



# Compliance Advisory

July 2011

## Former tax-exempt organizations may salvage status and continue sponsoring tax-favored retirement plans

On June 8, 2011, the IRS announced that approximately 275,000 organizations had lost their tax-exempt status because they did not file legally required annual reports for three consecutive years. The IRS also announced special steps to help these organizations apply for reinstatement of their tax-exempt status. This status is particularly important for entities that sponsor 403(b) plans or non-governmental section 457(b) plans.

### Changes brought about by PPA

The Pension Protection Act of 2006 (PPA) required most tax-exempt organizations to file an annual information return or notice with the IRS. For small organizations, this requirement was first effective in 2007. Any organization that does not file the required notices or returns for three consecutive years is subject to automatic revocation of its tax-exempt status.

### Impact on retirement plan sponsorship

Only 501(c)(3) tax-exempt organizations and certain educational organizations may sponsor 403(b) plans. If a tax-exempt organization that sponsors a 403(b) plan loses its tax-exempt status, the plan will have an employer eligibility failure. As a result, all vested pre-tax contributions made to the plan beginning in the year that the tax-exempt status is lost will be treated as taxable income to the participants. In addition, when those amounts are distributed from the plan, they will not be eligible rollover distributions.

Only non-church/non-governmental tax-exempt organizations and state and local governments may sponsor section 457(b) plans. If a tax-exempt organization that sponsors a section 457(b) plan loses its tax-exempt status, it becomes an "ineligible employer" and the plan becomes subject to the 409A nonqualified plan rules. As a result, participant accounts become subject to immediate taxation because they are not subject to a substantial risk of forfeiture.

An organization that loses its tax-exempt status may either accept the revocation or request reinstatement. Naturally, these actions will have different impacts on employer-sponsored retirement plans.

### Correcting a 403(b) plan employer eligibility failure

If a 501(c)(3) organization that sponsors a 403(b) plan loses its tax-exempt status and chooses not to request reinstatement, it should consider correcting the resulting employer eligibility failure by following the procedures provided by the IRS Employee Plans Compliance Resolution System (EPCRS). By following this process, vested pre-tax contributions (including employer contributions) will not become immediately taxable to participants and amounts distributed from the plan may qualify as eligible rollover distributions.

To make this correction, the plan sponsor must submit an application to the IRS under the Voluntary Correction Program (VCP):

- Using [Appendix F, Streamlined VCP Submission](#), and
- [Schedule 6, Employer Eligibility Failure \(401\(k\) and 403\(b\) Plans only\)](#), and
- Paying the appropriate [user fee](#).

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Operationally,

- All contributions (elective deferrals, employee post-tax, and employer) to the plan must cease no later than the date the VCP application is filed;
- All assets must remain in the trust, annuity contracts or custodial accounts; and
- Assets may be distributed only in accordance with the section 403(b) distribution rules.

The other method for correcting an employer eligibility failure is for the employer to regain its tax-exempt status.

### Tax-exempt status reinstatement options

The IRS has also provided guidance for former tax-exempt organizations to apply for reinstatement of their tax-exempt status. In some situations, this status may be restored retroactively.

To have its tax-exempt status reinstated, an organization must:

- File [Form 1023](#) (if applying under section 501(c)(3)), or [Form 1024](#) or a letter (if applying under a different Code section) with the IRS;
- Pay the appropriate [user fee](#);
- Write “Automatically Revoked” at the top of the application and on the mailing envelope. A small organization that is eligible for transition relief will instead write “Notice 2011-43” in both locations.

The effective date of reinstated tax-exempt status usually will be the date the organization filed its application for reinstatement.

Alternatively, an organization may request retroactive reinstatement back to the date of automatic revocation. To do so, the organization must attach a letter to the reinstatement application explaining why the organization failed to file required returns or notices for three consecutive years. IRS [Notice 2011-44](#) provides detailed information regarding the contents of this letter. The IRS will grant such requests only if it determines that the organization had “reasonable cause” for not making these filings.

Retroactive reinstatement must be requested within 15 months of the later of:

- The date of the IRS revocation letter; or
- The date on which the IRS posts the name of the organization on the revocation list published on the IRS website (for organizations that appeared on the June 8, 2011, listing, this date would be September 8, 2012).

[Notice 2011-43](#) provides special rules for small organizations that apply for reinstatement by December 31, 2012.

Retroactive reinstatement will preserve the 403(b) or 457(b) status of plans sponsored by an affected organization.

Currently, there is no other option available for 457(b) plans whose sponsors lose their tax-exempt status because these plans are not eligible for EPCRS. If these sponsors do not apply for retroactive reinstatement of their tax-exempt status, their 457(b) plans simply become subject to 409A plan rules.

### Recommended actions

Tax-exempt plan sponsors should review the IRS [Auto-Revocation List](#). If they discover that they have lost their tax-exempt status, they should discuss the situation with their legal advisor. In addition, they should notify their Prudential Retirement representative of their intentions regarding affected 403(b) plans or 457(b) plans. Prudential will not take any action with respect to these plans without notification from the plan sponsor.



#### Compliance Advisory by Prudential Retirement

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