FINAL REGULATIONS UNDER SECTION 403(b) OF THE INTERNAL REVENUE CODE

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On July 26, 2007, the Internal Revenue Service published its long-awaited final regulations under Section 403(b) of the Code. The final regulations, which were issued in proposed form in November 2004, will replace regulations issued in 1964 that have not been comprehensively revised in more than 40 years.

The final regulations, like the proposed rules, consolidate legislative and regulatory developments over the last four decades that have significantly eroded the differences between 403(b) plans and other salary reduction arrangements such as 401(k) and 457(b) plans. While the new regulations generally codify existing rules, they also impose new documentary requirements; eliminate good faith compliance with the statutory nondiscrimination requirements for nonelective contributions; and generally narrow the universal availability standard for elective deferrals by requiring that each employee have an effective opportunity to make deferrals and limiting some of the categories of employees that may be excluded in applying the universal availability requirement.

In conjunction with the issuance of the IRS regulations, the Department of Labor has issued Field Assistance Bulletin 2007-2 in which it discusses the impact of the IRS's final regulations on its safe harbor regulation under which employer programs for the purchase of annuity contracts or custodial accounts funded solely through salary reduction agreements are not treated as employee pension benefit plans for purposes of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

The IRS's final regulations are generally effective January 1, 2009, although deferred effective dates apply to certain church plans and 403(b) plans maintained pursuant to a collective bargaining agreement in effect on July 26, 2007.

Statutory Background

Section 403(b) of the Code provides an exclusion from an employee's gross income for contributions made by an eligible employer to purchase an annuity contract for the employee's benefit. A 403(b) plan may be funded in one of three ways:

1. Through annuity contracts issued by an insurance company and purchased for the employee by the employer;

2. Through custodial accounts meeting the requirements of Section 401(f)(2) of the Code and invested solely in mutual funds, which are treated as annuity contracts under Section 403(b)(7) of the Code; and

3. In the case of a church employer, through retirement income accounts.

To qualify for the exclusion from gross income provided by Section 403(b) of the Code, contributions under the 403(b) plan must be nonforfeitable, meet certain nondiscrimination requirements and be limited in amount.

403(b) vs. 401(k)

While the effect of various amendments made to Section 403(b) of the Code in the past 40 years has been to diminish the distinctions between 403(b) plans and other tax-favored employer-provided retirement plans (such as 401(k) plans and 457(b) plans for state and local government entities), the following significant differences continue to exist:

1. 403(b) plans are limited to certain employers and employees, i.e., employees of a public school, employees of an organization exempt from tax under Section 501(c)(3) of the Code, and certain ministers.

2. 403(b) plans may only be funded with an annuity contract, a custodial account holding only mutual fund shares, or a church retirement income account.

3. The coverage and nondiscrimination rules applicable to elective contributions under 401(k) plans do not apply to 403(b) plans. Instead, there is a universal availability requirement for elective deferrals.

4. The consequences of failing to satisfy many of the Section 403(b) rules differ, and frequently are less severe, than their qualified plan counterparts.

5. The Code Section 415 plan aggregation rules apply differently to 403(b) plans.
6. Catch-up elective deferrals unique to 403(b) plans are not available under the other types of plans that permit employee elective contributions.

7. Employers may make nonelective contributions for former employees for up to five taxable years after termination of employment.

Plan Document Requirement

A major change effected by the final (and proposed) regulations, and consistent with the trend toward making 403(b) plans and qualified plans uniform, is the new requirement that a 403(b) plan be maintained pursuant to a written defined contribution plan which, in both form and operation, satisfies the Section 403(b) regulations. The plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, and the time and form under which distributions will be made. The plan may incorporate by reference other documents, such as the insurance policy or custodial agreement, which, as a result of the reference, become part of the plan. In the event of any conflict between the plan and documents incorporated by reference, the plan governs. The plan document may allocate responsibility for performing administrative functions and must identify who is responsible for complying with those Code requirements, such as loans and hardship withdrawals, that apply on an aggregated basis to all contracts issued to a participant. The IRS has stated that it expects to publish guidance that includes model plan provisions that may be used by public school employers to satisfy the written plan requirement.

Responding to concerns that the adoption of a written plan document would jeopardize the exclusion from ERISA coverage of salary reduction-only plans under the Department of Labor's safe harbor for Section 403(b) programs, Field Assistance Bulletin 2007-2 addresses the interaction of ERISA and the final IRS regulations. Specifically, the Field Assistance Bulletin provides guidance (to the Employee Benefits Security Administration's national and regional offices) on the extent to which compliance with the IRS regulations would cause employers to exceed the limitations on employer involvement permitted under the Department of Labor's safe harbor.

According to the Department, the following activities by an employer would not cause its tax sheltered annuity program to be excluded from the safe harbor:

- conducting administrative reviews of the program's structure and operation for tax compliance defects;
- discrimination testing and compliance with maximum contribution limitations under the IRS regulations;
- fashioning and proposing corrections of operational failures;
- developing improvements to the program's administrative processes to avoid the recurrence of tax defects;
- obtaining the cooperation of independent entities involved in the program to correct tax defects;
- keeping records of its activities;
- terminating the program in accordance with the IRS regulations;
- certifying to an annuity provider facts within the employer's knowledge, such as employee addresses, service records and compensation levels; or
- limiting the funding media or products available to employees, or the annuity providers that may approach an employee, to a number designed to afford employees a reasonable choice of investments.

The Field Assistance Bulletin confirms, however, that an employer could not remain within the safe harbor if it had responsibility to make, or in fact made, discretionary determinations in administering the program, such as authorizing plan-to-plan transfers, processing distributions, satisfying joint and survivor annuity requirements, or making determinations with respect to hardship distributions, qualified domestic relations orders or eligibility for, or enforcement of, loans.

The Field Assistance Bulletin concludes that tax exempt employers will be able to comply with the new IRS 403(b) regulations while remaining within the Department of Labor's safe harbor, although the question of whether any particular employer has established or maintains an ERISA plan as a result of complying with the IRS's 403(b) regulations will continue to be determined on case-by-case basis.

Nondiscrimination Rules

Nonelective Contributions. For contributions other than elective deferrals, the IRS's final regulations replace the nondiscrimination standard that previously applied under Notice 89-23 (a reasonable, good faith interpretation of the statutory nondiscrimination rules in Section 403(b)(12) of the Code) with the same rules that apply to employer contributions to qualified plans. As a result, contributions to a 403(b) plan, other than elective deferrals and after-tax employee contributions, must satisfy the coverage and amount testing that apply to such contributions when made under a qualified plan. Similarly, matching and after-tax employee contributions must satisfy the actual contribution percentage test that applies to qualified plans. A failure to satisfy these nondiscrimination requirements or the universal availability requirement described below affects all contracts issued under the plan.

Elective Deferrals; Universal Availability. Elective deferrals under a 403(b) plan are not subject to the above nondiscrimination requirements. Instead, there is a universal availability requirement: if any employee of the employer is eligible to make elective deferrals, all employees must be eligible. To be considered eligible to make an elective deferral, an employee must have an effective opportunity to make or change a deferral election at least once each plan year, as well as receive a notice of the availability of the right to make an elective deferral, the period of time during which an election to defer may be made and any other conditions on deferral elections. Eligibility to make elective deferrals may be conditioned upon deferring more than $200 each year. Under the final regulations, the right to make elective deferrals includes the right to designate elective deferrals as Roth contributions if any employee of the employer may elect to make designated Roth contributions.

For purposes of determining whether all employees are eligible to make elective deferrals, the following categories of employees are not taken into account:

1. Employees who are eligible to make elective deferrals under another 403(b) plan or a 457(b) eligible governmental plan of the employer;

2. Employees who are eligible to make a cash or deferred election under a 401(k) plan of the employer;

3. Nonresident aliens;

4. Students performing services for a school; and

5. Employees who normally work less than 20 hours per week (or a lower number of hours per week specified in the plan).

Collectively bargained employees, employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan, visiting professors at public schools and religious order employees who have taken a vow of poverty are not excluded under the universal availability rule, even though they had been excluded under earlier IRS guidance. While the last three categories of employees are not excluded in the final regulations, the preamble to the regulations explain that other rules may provide relief for individuals who are under a vow of poverty and certain university professors. Moreover, there is transition relief for all four categories of employees.

- Subject to the above exclusions, the employees who are looked at to determine whether there is universal availability are all employees of the employer (see Controlled Group Rules for Tax Exempt Organizations, below, for a discussion of the rules for determining when separate tax exempt entities must be treated as a single employer). If the 403(b) plan covers the employees of more than one Section 501(c)(3) organization, the universal availability requirement applies separately to each common law entity, i.e., each Section 501(c)(3) organization. In the case of a 403(b) plan that covers employees of more than one State entity, the universal availability requirement is applied separately to each entity that is not part of a common payroll. Finally, if an employer has historically treated one or more of its geographically distinct units (i.e., units in separate Standard Metropolitan Statistical Areas) as separate for employee benefit purposes, it may treat the unit as a separate organization for purposes of the universal availability requirement if it is operated independently on a day-to-day basis.

Church Plans; Governmental Plans. Church 403(b) plans are not subject to either the nondiscrimination rules described above or the universal availability rule. Governmental plans are subject to the universal availability requirement and to the requirement that compensation in excess of the Code Section 401(a)(17) limit may not be taken into account, but are not subject to the other nondiscrimination rules.

Contributions; Limits on Contributions

The exclusion from income provided by Section 403(b) of the Code applies only to amounts that do not exceed the limit on elective deferrals under Section 402(g) and the overall limit on annual additions in Section 415 of the Code. The limit on elective deferrals, including elective deferrals under all other plans, contracts or arrangements of the employer, must be stated in the annuity contract.

Overall Limit on Contributions. Contributions for a participant under a 403(b) plan (nonelective employer contributions, including matching contributions, elective deferrals and after-tax employee contributions) must not exceed the overall limit on contributions under Section 415 of the Code ($45,000 for 2007). For purposes of Section 415, a 403(b) plan is treated as a plan maintained by the employee rather than the employer (even if the 403(b) plan is established and maintained by the employee's employer and covered by Title I of ERISA), unless the employee controls either the employer maintaining the 403(b) plan or another employer. If the employee controls any employer, then the 403(b) plan is treated as a defined contribution plan maintained by both the controlled employer and the participant and is aggregated for purposes of Section 415 with any other defined contribution plans maintained by the controlled employer.

> **Example:** For example, if a doctor is employed by (but does not control) a nonprofit hospital which is tax exempt under Section 501(c)(3) of the Code and which maintains a 403(b) plan for the doctor, and the doctor also owns more than 50% of a professional corporation by which he or she is employed, any defined contribution plan maintained by

the professional corporation must be aggregated with the hospital's 403(b) plan for purposes of Section 415. This is the case whether the 403(b) contributions are elective deferrals by the doctor or nonelective (or matching) contributions by the hospital.

<u>Comment</u>: Because of this aggregation rule, it is important that any employer contributing to a 403(b) plan for an employee obtain information from participants regarding other employers controlled by the participant and plans maintained by those controlled employers in order to monitor compliance with applicable limitations and to comply with reporting and withholding obligations. This might best be accomplished during the open enrollment period, and, explanation of the aggregation rules should also be provided in the 403(b) plan's summary plan description.

<u>Catch-up contributions</u>. Age 50 catch-up contributions (which are not subject to the Section 415 overall limit) are permitted under 403(b) plans, as is a special catch-up election under Code Section 402(g)(7) (which is subject to Section 415) for employees who have completed 15 or more years of service with an educational organization, hospital or certain other organizations described in the regulations. The final regulations have expanded the list of organizations whose employees qualify for this catch-up provision to include adoption agencies and agencies assisting substance abusers and the disabled. Under the special 403(b) catch-up election, employees with the requisite number of years of service with a qualifying organization may make an additional elective deferral each year of up to $3,000. Where an employee is eligible to make both the special 403(b) catch-up election and age 50 catch-up contributions, catch-up contributions are treated first as made under the special 403(b) catch-up election and then under the age 50 catch-up provision.

<u>Former Employees</u>. For purposes of applying the contribution limits to a 403(b) plan, a former employee is deemed to have includible compensation until the end of the fifth complete taxable year of the employee beginning after termination of employment (which could be a period approaching six years, depending upon when employment terminates). Based upon this compensation, the employer may continue to contribute to a 403(b) plan on behalf of a former employee, subject to the Section 415 limit (either the applicable dollar limit or 100% of the former employee's includible compensation, whichever is less). Unlike severance payments made directly to the former employee, these contributions would not be subject to FICA taxes. They are, however, subject to the nondiscrimination requirements applicable to nonelective employer contributions.

The final regulations also permit elective deferrals to be made from the same post-employment compensation as is permitted for 401(k) plans under the final Section 415 regulations, <u>i.e.</u>, certain compensation paid by the later of 2-1/2 months after severance from employment or the end of the limitation year in which severance from employment occurs. This change applies for taxable years beginning on or after July 1, 2007.

<u>Excess Contributions</u>. Any contribution made to a 403(b) plan for a year on behalf of an employee that exceeds the above limits is includible in the employee's income for that year. If the contribution exceeds the overall limit under Section 415 of the Code, it must be held in a separate account; if it is not, the annuity contract ceases to be a 403(b) contract. Any excess allocated to a separate account may be distributed to the employee. Excess deferrals may be

distributed by April 15 following the taxable year in which contributed (together with allocable income). In this case, the excess deferral is included in the employee's income for the year of deferral and the income is included in the employee's gross income for the year of distribution. If distributed after April 15, there would also be a 10% penalty tax for early distribution.

Time for Contributions. Contributions to a 403(b) plan must be transferred to the insurance company issuing the annuity contract (or to the entity holding assets of a custodial or retirement income account treated as an annuity contract) within a period that is no longer than is reasonable for the proper administration of the plan. A plan may require the transfer of elective deferrals within a specified period after the amounts would otherwise have been paid to the participant, such as within 15 business days following the month in which the amounts would otherwise have been paid. If the 403(b) plan is subject to Title I of ERISA, Department of Labor regulations would require elective deferrals to be transferred to the annuity contract as soon as reasonably practicable but in no event later than 15 business days following the month in which the amounts would otherwise have been paid to the employee.

Distributions

When distributions may be made from a 403(b) plan depends upon the type of contribution involved and the funding medium in which it is held in the 403(b) plan.

Amounts Not Held in a Custodial Account and Not Attributable to Elective Deferrals. These amounts may be distributed no earlier than the first to occur of the employee's severance from employment or the occurrence of an identified event, such as the occurrence of a financial need (including a need to buy a home), the passage of a fixed number of years, the attainment of a stated age or disability. After-tax employee contributions (and earnings) and excess deferrals are not subject to this distribution restriction. Nor does it apply to prevent distributions on termination of a 403(b) plan.

Amounts Held in a Custodial Account that are Not Attributable to Elective Deferrals. These amounts may not be distributed before the employee severs from employment, dies, becomes disabled or attains age 59-1/2. Amounts transferred from a custodial account to an annuity contract or retirement income account (in the case of a church plan), including earnings, continue to be subject to this distribution restriction.

Amounts Attributable to Elective Deferrals. These amounts are subject to the same distribution restrictions as amounts held in a custodial account, except that they may be distributed earlier on account of the employee's hardship. The amount that may be distributed on account of hardship, and the circumstances that constitute a hardship, are determined in the same way as under Section 401(k) of the Code and may not exceed the employee's aggregate elective deferrals, not including earnings. If the 403(b) plan includes both elective deferrals and other contributions, the elective deferrals must be maintained in a separate account to be distributable on account of hardship.

Severance from Employment. For purposes of the distribution rules, a severance from employment occurs when an employee ceases to be an employee of the eligible employer (including other entities treated, under the rules described in Controlled Group Rules for Tax

Exempt Organizations, below, as the same employer as the employer maintaining the plan) that maintains the 403(b) plan. There is therefore no severance from employment if the employee transfers from one Section 501(c)(3) organization to another such organization that is treated as the same employer under the controlled group rules. There is, however, a severance from employment when an employee of a Section 501(c)(3) organization transfers to another entity that is treated as the same employer but is not an eligible employer (for example, to a for-profit subsidiary of a non-profit organization) or to employment that is not employment with an eligible employer (for example, when an employee performing services for a public school continues to work for the same State employer).

Minimum Distribution. 403(b) plans are subject to the same minimum distribution rules as qualified plans, with some minor modifications. For this purpose, they are treated as IRAs under the minimum distribution rules of Code Section 401(a)(9), except that a surviving spouse may not elect to treat a 403(b) contract as his or her own contract.

Loans. Loans are permitted under 403(b) plans. Whether the availability of a loan, the making of a loan or a failure to repay a loan is to be treated as a distribution depends on the facts and circumstances.

Termination of 403(b) Plan. The final regulations permit a 403(b) plan to be terminated or amended to eliminate future contributions for existing participants or to limit participation to existing participants and employees (subject to the nondiscrimination requirements discussed above, including the universal availability rule). On plan termination, accumulated benefits must be distributed as soon as possible, and this may be accomplished by the delivery of a fully paid individual annuity contract. If the distribution restrictions on elective deferrals and custodial accounts described above apply to the 403(b) plan, the plan may be terminated (and accumulated benefits distributed) only if the employer (including all entities that are treated as the same employer under the controlled group rules) does not contribute to any other 403(b) plan during the period beginning on the date of plan termination and ending 12 months after the distribution of all assets from the terminated plan. An exception applies if fewer than 2% of the employees under the terminated plan are eligible under the alternative 403(b) plan.

Qualified Domestic Relations Orders. A distribution from a 403(b) plan pursuant to a qualified domestic relations order is permitted even if the employee from whose contract distribution is made has not had a severance from employment or other event permitting a distribution.

Transfers. The final regulations permit three types of transfers from annuity contracts that are not treated as distributions:

1. An exchange of one 403(b) contract for another within a plan;

2. A transfer of the assets of a 403(b) plan to another 403(b) plan; and

3. A transfer of the assets of a 403(b) plan to a qualified plan to purchase permissive service credit under the receiving defined benefit plan.

Contract exchanges within the same plan are permitted if the 403(b) plan provides for the exchange; the employee's accumulated benefit is not reduced by the exchange; the new contract is subject to the same (or more stringent) distribution restrictions as the exchanged contract; and the employer enters into an agreement with the issuer of the new contract under which the employer and the issuer will provide each other with certain information.

A plan-to-plan transfer is permitted if the participant or beneficiary for whom or with respect to whom the transfer is made is an employee or former employee of the employer for the receiving plan; both the transferor and transferee plan provide for transfers; the participant's or beneficiary's accumulated benefit is not reduced by the transfer; and the transferee plan imposes the same (or more stringent) distribution restrictions on the transferred amount and treats the amount transferred as a continuation of the participant's or beneficiary's interest in the transferor plan.

Except in the case of permissive service credit, a transfer (not to be confused with a rollover, discussed immediately below) may not be made from a 403(b) plan to a qualified plan or to a 457(b) eligible governmental plan.

The changes to the rules governing contract exchanges do not apply to a contract received in an exchange that occurs before September 25, 2007, provided the exchange satisfied the IRS guidance in effect at the time of the exchange.

Rollovers. Amounts distributed from a 403(b) plan may be rolled over, either by means of a direct rollover or within 60 days of the distribution, to an eligible retirement plan. An eligible retirement plan includes a qualified plan, a 403(a) annuity plan, a 457(b) eligible governmental plan, an individual retirement account or annuity, and another 403(b) plan. Amounts that are not taxable upon distribution may only be rolled over by means of a direct rollover, except where the rollover is to an IRA.

The 403(b) plan must permit direct rollovers of eligible rollover distributions and the payor must provide the distributee with a notice of rollover rights under Section 402(f) of the Code. The 20% income tax withholding on eligible rollover distributions that are not directly rolled over applies to distributions from a 403(b) plan, as does the automatic rollover requirement of Code Section 401(a)(31) for mandatory distributions where the distributee does not affirmatively elect a direct rollover or a distribution.

Effect of Failure to Satisfy Section 403(b)

The effect of failing to satisfy the requirements of the regulations varies with the type of failure. If there is a failure that relates to the annuity contract of one individual only (for example, an excess contribution), since all annuity contacts purchased for an individual by an employer are treated as a single contract, any other contract purchased for that individual by that employer will also be treated as failing to satisfy Section 403(b) of the Code. Other individuals covered by the 403(b) plan are not affected.

A failure to operate in accordance with the terms of the 403(b) plan affects all of the contracts issued to the employee or employees with respect to whom the operational failure occurs. It does not affect other individuals covered by the 403(b) plan unless the operational failure involves noncompliance with the discrimination requirements or the employer is not an employer eligible to maintain a 403(b) plan. If the nondiscrimination requirements are not met, the employer is not an eligible employer or there is no written plan, all contracts issued under the plan fail to be Section 403(b) annuity contracts, and all contributions and earnings would be taxable to employees.

Controlled Group Rules for Tax Exempt Organizations

The employer for a plan maintained by a tax exempt organization includes the organization whose employees participate in the plan and other organizations with which it is under common control. The common control rules must be considered when applying the nondiscrimination requirements, the overall limit on benefits and contributions under Section 415 of the Code and the minimum distribution rules under Section 401(a)(9) of the Code. While the controlled group rules generally do not apply to church entities or governmental entities (such as public schools), they apply for purposes beyond Section 403(b) of the Code including for purposes of the qualification rules relating to Section 401(a) plans.

Common control generally exists between two exempt organizations if at least 80% of the directors or trustees of one organization are representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is a representative of another organization if he or she is a trustee, director, agent or employee of the other organization. A trustee or director is controlled by another organization if that other organization has the general power to remove the trustee or director and designate a new trustee or director.

In addition to mandatory aggregation of exempt organizations, the regulations permit exempt organizations that maintain a single plan covering one or more employees of each organization to treat themselves as under common control if each organization regularly coordinates its day-to-day activities with the other. As an example, emergency relief organizations operating within different geographic regions may treat themselves as under common control if they have a single plan covering employees of both entities and regularly coordinate their day-to-day exempt activities. Similarly, an exempt hospital and another exempt organization with which it coordinates the delivery of medical services or medical research may treat themselves as under common control in an appropriate case. The final regulations authorize the IRS to issue further rules or rulings permitting permissive aggregation of tax exempt entities. Permissive disaggregation is permitted between churches and entities that are not churches that jointly contribute to a church plan. Finally, the regulations authorize the IRS to treat an entity (including a taxable entity) as being under common control with an exempt organization if the entities are structured to avoid or evade the common control rules or other requirements under Sections 401(a), 403(b) or 457(b) of the Code.

Effective Dates

The final regulations are generally applicable for taxable years beginning after December 31, 2008.

Collective Bargaining Agreements. If a 403(b) plan is maintained under one or more collective bargaining agreements in effect on July 26, 2007, the regulations do not apply before the earlier of the date on which the last collective bargaining agreement terminates or July 26, 2010.

Church-Related Organizations. If authority to amend a 403(b) plan is held by a church convention, the regulations do not apply until the first plan year beginning after December 31, 2009.

Transition Rules. The universal availability rule does not apply to plans that exclude certain categories of employees on July 26, 2007, until the first taxable year beginning after December 31, 2009. The excluded categories of employees are those who make a one-time election to participate in a governmental plan, certain visiting professors and religious order employees who have taken a vow of poverty. Where collectively bargained employees are excluded from eligibility to make elective deferrals, the universal availability rule does not apply until the first taxable year beginning after December 31, 2008, or, if later, the first to occur of the date on which the collective bargaining agreement terminates or July 26, 2010.

Governmental Plans. Governmental plans that exclude the categories of employees mentioned above have until January 1, 2011, or the earlier close of the first post-2008 legislative session of the body with authority to amend the plan.

In-Service Distributions. The prohibition on in-service distributions of nonelective contributions from annuity contracts does not apply to contracts issued before January 1, 2009, and any amendment to a 403(b) plan to eliminate in-service distributions is not subject to the anti-cutback rules if adopted before January 1, 2009.

Designated Roth Contributions. The provisions of the regulations addressing Roth contributions are effective for taxable years beginning after 2006.

Special Rules for Certain Contracts. The final regulations limit the types of contracts that qualify as an annuity contract. For example, life insurance, endowment and health or accident insurance contracts do not qualify. This new rule does not apply to a contract issued before September 24, 2007.