catch-up” provisions for certain section 403(b) annuitants. “Catch-up,” therefore, is basically ERISA’s version of “backloading.”

Unlike the section 403(b)(2) “backloading,” “catch-up” is not available to all employees who have section 403(b) annuities. Section 415(c)(4) allows only employees of educational institutions,50 hospitals, and home health service institutions51 to “catch-up” in their annuity contributions. Those employees who qualify for “catch-up” are permitted to elect one of three alternative methods for determining their annuity contribution limitation.52 The three alternatives are set out in section 415(c)(4)(A) through (C) and, conveniently enough, are referred to as the “A, B, and C election limitations.”

1. “A Election Limitation”

The “A election” is only available to an employee in the year he separates from an employer’s service. This is a once-in-a-lifetime election; if an employee chooses it he can never make another election under section 415(c)(4).53 Since an employee can only elect to have “A” apply once, in all other years he must compute his contribution limitation like an employee who does not qualify for the special elections. In other words, except in the year of the “A” election, his limitation would always be the lesser of (1) the exclusion allowance, or (2) the section 415(c)(1) limits of $25,000 or twenty-five percent of compensation.

The “A election” is not really an alternative to the normal computation of an annuitant’s contribution limitation; it is only a substitute for the “twenty-five percent of compensation” limitation contained in section 415(c)(1)(B).54 Conceptually then, in the year an employee utilizes the “A election” his contribution limitation is the lesser of the two following limitations:

(1) the exclusion allowance  
(2) the lesser of: (A) $25,000 or  
(B) the “A election limitation”

In order to determine the “A election limitation” for any given year, an employee computes his exclusion allowance for that year with one alteration: his “years of service” calculation cannot exceed ten for pur-

50 As defined in I.R.C. § 151(e)(4).
51 I.R.C. § 415(c)(4)(D)(iii) defines a home health service agency as “an organization described in subsection 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health, Education, and Welfare to be a home health agency (as defined in section 1861(o) of the Social Security Act).” The current version of section 1861(o) of the Social Security Act is 42 U.S.C. § 1395(x)(o) (1970). Temp. Treas. Reg. § 11.415(c)(4) (1976).
poses of computing the "A election" regardless of the actual number of his years of service.55

2. "B Election Limitation"

The "B election" can be made in any year, but once an employee chooses this election he is wedded to it. In all years thereafter the employee has only two choices: he may determine his limitation as if he were an employee who did not qualify for the elections, or elect to have the "B election limitation" apply.56

Like the "A election limitation," the "B election limitation" is not actually an alternative to the normal contribution limitations. The "B election" is also a substitute for the "twenty-five percent of compensation" limitation contained in section 415(c)(1)(B).57 The contribution limitation in the year the "B election" is utilized is the lesser of the following two limitations:

(1) the exclusion allowance
(2) the lesser of: (A) $25,000 or
(B) the lesser of:
   (i) $4,000 + 25% of "includible compensation" [as defined in section 403(b)(3)]58 or
   (ii) the exclusion allowance or
   (iii) $15,00059


If the professor separates from the service of his employer and chooses the "A election," his 1977 contribution limitation equals $25,000, the lesser of the two following limitations:

(1) $76,000 (exclusion allowance)
(2) lesser of: (A) $25,000 or
(B) $46,000 (exclusion allowance formula computed with "years of service" at ten)

If the doctor separates from the service of her employer and chooses the "A election," her 1977 contribution limitation equals $8,000, the lesser of the two following limitations:

(1) $19,000 (exclusion allowance)
(2) lesser of: (A) $25,000 or
(B) $8,000 (exclusion allowance formula computed with "years of service" at ten)

58 See text accompanying notes 66-80 infra for the potential problems caused by the use of the term "includible compensation."

If the professor chooses the "B election" his 1977 contribution limitation equals $11,500, the lesser of the two following limitations:

(1) $76,000 (exclusion allowance)
(2) lesser of: (A) $25,000 or
(B) lesser of:
   (i) $11,500 ($4,000 + 25% of "includible compensation"), or

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The computation of the "B election" is a study in redundancy. Having a $25,000 ceiling when a $15,000 ceiling is already in effect is bad enough, but why must the exclusion allowance appear twice? Despite the comic effect, the Code and the temporary regulations make it clear that this is how an employee's contribution limitation is to be determined when the "B election" is made.60

3. "C Election Limitation"

The "C election" can be made in any year, but like the "B election," once an employee chooses the "C election" he is stuck with it. In any subsequent year that he wishes not to have the normal limitations apply, the only election that will be available to him is the "C election."61

The "C election limitation" is not an alternative to the normal contribution limitations either. The "C election limitation" is a complete substitute for the exclusion allowance limitation of section 403(b).62

Regretably, it appears that the computation of the "C election limitation" is another lesson in redundancy. Rather than follow the language of the Code and maintain that the exclusion allowance limitation does not apply to those employees who elect the "C election limitation,"63 the Internal Revenue Service is instructing that the limitations of section 415(c)(1) may be put in place of the exclusion allowance limitation.64 According to the Service's view therefore, a "C election" requires an employee to take the lesser of the two following limitations:

(1) lesser of: (A) $25,000 or
   (B) 25% of participant's compensation

(2) lesser of: (A) $25,000 or
   (B) 25% of participant's compensation65

   (ii) $76,000 (exclusion allowance), or
   (iii) $15,000

If the doctor chooses the "B election" her 1977 contribution limitation equals $9,200, the lesser of the two following limitations:

(1) $19,000 (exclusion allowance)
(2) lesser of: (A) $25,000 or
   (B) lesser of:
      (i) $9,200 ($4,000 + 25% of "includible compensation"), or
      (ii) $19,000 (exclusion allowance), or
      (iii) $15,000

63 I.R.C. § 415(c)(4)(C).
65 For an illustration of the computation of the "C election limitation," let us examine the two examples used earlier in the text.

If the professor chooses the "C election" his 1977 contribution limitation equals $7,500, the lesser of the two following limitations:

(1) lesser of: (A) $25,000 or
   (B) $7,500 (25% of participant's compensation)

(2) lesser of: (A) $25,000 or
   (B) $7,500 (25% of participant's compensation)
Although the redundancy inherent in both the "B" and "C" elections is painless to work with, one wonders what prompts its intrusion into an already complex section of the Code.

C. Computation Problems with Salary Reductions Plans

The major criticism of the post-ERISA contribution limitations for section 403(b)(3) annuities is that on their face they do not provide any guidance for those who contribute to their annuities under salary reduction agreements. When taxpayers who have salary reduction annuity plans compute their yearly contribution limitations, they must formulate substitute limitations that are the equivalent of the limitations contained in the Code. Neither Congress nor the Internal Revenue Service offers any guidance on which is the correct substitute. These substitutions are necessitated by the Code's use of such terms as "participant's compensation" and "includible compensation."

"Includible compensation" and "participant's compensation" both appear as components of the various possible contribution limitations for section 403(b) annuities. "Participant's compensation" is the determinant of the second general limitation that ERISA has imposed upon section 403(b) annuities, the section 415(c)(1)(B) limitation of "twenty-five percent of participant's compensation." "Includible compensation" figures in both the exclusion allowance formula and the calculation of the "B election limitation."

For purposes of computing the section 403(b) annuity contribution limitations, "includible compensation" cannot be distinguished from "participant's compensation." Includible compensation is defined in section 403(b)(3) as the amount received from an employer which is includible in the employee's gross income. By definition, the term cannot include any amount contributed by the employer towards a section 403(b) annuity. "Participant's compensation" is defined in section 415(c)(3) as the compensation received by the participant from the employer for the year. Both Congress and the Internal Revenue Service, however, have made it clear that "participant's compensation" does not include amounts contributed toward the purchase of a section 403(b) annuity.

Determining "includible compensation" or "participant's compensation" never poses a problem when an employee has an employer funded

If the doctor chooses the "C election" her 1977 contribution equals $6,000, the lesser of the two following limitations:

(1) lesser of (A) $25,000 or
    (B) $6,000 (25% of participant's compensation)
(2) lesser of (A) $25,000 or
    (B) $6,000 (25% of participant's compensation)

66 I.R.C. § 403(b)(2) ((20% "includible compensation" times "years of service") minus "prior contributions").
67 I.R.C. § 415(c)(4)(B)(i) ($4,000 + 25% of "includible compensation").
68 I.R.C. § 403(b)(3); see notes 18-19 supra and accompanying text.
69 See note 68 supra.
70 See note 43 supra.
annuity plan. Under an employer funded plan the annuity is viewed as a supplement to the employee’s salary; therefore “includible compensation” and “participant’s compensation” will always equal an employee’s salary when an employer funded plan is in effect. The size of the contributions to an employer funded annuity never affect an employee’s “includible compensation” or his “participant’s compensation.”

Determining “includible compensation” and “participant’s compensation” when an employee has a salary reduction plan is not so straightforward. When a salary reduction plan is in effect, both of these terms can only be determined by subtracting the employee’s annuity contribution for that year from his salary for that year. Therefore, an employee who has a salary reduction plan will only know what his “includible compensation” and “participant’s compensation” are when he knows how much his annuity contribution will be for that year. And an employee who wants to reduce his salary by the maximum amount allowable will not know the amount of his allowable annuity contribution until he has computed his contribution limitations (a computation which requires “includible compensation” and “participant’s compensation” to be known). This problem of circularity that arises when an employee attempts to calculate the maximum allowable contribution to a section 403(b) salary reduction plan is resolvable only by employing substitutes for the contribution limitations that use the terms “includible compensation” and “participant’s compensation.”

A substitution for the section 415(c)(1)(B) limitation (twenty-five percent of “participant’s compensation”) was used earlier in this Comment in the doctor’s example. Based on the premise that “participant’s compensation” equals salary minus the annuity contribution ($C=S-A$), twenty percent of salary was derived as a substitution for twenty-five percent of “participant’s compensation.” To illustrate the use of this substitute, return for a moment to the doctor’s example.

If the doctor made no election in 1977 her contribution limitation would be the lesser of the following two:

1. $19,000 (exclusion allowance)
2. lesser of:
   1. $25,000 or
   2. $6,000 (20% of salary)

So long as the section 415(c)(1)(B) limitation ($6,000) is the lowest contribution limitation, $6,000 will be the doctor’s 1977 annuity contribution if she contributes the maximum allowable amount. Her “participant’s compensation” would therefore equal $24,000 ($24,000(C) =

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71 See discussion in text before note 12 supra for the distinction between employer funded plans and salary reduction plans and their respective computations of “includible income.”

72 See note 46 supra.

73 See text at note 46 supra.

74 The exclusion allowance limitation contains the term “includible compensation,” so a substitute limitation must be employed; in order to simplify the discussion in the text, the substitute for the exclusion allowance limitation will be discussed later. See text at notes 75-80 infra.
$30,000(S) - $6,000(A)] and twenty-five percent of "participant's compensation" would equal twenty percent of salary, proving that the substitution used was valid. But what happens if the section 415(c)(1)(B) limitation is not the lowest of the doctor's contribution limitations?

Assume in the example immediately above, the doctor's exclusion allowance was $5,000 instead of $19,000. Since the exclusion allowance limitation would then be the lowest contribution limitation, $5,000 would be the doctor's maximum allowable annuity contribution and her "participant's compensation" for 1977 would be $25,000 [$25,000(C) = $30,000(S) - $5,000(A)]. Technically, then, the substitution used for the section 415(c)(1)(B) limitation would be invalid if the doctor were to contribute $5,000 in 1977, because twenty percent of her salary ($6,000) would no longer equal twenty-five percent of "participant's compensation" (twenty-five percent of $25,000(C) = $6,250). It might seem that the substitution employed should be disregarded and a new computation of the section 415(c)(1)(B) limitation undertaken using $25,000 as "participant's compensation." Such a re-computation, however, is wholly unnecessary. Any re-computation of the section 415(c)(1)(B) limitation in such instances will always result in a limitation that is higher than the original section 415(c)(1)(B) limitation. This means that the re-computation is futile because a limitation lower than the original section 415(c)(1)(B) limitation exists even before the recomputation is made.

For example, in the doctor's case the substitute (twenty percent of salary) was employed to compute the doctor's original section 415(c)(1)(B) limitation of $6,000. This original computation assumed that the doctor's "participant's compensation" was $24,000; however, since her lowest limitation turned out to be $5,000, her "participant's compensation" in fact became $25,000. If the computation employing the substitute had to be disregarded and the section 415(c)(1)(B) limitation were required to be re-computed using $25,000 instead of $24,000 as "participant's compensation," $6,250 (twenty-five percent of $25,000) would technically become the new section 415(c)(1)(B) limitation. This would not, however, change the doctor's 1977 annuity contribution limitation. The $5,000 exclusion allowance would remain the lowest of her contribution limitations even after the re-computation of her section 415(c)(1)(B) limitation. A re-computation of the doctor's section 415(c)(1)(B) limitation, therefore, need never be made if there is already another contribution limitation below it. Therefore, when an employee wishes to contribute the maximum allowable amount under a salary reduction plan like the doctor's, the section 415(c)(1)(B) limitation need only be calculated once, even if a substitute for that limitation is employed.

The way in which substitutes are used for the limitations that contain the term "includible compensation" is best understood by examining the "B election limitation." It will be recalled that the "B election" requires an employee to take the lesser of the following limitations:

\[
\text{(1) the exclusion allowance } [(20\% \cdot Y) - A]^{75} \text{ or }
\]

---

75 See note 66 supra.
(2) the lesser of:  
(A) $25,000 or 
(B) the lesser of:  
(i) (25% · I) + $4,000 or 
(ii) the exclusion allowance, or 
(iii) $15,000

As can be seen, “includible compensation” (I) is a component of two of the above limitations, so both of these limitations will require substitutes if an employee wishes to compute his maximum allowable contribution under a salary reduction annuity plan.

A substitute for the exclusion allowance formula was explained earlier in this Comment in the doctor’s example,76 and can readily be employed here. A substitute for the section 415(c)(4)(B)(i) limitation [(25% · I) + $4,000] is also ascertainable.77 Using these two substitutes, the doctor’s contribution limitation now becomes the lower of the following two:

(1) \[
\frac{(Y \cdot S) - (5 \cdot A)}{Y + 5}
\]

or

(2) the lesser of:  
(A) $25,000 or 
(B) the lesser of:  
(i) (20% · S) + $3,200 or 
(ii) \[
\frac{(Y \cdot S) - (5 \cdot A)}{Y + 5}
\] or 
(iii) $15,000

The doctor’s 1977 exclusion allowance was computed earlier using the first substitute set out above. Using this substitute, her exclusion allowance equaled $19,000. This substitution, however, is technically valid only as long as it equals the section 403(b)(2) formula; and this substitution will equal the section 403(b)(2) formula only as long as $11,000 is the doctor’s “includible compensation.” [(20% · Y) - A = EA; (20% · $11,000 · 15) - $14,000 = $19,000]. Since “includible compensation” (I) equals salary (S) minus the annuity contribution (A) [(I = S - A)], this substitution will be technically valid only when the 1977 annuity contribution equals the exclusion allowance limitation of $19,000.

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76 See discussion in text accompanying notes 32-34 supra.

77 When a salary reduction plan is in effect and the employee wishes to determine his maximum allowable annuity contribution, “includible compensation” (I) equals salary (S) minus the maximum allowable annuity contribution (A). (I = S - A). The maximum allowable annuity contribution under the section 415(c)(4)(B)(i) limitation equals (25% · I) + $4,000. By substituting S-A for I in the section 415(c)(4)(B)(i) limitation, a substitute limitation can easily be derived:

\[
A = (25% \cdot I) + $4,000
\]

\[
A = 25% \cdot (S-A) + $4,000
\]

\[
4A = S-A + $16,000
\]

\[
5A = S + $16,000
\]

\[
A = \frac{S}{5} + $3,200
\]

78 It must be remembered that A in this substitute equals “prior employer contributions” but in notes 46 and 77 A equals the “maximum annuity contribution.”
This should sound familiar; it is the same situation that presented itself when a substitution was employed for "participant's compensation." Technically, the substitution for the exclusion allowance limitation would have to be disregarded and the exclusion allowance limitation re-computed when the annuity contribution differs from the original exclusion allowance contribution. Such a re-computation, however, is just as unnecessary in this instance as it was in the earlier situation involving the section 415(c)(1)(B) limitation (twenty-five percent of "participant's compensation"). If the annuity contribution differs from the exclusion allowance limitation, it will be because another of the "B election" contribution limitations is lower than the exclusion allowance limitation. Therefore, any re-computation of the exclusion allowance would be based upon a higher "includible compensation," and would necessarily result in an exclusion allowance limitation that is even higher than the exclusion allowance limitation originally computed. The exclusion allowance limitation, therefore, can be properly computed by employing this substitute. The fact that technically it may be potentially invalid is irrelevant.

Turning to the substitute this Comment suggests for the \((25\% \cdot I) + \$4,000\) limitation contained in section 415(c)(4)(B)(i), all of the same problems involving the technical invalidity of a substitute limitation are again present. And for the same reason that the substitutes for the section 415(c)(1)(B) limitation and the exclusion allowance limitation were appropriate, the substitute for the section 415(c)(4)(B)(i) limitation is also proper despite the apparent technical invalidity. As with all the substitute limitations this Comment has suggested, if the substitute for the section 415(c)(4)(B)(i) limitation becomes technically invalid, its invalidity will have no affect upon the determination of the employee's maximum allowable annuity contribution.

Regrettably, the potential for confusion regarding all these substitutions is great because of the present lack of guidance from the Internal Revenue Service. The IRS has yet to give consideration to the complex computations regarding maximum allowable annuity contributions when salary reduction plans are in effect. The only regulations the IRS has promulgated under section 415 demonstrate the computation of the contribution limitations using only employer funded plans as examples. This reluctance on the part of the IRS to provide guidance to employees who hold salary reduction annuity plans is unwise. The majority of taxpayers who have section 403(b) annuities contribute to them either under a salary reduction arrangement alone or under a salary reduction arrangement held in conjunction with an employer funded plan. And while these substitute limitations are not difficult to fashion, it hardly seems efficient to leave their determination to the individual taxpayers.

\[79\text{ See note 77 supra.}\]

\[80\text{ Temp. Treas. Reg. \S 11.415(c)(4)-1(c) (1976). In the examples contained in the regulations, "participant's compensation" and "includible compensation" are set at the same amount, which is never the case in a salary reduction plan.}\]
III. THE COMBINATION RULES OF ERISA AND THEIR EFFECT UPON SECTION 403(b) ANNUITY CONTRIBUTION LIMITATIONS

A. ERISA's Combination Rules in Brief

The limitations contained in section 415 cannot be avoided by creating multiple plans for an employee. Section 415 requires an employee to combine the benefits or contributions of all plans held with the same employer, causing the aggregate of those benefits or contributions to be subjected to the applicable section 415 limitations. In general, when two or more plans are held with the same employer, the overall limitations section 415 imposes would be computed by combining similar plans into one. In the case of two dissimilar plans, the computation would reduce the limitation on one type of plan by the benefits or contributions of the other.

The section 415 limitations cannot be avoided by an employer's use of separate corporations either. All "related" corporations, those deemed to be under a common control, are treated as one employer for purposes of applying the section 415 limitations. An employee having separate plans with two or more "related" employers, therefore, would be required to combine all those plans for limitation purposes. The determination of what constitutes common control is made in accordance with I.R.C. § 1563(a) with one important exception: a corporation having "more than fifty percent" of the voting stock of another corporation is considered to be in control of that other corporation. This is a more expansive version of control than the "at least eighty percent of voting stock" test contained in section 1563(a) itself.

As a general rule, there is no requirement that an employee aggregate benefits or contributions when he has separate plans with two or more unrelated employers. Therefore, an employee who has a qualified plan with one employer could contribute the maximum amount allowable into that qualified plan, and also contribute in the same year the maximum allowable amount into another qualified plan, as long as the second plan is held with an "unrelated" employer. An exception to this general rule applies to taxpayers who have individual retirement ac-

81 I.R.C. § 415(f)(1)(A) (all defined benefit plans maintained with an employer are treated as one defined benefit plan); I.R.C. § 415(f)(1)(B) (all defined contribution plans maintained with one employer are treated as one defined contribution plan).

82 This reduction is done in accordance with I.R.C. § 415(e) and is somewhat complicated. Basically, section 415(e) establishes a formula under which a defined benefit fraction (set out in I.R.C. § 415(e)(2)) for the year is added to a defined contribution plan fraction (set out in I.R.C. § 415(e)(3)). If the sum of these fractions for any year exceeds 1.4, one or more of the plans will be disqualified. I.R.C. § 415(e)(1), (g). The order in which the plans will be disqualified in the event the 1.4 limit is exceeded has yet to be determined. See Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. 345 (1974), reprinted in 1974-3 C.B. at 506.


84 Generally speaking, I.R.C. § 1563(a) would consider a corporation having at least eighty percent of the voting stock of another corporation to be in control of that other corporation.

85 I.R.C. § 415(h).
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counts, individual retirement annuities, or retirement bonds. These taxpayers cannot, in the same year, maintain any plan other than one of the three just mentioned.

B. The Uniqueness of Section 403(b) Annuities Attributable to Section 415(e)(5)

Since section 403(b) annuities are treated as defined contribution plans for limitation purposes, they are generally subject to the combination rules set out above. A major exception, however, applies to these annuities. Unlike all other post-ERISA retirement plans, section 403(b) annuities are not required to be combined with other plans an employee holds with the same employer. This singular exception granted section 403(b) annuities is contained in section 415(e)(5).

Section 415(e)(5) deems these annuities to be under the “control” of the employee. For example, when an employee has both a defined contribution plan and a section 403(b) plan with one employer, section 415(e)(5) conceptually creates another employer for the employee by placing the employee in “control” of his annuity. Since the employee is in control, constructively he is his own employer for purposes of the annuity. Provided the employee is not “related” to his employer, he then has two “unrelated” employers — himself and his employer. The general rule that prevents the combination of plans when they are held with two or more unrelated employers would therefore apply to allow the employee to contribute the maximum allowable amount into both his defined contribution plan and his annuity.

Due largely to an apparent misprint in the original section 415(e)(5), this section has been misinterpreted by those who have attempted to explain it. As originally enacted, section 415(e)(5) instructed that it applied only “for purposes of this subsection.” Since the subsection of which section 415(e)(5) is a part contains limitations that apply only when a defined benefit plan and a defined contribution plan are held by the same employee, many commentators maintained that section 403(b) annuities were under the control of an employee only when an employee has both a defined benefit plan and a defined contribution

86 As defined in I.R.C. § 408(a).
87 As defined in I.R.C. § 408(b).
88 As defined in I.R.C. § 409.
89 I.R.C. § 219(b)(2).
90 See note 40 supra.
91 A combination provision that applied to section 403(b) annuities even before ERISA logically requires any employee who has two or more section 403(b) annuities with the same employer to treat them as one annuity for contribution purposes. I.R.C. § 403(b)(5). Combining section 403(b) annuities produces an exclusion allowance that is substantially less than the sum of the individual exclusion allowances of one or more annuities.
92 The “control” label used in I.R.C. § 415(e)(5) is the same as that defined in I.R.C. § 1563(a) as modified by I.R.C. § 415(h).
plan. The Tax Reform Act of 1976 corrected section 415(e)(5) by changing the instruction to "for purposes of this section." It is now beyond doubt that the section 415(e)(5) "control" label applies to all employees who have section 403(b) annuities. And yet, due perhaps to the small nature of the change the 1976 Act made in the wording of section 415(e)(5), some commentators are still maintaining that the section 415(e)(5) control label applies only when a defined benefit plan and a defined contribution plan are in effect. Hopefully, as more commentators become aware of the significance of the 1976 Act's change, the confusion surrounding the operation of section 415(e)(5)’s “control” label will disappear.

1. Illustration of the Operation of the Section 415(e)(5) Control Label

The situations of the two sample employees used as examples throughout this Comment offer a good illustration of the effect section 415(e)(5) has upon the contribution limitations of section 403(b) annuitants. In the professor's case, section 415(e)(5) constructively creates two employers for him — the university and himself. He could therefore take full advantage of the tax-deferral potential of both his annuity and any other qualified plan offered by the university (provided of course he did not “control” the university, which is unlikely). Unsurprisingly, there is a catch. The contributions (or benefits) to the university’s other qualified plan will eventually serve to reduce the professor’s contribution limitation on his section 403(b) annuity. This is due to the exclusion allowance formula. It will be recalled that according to the formula the exclusion allowance is reduced by the amount of the “employer’s prior contributions.” If the professor maintains two plans with the university, even if section 415(e)(5) deems him to be in control of his annuity plan, the amount the university puts into both those plans is included in the “employer’s prior contributions” component of his exclusion allowance formula. The ceiling the exclusion allowance
places on the professor’s annuity contributions, therefore, will be falling very quickly when two plans are in effect. Eventually, if contributions remain high, it will drop well below the professor’s section 415(c)(1) limitation and place a tight restriction on his yearly annuity contributions.100

The other employee used as an example throughout this Comment is a doctor who works part-time at a hospital. The effect the “control label” of section 415(e)(5) has upon her situation will depend upon the relation she has with her full-time employer. If the doctor’s full-time employer is a professional corporation and the doctor exercises no “control”101 over the professional corporation, placing the doctor in “control” of her annuity does not alter her situation. She still has “unrelated” employers, herself (constructively), the professional corporation, and the hospital; she would not be required to combine her annuity with any other plan. She could contribute separately to her annuity plan and to any plan she held with the professional corporation. Also, if the hospital offered a qualified plan in addition to the section 403(b) annuity plan, she could participate in that qualified plan just as the professor could in the example immediately above.

If the doctor does “control” her full-time employer, however, the result would be different. Since she “controls” the professional corporation and is deemed by section 415(e)(5) to be in “control” of her annuity, conceptually she would be her own employer for both her annuity and any plan she held with the professional corporation. The rules governing plans held with the same employer102 would therefore require her to combine her section 403(b) annuity with any plans she held with the professional corporation.103 If the hospital offered a qualified plan in addition to a section 403(b) annuity plan, however, the doctor would not have to combine the additional hospital plan with the section 403(b) plan and the plan held with the professional corporation.

2. The Exception to the Section 415(e)(5) Control Label: The “C Election”

Despite some early confusion caused by a misprint in the only Revenue Ruling on section 415, it is clear that those employees who are eligible for the special elections in section 415(c)(4) will avoid the operation of section 415(e)(5) by choosing the “C election.”104 For

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100 It will be recalled that, given the right circumstances, it is possible for the exclusion allowance to be reduced to zero. See note 25 supra.

101 As defined in I.R.C. § 1563(a) and modified by I.R.C. § 415(h).

102 I.R.C. § 415(e), (f), (g). See notes 81-82 supra.


example, if the professor in the illustration above decided to have the
"C election limitation" apply, section 415(e)(5) would not deem him to
be in "control" of his annuity in that year. He would therefore not
have two employers (himself and the university), but only one (the uni-
versity), and would be required to combine his annuity with other plans
he had with the university when computing his yearly contribution (or
benefit) limitation.105

Creating such an exception to the section 415(e)(5) "control" label
for an employee who chooses the "C election" makes sense. The "C
election" provides a special limitation that is attractive to employees
who have either recently begun their employment or who have high prior
contributions to their annuities. Both of these types of employees will
more likely have exclusion allowances below their section 415(c)(1)
limitations.106 The "C election," which permits employees to disre-
gard the exclusion allowance limitation, enables these employees to
contribute more to their annuities each year.107 The "C election" was
not intended, however, to provide employees like our professor with an
escape from the relatively low annual contribution limitation event-
ually imposed when one employee has two plans in effect with the
same employer.

If the professor were permitted to escape his low exclusion allow-
ance limitation by choosing the "C election," and yet still remain in
"control" of his annuity, he would gain an incredible tax deferral wind-
fall. To illustrate, assume the professor maintained a defined contribu-
tion plan with the university in addition to his annuity. As was pointed
outside, absent any special elections, making contributions to both
plans substantially lowers the professor's contribution limitation each

out it caused a great deal of confusion by stating that an employee who chose the "A elec-
tion" would not be deemed in "control" of his annuity. Rev. Rul. 75-481, § 8.04, 1975-44
I.R.B. 9, at 13. See, e.g., Wild, The Impact of ERISA on Section 403(b) Annuity Plans,
34 N.Y.U. INST. FED. TAX (ERISA Supp.) 73, 98-99 (1976) (author noted the peculiarity
of the Internal Revenue Service's position as reflected in Rev. Rul. 75-481, 1975-44 I.R.B.
9, at 13).

When the 1975 Revenue Rulings were bound and placed in the Cumulative Bulletin,
however, this mistake did not appear and the "C election" was properly identified as
the election that prevented the application of the I.R.C. § 415(e)(5) "control" label. Rev.

105 This is one of the examples given in both Rev. Rul. 75-481, § 8.04, 1975-2 C.B.
C.B. at 507.

106 ERISA, it will be recalled, did not do away with the exclusion allowance limitation.
This limitation still operates as a ceiling upon section 403(b) annuity contributions, and
is designed to permit high yearly contributions only when an employee has a number of
years of service and low contributions in prior years. See discussion in text accompany-
ing notes 13-34 supra for the mechanics of the exclusion allowances.

ERISA's limitation upon section 403(b) annuity contributions created an over-all ceil-
ing that applies only when an employee's exclusion allowance is above either $25,000
or 25% of compensation. In all other cases (the "C election" aside) it will be the exclu-
sion allowance that will limit an employee's yearly annuity contribution.

107 I.R.C. § 415(c)(4)(C). The "C election limitation," it will be recalled, is taken in
lieu of the exclusion allowance limitation and effectively allows an employee the lesser of
the two following limitations: $25,000 or 25% of compensation. Temp. Treas. Reg.
§ 415(c)(4)-1(a)(3), -1(a)(5)(iii) (1976); see discussion in text at notes 61-65 supra.
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year because of the depressing effect his dual contributions have upon his exclusion allowance.\textsuperscript{108} Since the exclusion allowance is not applied to an employee who chooses the "C election," the professor could avoid his low exclusion allowance limitation by choosing the "C election." Further, during each year the professor remained in control of his annuity, he could conceivably place up to $25,000 or 25 percent of his compensation into his annuity and put the same amount into his defined contribution plan.\textsuperscript{109} Allowing the professor to retain "control" of his annuity and still choose the "C election" would thus permit him to defer up to $50,000 or 50 percent of his compensation every year.

To prevent such a windfall, section 415(e)(5) does not deem employees who choose the "C election" to be in "control" of their annuities. Employees like the professor therefore, are required to combine their annuities with other plans when they hold them with the same employer and choose the "C election."

Employees in the doctor's situation above are also not allowed to avoid lower annuity contribution limitations by choosing the "C election." Returning to the doctor's example, it will be recalled that if the doctor is in "control" of her full-time employer, the section 415(e)(5) "control" label requires her to combine her annuity with any plans she holds with her full-time employer. It would appear then that by choosing the "C election," and thereby removing the "control" label of section 415(e)(5), she would not be forced to combine her annuity with her other plans. Such a possibility, however, has been foreclosed by the Internal Revenue Service. The temporary regulations for the section 415(c)(4) elections specifically provide that an employee cannot avoid a required combination of plans by making an election pursuant to section 415(c)(4).\textsuperscript{110}

IV. CONCLUSION

The contribution limitations of section 403(b) annuities can be readily determined once the interaction between section 403(b) and section 415(c) is understood. Most of the confusion concerning the computation of the contribution limitations involves salary reduction annuity plans. While this Comment has proposed some obvious substitute limitations which aid in clearing up the confusion, this confusion will persist until the Internal Revenue Service provides some official guidance on the correct computation of the contribution limitations for salary reduction plans. Hopefully, the Internal Revenue Service will take the opportunity to eliminate this difficulty when the final regulations for section 415(c) are promulgated and the regulations for section 403(b) are revised to encompass ERISA's changes.

In light of the penalties imposed upon a taxpayer who exceeds his

\textsuperscript{108} See text accompanying notes 98-100 supra.

\textsuperscript{109} Under the "C election" his limitation for each plan would be $25,000 or 25% of compensation.

contribution limitation, the confusion regarding salary reduction plans is especially unfortunate. If a taxpayer miscalculates and exceeds his contribution limitations the penalty is stiff. The amount in excess of his limitation must be included in the taxpayer’s gross income for that year, and in future years the excess will be included in the “prior employer contributions” component of the taxpayer’s exclusion allowance formula. In effect, the excess serves to reduce an employee’s exclusion allowance even though that amount was not excluded from his income in a prior year. Also, there is an additional penalty imposed upon custodial accounts that are allowed section 403(b) treatment. It will be recalled that amounts deferred under section 403(b) are allowed to be invested in one medium in addition to insurance contracts; ERISA authorizes contributions to be made to custodial accounts that invest solely in mutual funds. When a taxpayer has invested in mutual funds and his yearly contribution exceeds the limitation set out in section 415(c), not only is he taxed on the excess as explained above, but also a separate six percent excise tax is levied upon that excess. Curiously enough, neither Congress nor the Internal Revenue Service has explained the rationale for this additional penalty for those taxpayers who choose to invest in mutual funds over insurance contracts.

Despite some of the present confusion regarding contribution limitations, section 403(b) annuities afford an excellent method of tax deferral for those taxpayers who qualify. For one, these annuities are completely portable. Upon separation of service with one employer a taxpayer can transfer his annuity plan to be held with his subsequent employer and no penalty attaches. Also, since salary reduction arrangements can be renegotiated every tax year, the flexibility of salary reduction arrangements allows a taxpayer to tailor his annuity contributions to fit his annual tax savings plans.

Aside from the problems regarding the computation of the contribution limitations, the only caveat about section 403(b) annuities concerns the special “catch-up” elections. It cannot be overemphasized that the “A,” “B,” and “C” elections are all lifetime elections. A taxpayer must carefully assess his future tax position before he decides upon one of these elections.

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111 I.R.C. § 415(a)(2).
112 I.R.C. § 403(b)(7); see note 8 supra.
113 I.R.C. § 4973(a)(2), (c).