CHURCH ALLIANCE
Acting on Behalf of Church Benefits Programs

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July 31, 2017

By electronic submission (http://www.regulations.gov)

The Honorable Steven T. Mnuchin
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Request for Information – Review of Regulations

To Whom It May Concern:

I. Introduction

The Church Alliance welcomes the opportunity to respond to the request of the Department of the Treasury ("Treasury") for recommendations on Treasury Regulations that can be eliminated, modified, or streamlined in order to reduce burdens. As described in greater detail below, we believe that there is an urgent need to modify certain regulations under Section 403(b) of the Internal Revenue Code of 1986, as amended (the "Code"), which are creating substantial burdens for clergy, church lay workers, and ministries that participate in 403(b)(9) plans.

Last year, members of the church benefits community were informed by the Internal Revenue Service ("IRS") that only churches and church-associated organizations described in section 3121(w)(3)(B) of the Code ("QCCOs"), can participate in 403(b)(9) plans. Under this interpretation of the Code and Treasury Regulations – an abrupt departure from over thirty years of prior understanding and precedent – church-associated organizations that are not described in Code section 3121(w)(3)(B) – commonly referred to as "non-QCCOs" – cannot participate in 403(b)(9) plans.

This issue raises considerable concern and burdens for the Church Alliance and the 403(b)(9) plans and programs represented through it. The IRS interpretation of the Code and Treasury Regulations is inconsistent not only with the Congress's intent when adding section 403(b)(9) to the Code in 1982, but also with the previous practices of the IRS and the understanding and practice of the church benefits community since that time. Consequently, this issue is of enormous significance, and a clear example of the kinds of regulations to be addressed in response to this request for information, which: (i) are outdated, unnecessary, or ineffective, (ii) impose costs that exceed benefits, and/or (iii) create a serious inconsistency or otherwise interfere with regulatory reform initiatives and policies.

II. The Church Alliance and Non-QCCO Participation in 403(b)(9) Plans

The Church Alliance is an organization composed of the chief executives or executive directors of thirty-seven church benefits boards and programs, covering mainline and evangelical Protestant denominations, two branches of Judaism, and Catholic schools and institutions. Church Alliance members provide employee benefit plans, including 403(b)(9) church retirement income account plans, to approximately one million participants (clergy and lay workers) serving over 155,000 churches, parishes, synagogues and church-associated organizations across the country.

Non-QCCOs have relied on statutory language to participate in 403(b)(9) church retirement income account plans offered by Church Alliance members since section 403(b)(9) was added to the Code in 1982. Notably, the Church Alliance estimates that over 1,400 non-QCCOs currently participate in various denominational 403(b)(9) plans. IRS 403(b) field auditors have, to our knowledge, never raised any concerns relating to this common practice. As described in greater detail below, the recent IRS and Treasury interpretation threatens to create severe burdens for non-QCCOs, and is not justified by the language or legislative history of the underlying statute. We strongly believe that these considerations weigh in favor of clarification of the 403(b)(9) regulations as part of Treasury's regulatory review efforts, at the earliest possible opportunity.

III. Potential Impact on Church-Associated Organizations and their Employees

If the Code section 403(b) regulations are not modified to make clear that non-QCCOs may participate in 403(b)(9) plans, and if the IRS begins enforcing this interpretation, non-QCCOs and their employees will be denied access to several plan design features that are very important in the 403(b)(9) church plan context, and will also incur substantial burdens in transitioning to a new type of retirement plan. These impacts are all examples of the regulatory burdens and inconsistencies that this request for information is intended to address:

A. Investing in Non-Registered Funds and Collective Investment Trusts. If non-QCCOs cannot participate in 403(b)(9) plans, the only way for them to take advantage of the benefits available to tax-exempt employers under Code section 403(b) would be through participation in 403(b)(1) annuity contracts and 403(b)(7) custodial accounts. However, these latter types of plans offer limited investment fund options to the employees of non-QCCOs. This is because 403(b)(1) plans must be invested in state-regulated insurance contracts and 403(b)(7) custodial accounts can only be invested in registered mutual funds. In contrast, as permitted by Code section 403(b)(9), most church 403(b)(9) plans provide non-registered investment fund options, particularly socially screened funds that reflect the social policies and faith and belief of a church or convention or association of churches. These faith-based, screened funds are a very important component of the investment options offered by church 403(b)(9) plans and are generally not available in the registered mutual fund market. Many church 403(b)(9) plans also provide collective investment fund investment options, such as stable value funds, because of the lower fees generally associated with collective investment funds; these investment vehicles are also not an available investment option for a 403(b)(1) annuity contract or a 403(b)(7) custodial account. Simply put, without regulatory clarification, employees of non-QCCOs could lose access to the investment options that they have come to expect – without any significant legal or policy justification.

B. Self-Annuitization. Many church 403(b)(9) plans offer annuities as a form of distribution and, as permitted under the regulations governing 403(b)(9) retirement income accounts, "self-annuitize" these benefits. If non-QCCOs are forced to move to 403(b)(1) annuity contracts or 403(b)(7) plans, they will no longer be able to provide their workers with annuities through the plan itself. Self-annuitization is an important feature for church plans because it allows the church to retain the assets underlying the annuity in the 403(b)(9) plan, thereby realizing economies of scale that benefit all participants. In addition, participants often pay a lower fee to obtain these annuities than they would pay if they purchased an annuity from a commercial insurance company. Self-annuitized funds can also continue to be invested consistent with the social policies, faith and belief of a particular church or church convention or association.

C. Transition Costs for Former 403(b)(9) Funds. If non-QCCOs cannot participate in 403(b)(9) plans and instead elect to set up a new 403(b)(7) plan for non-QCCO employees, the process of establishing the new plan and transferring prior accumulations will be extremely burdensome for affected employers (and, if the plan was established or maintained by a section 414(e)(3)(A) organization, for that organization). If prior accumulations are not required to be transferred, the employer (or section 414(e)(3)(A) organization) will be faced with the administrative burden and expense of maintaining two plans, and participants employed by non-QCCOs will be forced to deal with the confusion of having two different plans with different investment options. Also, the section 414(e)(3)(A) organization maintaining the 403(b)(9) plan may choose not to establish a separate 403(b)(7) plan for non-QCCOs due to cost concerns. Without having the option to participate in the denomination's 403(b) plan, some non-QCCOs may choose to stop offering a retirement plan to their employees. These transition costs add up. Whether absorbed by employers or passed along to employees, they threaten to reduce the retirement savings of plan participants. In addition, transition costs could put extreme pressure on the budgets of church benefits organizations – many of which are small to mid-sized nonprofit entities.

D. Inability to Maintain a 403(b) Plan. A few 403(b)(9) plans are grandfathered defined benefit plans. Non-QCCOs participating in these plans could not establish a 403(b)(7) plan without fundamentally changing the nature of the benefits being provided to their employees. Rather, they would have to establish a defined benefit 401(a) plan, which due to the cost and resources involved would not be feasible for most employers if the 414(e)(3)(A) organization maintaining the 403(b)(9) plan chose not to establish such a plan. Such non-QCCOs may instead have to stop offering a defined benefit plan to their employees, jeopardizing employees' retirement security.

III. Support for Non-QCCO Participation in 403(b)(9) Plans

In addition to the policy concerns outlined above, we strongly believe that the plain meaning of the Code, the legislative history of the underlying statute, and the legal interpretations of the Code issued by the IRS and Treasury over the past thirty years, strongly support the ability of non-QCCOs to participate in 403(b)(9) plans. These considerations also support clarification of the 403(b)(9) regulations to align with the legislative intent and accepted practice that has developed around these provisions.

A. Plain Meaning of the Statute and Regulations. Code section 403(b)(9) focuses primarily on the types of organizations that can establish or maintain 403(b)(9) plans. It is critical to note that this focus is different from the issue of which types of employers can *participate in* 403(b)(9) plans. On the latter issue, section 403(b)(9) clearly states that employees of 501(c)(3) organizations can participate in a 403(b)(9) plan, and employees of non-QCCOs are included in this category of employees. Section 403(b)(9)(B) states:

> "For purposes of this paragraph, the term "retirement income account" means a defined contribution program established or maintained by a church, or a convention or association of churches, including an organization described in section 414(e)(3)(A), *to provide benefits under section 403(b) for an employee described in paragraph (1) [403(b)(1)] or his beneficiaries*."

Code section 403(b)(1)(A)(i) refers to employees employed by an employer described in section 501(c)(3) which is exempt from tax under section 501(a). A church or a convention or association of churches or an organization described in Code section 414(e)(3)(A) has to establish *or* maintain the plan, but participation is not limited to just the employees of these organizations. If Congress intended non-QCCOs to be excluded from participating in 403(b)(9) plans, it could have easily said so – by instead of using the words italicized above, simply stating "*to provide benefits under section 403(b) for its employees and their beneficiaries."* But it did not. In fact, in imposing nondiscrimination requirements on 403(b) plans in 1986, Congress specifically made such requirements applicable to non-QCCOs. Since Congress used a broad approach to establish 403(b)(9) plan participant eligibility, the plain meaning of section 403(b)(9) supports non-QCCO participation in 403(b)(9) plans.

We believe that the regulations under Code section 403(b) are inconsistent with the statute. The Church Alliance noted this inconsistency in comment letters when the 403(b) regulations were issued in both proposed and final form. Treasury regulation section 1.403(b)-2(b)(15) provides that a retirement income account is "a defined contribution program established or maintained by a church-related organization to provide benefits under section 403(b) for its employees or their beneficiaries...." (Emphasis supplied). The regulations go on to define a "church-related organization" as "a church or a convention or association of churches, including an organization described in Code section 414(e)(3)(A)". But, as pointed out above, the statute requires only that a church or principal purpose organization within the meaning of Code section 414(e)(3)(A) establish or maintain a section 403(b)(9) retirement income account. It does not require that a 403(b)(9) plan be established or maintained only for employees of churches and such organization. As noted by the Church Alliance in its comment letters, the regulations are inconsistent with the statute on this point, and should be modified.

B. History of Code Section 403(b)(9). Modification of the regulations is also appropriate because nothing in the history of Section 403(b)(9) suggests that non-QCCOs should be precluded from participation in 403(b)(9) retirement income account plans. Paragraph (b)(9) was added to Code section 403(b) by section 251 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). A primary objective of the added language was to permit churches and organizations described in Code section 414(e)(3)(A)[1] to continue to provide 403(b) annuities to ministers and lay employees.

[1] The IRS has ruled on numerous occasions that church benefits boards and retirement plan administration committees controlled by or associated with a church or convention or association of churches are organizations described in Code section

By way of background, the need for section 251 of TEFRA arose when the IRS commenced a study on limiting providers of section 403(b) annuities to insurance companies. A ruling request filed by a member of the Church Alliance on the section 403(b) status of its plans was suspended pending the outcome of that study. Shortly thereafter, the IRS published Revenue Ruling 82-102, which held that only insurance companies and registered mutual funds were able to issue section 403(b) annuities. In response, the Church Alliance worked with members of Congress and Treasury legislative counsel to draft language that eventually became Code section 403(b)(9). The legislation was expressly intended to permit churches and section 414(e)(3)(A) organizations to continue to provide 403(b) annuities.

The legislative history of section 251 of TEFRA illustrates that the addition of section 403(b)(9) to the Code focused primarily on the type of organizations that can *provide* 403(b) annuities and not on which organizations can *participate in* a church 403(b) plan. There is no evidence in the legislative history that Congress intended to limit the types of church-associated organizations eligible to participate in 403(b)(9) plans. Rather, section 403(b)(9) indicates that church plans under section 414(e) could continue to cover employees of organizations exempt from tax under Section 501(a) and controlled by or associated with a church or convention or association of churches. However, only a church or a church section 414(e)(3)(A) organization can *establish or maintain*, i.e., be a provider of, a section 403(b)(9) annuity program.

This view of the intended scope of Code section 403(b)(9) is supported by the General Explanation of the Revenue Provisions of TEFRA, prepared by the staff of the Joint Committee on Taxation, an excerpt from which is attached as Appendix B to this letter. Page 330 of the General Explanation indicates (in the highlighted text) that, for purposes of Code section 403(b)(9), the term "church" includes not only a convention or association of churches, but also an organization which is exempt from tax and is controlled by or associated with a church or convention or association of churches. The General Explanation further explains that church employees include duly ordained, commissioned, or licensed ministers and lay employees, including employees of tax-exempt organizations (whether civil law corporations or otherwise organized) that are controlled by or associated with a church. Thus, employees of tax-exempt organizations that are controlled by or associated with a church or a convention or association of churches are to be treated as church employees eligible to participate in a 403(b)(9) plan—and both QCCOs and non-QCCOs are such organizations.

Section 1120 of the Tax Reform Act of 1986 (TRA '86) confirms Congress's view that non-QCCOs are eligible to participate in 403(b)(9) plans. TRA '86 amended the rules applicable to annuities qualifying for favorable tax treatment under section 403(b) of the Code to require that such annuities generally must be purchased under a plan that is nondiscriminatory within the meaning of Code section 403(b)(12).[2] This requirement applies not only to annuity contracts under Code section 403(b)(1), but also to custodial accounts and retirement income accounts under Code sections 403(b)(7) and (9), respectively. However, the nondiscrimination requirement of Code section 403(b)(12) does not apply to 403(b) plans contributed to by churches (i.e., houses of worship) or QCCOs. See Code section 403(b)(1)(D). Thus, in the case of a 403(b)(9) plan, the

414(e)(3)(A). References in this comment to section 414(e)(3)(A) organizations are intended to include such church benefits boards and retirement plan administration committees.

[2] The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA '88") redesignated Code section 403(b)(10), which was added by TRA '86, as Code section 403(b)(12).

only type of sponsor that the nondiscrimination requirement could apply to is a non-QCCO. In other words, if Congress had intended for non-QCCOs to be ineligible to participate in 403(b)(9) plans, it would not have needed to extend the nondiscrimination requirement to such plans. By subjecting 403(b)(9) plans provided by non-QCCOs to nondiscrimination requirements, Congress confirmed its view that non-QCCOs are eligible to participate in a 403(b)(9) plan.

C. <u>IRS Notices, Announcements, Letter Rulings and Memorandums.</u> Several IRS memoranda, rulings and notices have discussed non-QCCO participation in 403(b)(9) plans. None have suggested that participation by non-QCCOs in 403(b)(9) plans is prohibited.

1. <u>GCM 39793</u> (July 17, 1989). In this General Counsel Memorandum, a church-affiliated private university participated in a 403(b)(9) church retirement income account plan. The IRS found that the university's 403(b)(9) plan was entitled to church plan status under Code section 414(e) and did not raise an issue about the ability of the university, a non-QCCO, to participate in a 403(b)(9) church retirement income account plan.

2. <u>PLR 200816031</u>. The IRS ruled that a retirement plan adopted by a corporation primarily for employees of individual church congregations, as well as those who served in other supporting organizations and shared common religious beliefs and convictions with the church there involved, constituted a church plan under Code section 414(e) <u>and</u> a retirement income account under Code section 403(b)(9).

3. <u>IRS Notice 89-23</u>. Notice 89-23 includes references to "retirement income accounts" when describing employers sponsoring 403(b) plans subject to retirement plan nondiscrimination testing. As discussed previously, only non-QCCOs participating in a retirement income account are subject to nondiscrimination testing; thus, this Notice suggests that the IRS believed non-QCCOs are eligible to participate in 403(b)(9) plans.

4. <u>IRS Announcement 95-33</u>. These "employee plan examination guidelines" provided that retirement income accounts are subject to nondiscrimination testing "except those maintained by §3121(w)(3) churches," again indicating that non-QCCOs may participate in retirement income accounts.

D. <u>The 414(e)(3)(A) Cross-Reference</u>. The cross-reference in Code section 403(b) to section 414(e)(3)(A) organizations further supports non-QCCO participation in 403(b)(9) retirement income account plans. The purpose of the cross-reference is to identify the types of organizations, beyond churches or conventions or associations of churches, that can establish or maintain retirement income account plans, i.e., be a provider of 403(b) annuities. Section 414(e)(3)(A) organizations may, pursuant to the cross-referenced Code section, maintain a church plan not only for employees of a church or a convention or association of churches, but also for employees of an organization "*which is exempt from tax under section 501 and which is controlled by or associated with a church or a convention or association of churches*." (This statutory text includes non-QCCOs.) See Code section 414(e)(3)(B)(ii). Thus, by cross-referencing section 414(e)(3)(A) to include organizations described therein as a type of organization that can be a provider of 403(b) annuities, Congress was acknowledging that section 414(e)(3)(A) organizations may maintain church plans for non-QCCOs, if those organizations satisfy the enumerated requirements. If Congress had intended to narrow the types of organizations to which 403(b) annuities can be provided under section 403(b)(9), it could have easily added a non-QCCO exclusion when cross-referencing section 414(e)(3)(A). However, no such exclusion exists.

The IRS has issued a number of rulings over the years that make it clear that the employees of church-associated hospitals, colleges, universities, nursing homes and the like, all of which are non-QCCOs[3], may participate in a church plan because they are deemed to be church employees under the rules described in the preceding paragraph. This means that these employees are employees for whom a 414(e)(3)(A) organization can fund or administer a retirement or welfare benefit plan or program. The cross-reference to a section 414(e)(3)(A) organization in section 403(b)(9) thus must be read to mean that 403(b)(9) retirement benefits can be provided for the benefit of employees of church-controlled or associated employers, and the employees of non-QCCOs are clearly included in this category of employees—the IRS has so ruled in numerous private letter rulings over the years.

IV. Conclusion

Non-QCCOs have had a long history of participating in church 403(b)(9) retirement income account plans and programs, and should be permitted to continue to do so under a modified version of the regulations. If it is determined they can no longer participate, employers that wish to continue to take advantage of the benefits under section 403(b)(9) would need to either 1) offer multiple types of 403(b) plans to cover all types of church-associated organizations, increasing administrative burden and cost that will inevitably reduce benefits to workers who have devoted their lives to religious institutions, or 2) choose not to offer other 403(b) plans, which may cause some non-QCCOs to cease offering a retirement plan to their employees. In addition, employees of non-QCCOs would lose access to important non-registered, faith-based screened investment fund options and would not have the ability to obtain "self-annuitized" annuity payments.

Based on the Church Alliance's work in 1982, we believe these consequences are contrary to the intent of Congress when it drafted and passed Code section 403(b)(9), and that the regulations should be modified to correct that inconsistency. Appendix A to this letter outlines the specific modifications to the regulations under Code section 403(b) that we believe would achieve this result. We would welcome the opportunity to discuss the rationale for these proposed modifications, and this issue more generally, with you at your convenience. Thank you for your consideration of this important matter.

Please contact the undersigned at (202) 778-9000 if you have any questions or wish to discuss any of this information further.

Sincerely,

Karishma S. Page
Partner,
K&L Gates LLP
On behalf of the Church Alliance

[3] It is almost certain, if not certain, that these organizations are non-QCCOs because they all provide goods, services or facilities to the general public and derive most, if not all, of their revenue from such provision.

APPENDIX A

SUGGESTED MODIFICATIONS TO REGULATIONS UNDER SECTION 403(B)

1.403(b)-2(b)(15) Retirement income account means a defined contribution program established or maintained by a church-related organization to provide benefits under section 403(b) for ~~its~~ employees or their beneficiaries as described in ~~§1.403~~section 414(~~b~~e)~~-9~~(3)(B)(ii).

1.403(b)-4(C)(3)(ii)(B) All entities that are in a church-related organization or an organization ~~controlled by a church-related organization under~~ described in section 414(e)(3)(B)(ii) are treated as a single qualified organization (so that years of service and any special section 403(b) catch-up elective deferrals previously made for a qualified employee for a church or other entity within a church-related organization or an organization ~~controlled by the church-related organization~~described in section 414(e)(3)(B)(ii) are taken into account for purposes of applying this paragraph (c)(3) to the employee with respect to any other entity within the same church-related organization or organization ~~controlled by a church-related organization~~described in section 414(e)(3)(B)(ii)).

1.403(b)-4(e)(*3)* Service with more than one eligible employer.

(i) General rule. With respect to any section 403(b) contract of an eligible employer, except as provided in ~~paragraph~~section 415(~~e~~c)(~~3~~7)(~~ii~~B)~~ of this section~~, any period during which an individual is not an employee of that eligible employer is disregarded for purposes of this paragraph (e).

~~(ii) Special rule for church employees. With respect to any section 403(b) contract of an eligible employer that is a church-related organization, any period during which an individual is an employee of that eligible employer and any other eligible employer that is a church-related organization that has an association (as defined in section 414(e)(3)(D)) with that eligible employer is taken into account on an aggregated basis, but any period during which an individual is not an employee of a church-related organization or is an employee of a church-related organization that does not have an association with that eligible employer is disregarded for purposes of this paragraph (e).~~

1.403(b)-8(e) Retirement income accounts. See §1.403(b)-9 for special rules under which a retirement income account ~~for employees of a church-related organization~~ is treated as a section 403(b) contract for purposes of §§1.403(b)-1 through 1.403(b)-7, this section and §§1.403(b)-9 through 1.403(b)-11.

1.403(b)-9(a)(*1) Treatment as a section 403(b) contract.* Under section 403(b)(9), a retirement income account ~~for employees of a church-related organization (as defined in §1.403(b)-2)~~ is treated as an annuity contract for purposes of §§1.403(b)-1 through 1.403(b)-8, this section, §1.403(b)-10 and §1.403(b)-11.

1.403(b)-10(f) Defined benefit plans.

(1) Defined benefit plans generally. Except for a TEFRA church defined benefit plan as defined in paragraph (f)(2) of this section, section 403(b) does not apply to any contributions or accrual under a defined benefit plan.

(2) TEFRA church defined benefit plans. See section 251(e)(5) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, for a provision permitting certain arrangements established or maintained by a church-related organization and in effect on September 3, 1982 (a TEFRA church defined benefit plan) to be treated as section 403(b) contract even though it is a defined benefit arrangement. ~~In accordance with section 403(b)(1), for purposes of applying section 415 to a TEFRA~~

~~church defined benefit plan, the accruals under the plan are limited to the maximum amount permitted under section 415(c) when expressed as an annual addition, and, for this purpose, the rules at §1.402(b)-1(a)(2) for determining the present value of an accrual under a nonqualified defined benefit plan also apply for purposes of converting the accrual under a TEFRA church defined benefit plan to an annual addition.~~ See section 415(b) for ~~additional~~the limits applicable to TEFRA church defined benefit plans.

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION

OF THE

REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

(H.R. 4961, 97TH CONGRESS; PUBLIC LAW 97-248)

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 31, 1982

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4. Retirement savings for church employees (sec. 251 of the Act and secs. 403 and 415 of the Code)

Prior Law

Subject to limits, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted. The amount paid by the employer is excluded from the employee's income for the taxable year to the extent that payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity.

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (sec. 415). Under the overall limits, annual additions [1] to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of a specified dollar amount, or 25 percent of the employee's compensation from the employer for the year. Under a special rule (sec. 415(c)(4)(C)), an employee of an educational institution, hospital, or home health service agency may elect to compute the annual exclusion allowance for payments under a tax-sheltered annuity solely by reference to the maximum annual employer payment which could be made under the overall limit. Under prior law, this rule applied to employees of a church hospital, etc., but not to other church employees.

In addition, to allow certain lower-paid employees catch-up payments (*i.e.*, payments permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit which takes into account only the current year), alternative special elections are provided to increase the overall limit for the year of the election. An individual is allowed only one of the special elections under section 415 during his lifetime. The first alternative catch-up election (sec. 415(c)(4)(A)) may be made only for the year of an employee's separation from the service of the contributing employer (the separation year catch-up election). The second alternative catch-up election (sec. 415(c)(4)(B)) generally may be made for any year, but is subject to limitations which the separation year catch-up election is not. Of course, neither election in-

[1] With respect to a tax-sheltered annuity, annual additions consist of employer contributions and certain employee contributions.

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creases the amount excludable from the employee's income for the year under the exclusion allowance. Under prior law, the alternative catch-up elections were available to church and nonchurch employees of educational institutions, hospitals, and home health services, but not to other church employees.

Reasons for Change

Congress concluded that the prior-law provisions relating to tax-sheltered annuities often made it difficult for churches to provide ministers and lay employees adequate retirement income. The prior-law formula for fixing an employee's annual exclusion allowance may not have reflected the career pattern of a minister or lay employee who moves from one employing organization to another within a church. In addition, the formula did not take into account the historically low salaries paid to ministers and other church employees.

Congress also concluded that the tax treatment of retirement savings provided church employees by an associated organization, such as a church pension board, should be clarified.

Explanation of Provision

Overview

The Act revises the prior-law rules relating to tax-sheltered annuity programs maintained by churches for their employees by generally increasing the ability of churches to provide retirement income for their employees and by clarifying the status of such programs under the tax law. For purposes of the Act's provisions, the term church includes a convention or association of churches, or an organization which is exempt from tax and is controlled by or associated with a church or a convention or association of churches. Church employees include duly ordained, commissioned, or licensed ministers and lay employees, including employees of tax-exempt organizations (whether civil law corporations or otherwise organized) which are controlled by or associated with a church.

Exclusion allowance increased

The Act generally increases the annual exclusion allowance for church employees whose adjusted gross income for the year does not exceed $17,000. Thus, an employee's eligibility for the increased exclusion allowance is determined by taking into account both includible compensation paid by the church and income from other sources. However, for this purpose an employee's adjusted gross income does not include income attributable to the employee's spouse.

Under the Act, the exclusion allowance for an eligible church employee is not less than the lesser of $3,000 or the employee's includible compensation for the year. Solely for the purpose of determining includible compensation under the special rule, the includible compensation of an eligible church employee who is a foreign missionary is considered to include the amount paid by the church during the taxable year for the purchase of a tax-sheltered annuity for the employee. A church employee is a foreign missionary for a taxable year for which the employee's principal duties are the propagation of religious doctrine or the performance of sacerdotal functions or humanitarian good works for the church outside the United States.

The Act also provides that for purposes of the exclusion allowance, all years of an employee's service with an organization that is a part of a particular church are treated as years of service with one employer. Thus, although a minister or lay employee may, during the span of a career with a church, transfer from one organization to another within the particular church, or from the church to an associated organization, all service with such organizations is treated as service with a single employer. Payments made by all such organizations on behalf of an employee are also to be taken into account under the exclusion allowance formula as contributions made by a single employer. While this rule applies for computing post-1981 exclusion allowances, pre-1982 service with, and pre-1982 payments by a particular church (as defined by the Act) are taken into account under the computations.

The Act makes available to all church employees the prior-law special elections permitted under the overall annual limit (sec. 415). The Act also permits a church employee an additional election pursuant to which the church may make payments for the year in excess of the otherwise applicable overall annual limit. The employee's election will increase the overall annual limit to the lesser of (1) the amount paid by the church for the year (plus any employee paid taken into account), or (2) $10,000. Employer payments permitted for a church employee under this provision (*i.e.*, payments in excess of the otherwise applicable annual limits) may not exceed $40,000 for the employee's lifetime. Of course, payments made pursuant to the election are excludable from the employee's income only if they are otherwise permitted under the employee's exclusion allowance for the taxable year. In addition, the election may not be made for the taxable year for which the separation year catch-up election is made.

Retirement income accounts maintained by churches

The Act also provides that generally the tax rules relating to tax-sheltered annuity contracts apply to retirement income accounts provided by a church for its employees. Under the Act, a retirement income account means a program which is a defined contribution plan (sec. 414(i)) and which is established or maintained by a church to provide retirement benefits for its employees under the tax-sheltered annuity rules. Thus, a church-maintained retirement income account differs from a tax-sheltered annuity only in that the account is not maintained by an insurance company. However, the Act also provides that a church-maintained retirement income program in existence on September 3, 1982, will not be considered as failing to satisfy the requirements for a tax-sheltered annuity (sec. 403(b)) merely because the program is a defined benefit plan (sec. 414(j)). For this purpose, a church-maintained retirement income program is considered to be in existence on September 3, 1982, notwithstanding that after that date the program is amended, otherwise modified, or extended to benefit other employees. In addition, if a church-maintained retirement income program which is otherwise a defined benefit plan provides a benefit which is based, in part, on the balance of a separate account of an employee, the separate account can qualify as a defined contribution plan for purposes of the rules relating to retirement income accounts.

The assets of a church-maintained retirement income account for the benefit of an employee or his beneficiaries may be commingled in a common fund made up of such accounts. However, that part of the common fund which equitably belongs to any account must be separately accounted for (*i.e.*, it must be possible at all times to determine the account's interest in the fund), and cannot be used for, or diverted to, any purposes other than the exclusive benefit of such employee and beneficiaries. Provided these requirements are met, the assets of a retirement income account also may be commingled with the assets of a tax-qualified plan without adversely affecting the status of the account or the qualification of the plan.

The assets of a church plan (sec. 414(e)) also may be commingled in a common fund with other amounts devoted exclusively to church purposes (for example, a fund maintained by a church pension board) if that part of the fund which equitably belongs to the plan is separately accounted for and cannot be used for or diverted to purposes other than for the exclusive benefit of employees and their beneficiaries. Of course, the reasonable costs of administering a retirement income account (including an account which is a part of a common fund) may be charged against the account. Such costs include the reasonable costs of administering a retirement income program of which the account is a part, including costs associated with informing employees and employers of the availability of the program. Any common fund is subject to the fiduciary standards (including the rules relating to prohibited transactions) of the Employee Retirement Income Security Act of 1974 if any participating trust is subject to those standards.

The Act also allows a church which maintains a tax-sheltered annuity, retirement income account, or pension plan a retroactive amendment period if the annuity, account, or plan is required to be amended by reason of any law, or any regulation, ruling, or other action under the tax laws. During the correction period, the annuity, account, or plan would be treated as satisfying the applicable tax-law requirement. To qualify for this treatment, the required amendment or other modification generally must be made not later than at the next earliest church convention. However, the Secretary of the Treasury may prescribe an alternative time period within which the required amendment is to be made. In this regard, the Secretary is to take into account that church governing bodies typically meet at lengthy intervals. Of course, in no event is the permitted correction period for a church to be less than that allowed under prior law (sec. 401(b)).

Effective Date

The provisions generally apply to taxable years beginning after December 31, 1981. The provisions relating to the overall limits apply to years beginning after that date. The retroactive amendment period rules apply as of July 1, 1982, and permit amendments to correct defects in existence on that date.

The provision relating to retirement income accounts provided by a church for its employees is effective for taxable years beginning after December 31, 1974.