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Section 403(b)

FINAL REGULATIONS OVERVIEW AND ACTION PLAN

2008

Whitepaper

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Background

On July 23, 2007, the Internal Revenue Service issued final regulations regarding 403(b) plans.[1] These final regulations (referred to in this document as the "Final Regulations") are a comprehensive update on prior guidance issued under Code Section 403(b). In some cases, this prior guidance has been adopted, and in some cases it can no longer be relied on.

The purpose of this technical bulletin is to provide you with a general overview of the Final Regulations, with an emphasis on some of the major changes that might impact the operation of your existing 403(b) plan(s) and contracts – it is not intended to be an exhaustive discussion of every nuance of the Final Regulations or Code section 403(b). Since 403(b) plans can only be sponsored by certain entities and maintained for certain employees, more specifically public schools and organizations exempt from tax under Code section 501(c)(3), and certain ministers[2], we will attempt to highlight which rules have general applicability, and which rules are unique to the specific type of sponsoring entity.

The Final Regulations are generally effective for plan years beginning on or after January 1, 2009, although there are some transition rules, discussed at the end of this bulletin, that provide for a later effective date for certain provisions.

Written Plan Requirement

In order for contributions under Code section 403(b) to receive favorable tax treatment (meaning, no inclusion in the employee's gross income), 403(b) annuity contracts must be maintained pursuant to a "plan."

The Final Regulations define a plan as a written defined contribution plan which satisfies the requirements of the Code and the Final Regulations in both form and operation. The written plan:

- Should contain provisions of general applicability, such as eligibility provisions;
- Need not be one single document, but can incorporate other documents (such as the insurance policy or custodial account) by reference;
- Can allocate responsibility for performing the plan's administrative functions to identified parties (such as the issuers), but not to individual participants; and
- Must identify who is responsible for administering requirements that are impacted by the aggregation of multiple contracts[3], such as loan and hardship provisions.

STOP *This is a new requirement.*

GO ***Action Plan.*** *Employers sponsoring a 403(b) arrangement should determine if the arrangement is maintained pursuant to a written plan document. If no, they need to adopt a written plan document. If yes, they should review their plan document to make sure it complies with the requirements of the Final Regulations. To the extent the plan is made up of other documents that are incorporated by reference, the sponsoring employer should ensure that there are no conflicts between the written plan and the incorporated documents.*

Interaction With Title I Of Erisa

Plans sponsored by governmental and most church entities are not subject to ERISA.[4] However, plans sponsored by 501(c)(3) organizations are subject to ERISA; therefore, this section pertains only to plans maintained by 501(c)(3) organizations.

Title I of ERISA[5] applies to employee pension benefit plans which are established and maintained by an employer. However, ERISA's regulations provide a safe harbor[6] for an employer who has limited involvement in its 403(b) arrangement, in which case such employer would not be considered as having "established or maintained" the plan and would not be subject to Title I of ERISA.

To qualify for the safe harbor, participation by participants in the plan must be voluntary, all rights under the annuity contract must be enforceable solely by the participant, and the employer's activities must be limited to such activities as permitting annuity contractors to publicize their products to employees, requesting information from the contractors, and summarizing the information received from the contractors; collecting deferral contributions, remitting those contributions, and maintaining records of those contributions; and holding one or more group annuity contracts covering employees in the employer's name.

[1] 403(b) is the section under the Internal Revenue Code of 1986, as amended ("Code"), dealing with tax-sheltered annuity arrangements. Generally, this refers to a plan of an employer under which 403(b) contracts for the employer's employees are maintained.

[2] See Code section 403(b)(1)(A).

[3] The Final Regulations require that all 403(b) contracts purchased for an individual by an employer be treated as if they were purchased under a single contract.

[4] ERISA §4(b)(1) and (2).

[5] Title I of ERISA includes ERISA's rules regarding reporting and disclosure, participation and vesting, funding, fiduciary obligations, and administration and enforcement.

[6] 29 CFR §2510.3-2(f).

The 403(b) community was concerned that the new written plan document requirement would somehow nullify the limited involvement safe harbor. However, the Department of Labor has announced that it believes tax-exempt employers can comply with the Final Regulations and still remain within the limited involvement safe harbor for 403(b) programs funded solely by elective deferral contributions.[7]

Action required.

***Action plan.** Employers who facilitate 403(b) arrangements between their employees and contract issuers and who intend to comply with the limited involvement safe harbor should (1) review their current involvement to determine whether they are complying with the safe harbor; (2) decide whether they will continue to comply with the safe harbor; and, (3) determine what steps they must take to comply with the safe harbor and the Final Regulations.*

Universal Availability For Elective Deferrals

GENERALLY

The universal availability rules apply to an employee's right to make elective deferral contributions. In short, the "universal availability" requirement[8] requires that if ANY employee of the employer can make 403(b) elective deferrals, then ALL employees of the employer must be permitted to make 403(b) elective deferrals. This rule not only applies to the ability to make traditional pre-tax deferrals, but also the ability to designate deferrals as post-tax "Roth" contributions.

Each employee must be given an "effective opportunity" to make deferrals, including notice of availability of the election, and a certain period of time to make an election. To that end, at least once per year the plan must provide employees with an opportunity to make or change their deferral elections.

ALLOWABLE EXCLUSIONS

The Final Regulations permit the exclusion of certain groups of individuals when deciding whether or not the plan satisfies the universal availability requirement, as follows:

- Employees eligible under another section 403(b) plan, or a 401(k) or 457(b) plan of the employer;
- Employees who are non-resident aliens;
- Employees who are students performing certain services for the employer, subject to certain conditions; and
- Employees who normally work fewer than 20 hours per week.

However, if the plan permits an individual within one of those excluded groups to make elective deferrals into the 403(b) plan, it must allow all other individuals within that excluded group to defer.

Although not specifically listed as permissible exclusions, the Final Regulations provide that the following two categories of individuals can be excluded for purposes of universal availability because they would not be considered "employees" of the sponsoring entity:

- Individuals working under a vow of poverty for an employer controlled by a church, where the individual is treated as an agent (not an employee) of the church; and
- Visiting professors, but only if the individual continues to receive his or her compensation from the home university and elective deferrals are made to the home university's 403(b) plan.

This is a change from prior guidance. The following classes of employees cannot be prohibited from making elective deferral contributions without violating the universal availability requirement:

- *Employees covered by a collective bargaining agreement;*
- *Employees who make a one-time election to participate in a 414(d) governmental plan rather than the 403(b) plan;*
- *Professors providing temporary services to another public school; and*
- *Employees affiliated with a religious order and who have taken a vow of poverty, where the religious order provides for the support of such employees in their retirement.[9]*

Action Plan. Sponsoring employers should review their plans to determine whether any of the above employee groups are excluded from eligibility to participate. If yes, the plan will have to be modified to allow for the eligibility and participation of those employees. The Applicability Dates section of this technical bulletin describes when a plan which currently contains any of the above prohibited exclusions must begin to allow those employees to participate.

Nondiscrimination

Employer contributions and after-tax employee contributions (not elective deferral contributions) made under a 403(b) contract cannot discriminate in favor of highly compensated employees. The type of sponsoring entity determines which of the nondiscrimination rules apply.

[7] Field Assistance Bulletin 2007-02.

[8] Code section 403(b)(12)(A)(ii).

[9] These exclusions were permitted under Notice 89-23, 1989-1CB 654.

All sponsoring entities are subject to the following:

- Compensation that can be taken into account under the 403(b) plan must be limited to a certain dollar amount, currently $225,000[10]; and
- Universal availability rules (discussed above).

Only non-governmental entities are subject to the following:

- Minimum coverage requirements;[11]
- Average contribution percentage testing (for matching and after-tax contributions);[12] and
- Nondiscrimination in contributions and benefits.[13]

STOP *Prior guidance allowed plans to apply a "good faith reasonable standard" in satisfying these nondiscrimination requirements. The Final Regulations only allow the good faith standard to be used by public schools and certain church entities for the limited purpose of determining their controlled group (as discussed further below).*

Plan Termination

There has always been uncertainty whether a 403(b) plan, once established, could be terminated. Historically, sponsoring employers who no longer wanted to offer the plan would freeze it with regard to future contributions. The Final Regulations provide guidance which would allow plans to include provisions that permit plan termination.

Upon plan termination, benefits either can be distributed to participants or rolled over by them to a different eligible retirement plan. However, distributions of elective deferrals and from custodial accounts can only be made if the employer[14] does not make contributions to any other 403(b) contract starting on the date of termination and ending 12 months following the date of distribution of all of the plan's assets.[15]

STOP *It is now clear that a sponsoring employer can terminate its 403(b) plan, but the sponsoring employer must proceed with caution.*

GO ***Action Plan.*** *This is a great opportunity for employers with frozen 403(b) plans to finally terminate their 403(b) plans. If an employer is considering terminating its 403(b) plan, it must understand that contributions cannot be made to other 403(b) contracts, with limited exception, during the 12-month period after total distribution from the terminating plan. In either case, the 403(b) plan will have to be amended to allow for plan termination and describe how distribution of assets will occur on termination.*

Nontaxable Exchanges And Transfers

The Final Regulations permit three types of non-taxable exchanges or transfers from and between 403(b) contracts, as follows:

CONTRACT EXCHANGES

This exchange, similar to the "90-24 transfer[16]," is where there is a change in investment within the same plan. To qualify, exchanges occurring after July 26, 2007 must satisfy the following:

- The plan under which the contract is issued permits the change;
- After the exchange, the participant will have an accumulated benefit in the new contract that is at least equal to the accumulated benefit under the old contract;
- The new contract includes distribution restrictions that are not less stringent than the old contract; and
- The employer enters into a contract with the issuer of the new contract under which the employer and issuer agree to share certain information with each other, including participant employment information which takes into account other 403(b) contracts or qualified employer plans (such as whether severance of employment has occurred for distribution purposes or whether hardship requirements are satisfied) and other information necessary to satisfy tax requirements.

Exchanges occurring on or before July 26, 2007 must satisfy the requirements under Revenue Ruling 90-24.

PLAN-TO-PLAN TRANSFER

This is where another employer's plan is receiving the exchange, and the following requirements must be met:

- The participant must be an employee or former employee of the receiving plan's sponsoring employer;
- The transferring plan provides for transfers and the receiving plan accepts transfers;
- After the transfer, the participant has an accumulated benefit in the receiving plan that is at least equal to the accumulated benefit in the transferring plan immediately before the transfer;

[10] This limit is subject to change under Code section 401(a)(17).

[11] Minimum coverage requirements are detailed under Code section 410(b).

[12] Average contribution percentage (or ACP) testing is described under Code section 401(m).

[13] These rules are described in Code section 401(a)(4).

[14] The term "employer" for this purpose includes all entities on the date of termination that would be combined and treated as a single employer under the controlled group rules of Code section 414.

[15] There is a limited exception to this limitation – contributions to another 403(b) contract during the period that begins 12 months before the date of termination and ends 12 months after final distribution can be disregarded if such contributions are made for the benefit of fewer than 2% of the terminating 403(b) plan's participants.

[16] See Revenue Ruling 90-24, 1990-1 CB 97.

- The receiving plan includes distribution restrictions that are not less stringent than the transferring plan; and
- If the transfer is not a complete transfer of the participant's interest in the transferring plan, the recipient plan treats the amount transferred as a continuation of a pro rata portion of the participant's interest in the 403(b) plan (for example, a pro rata portion of the participant's interest in any after-tax employee contributions).

PURCHASE OF PERMISSIVE SERVICE CREDIT
This is where 403(b) assets are transferred to a qualified plan under Code section 401(a) for the purpose of purchasing permissive service credits under, or making repayment to, a governmental defined benefit plan.

If a transfer or exchange does not fall within one of the above three categories, it is treated as a taxable distribution of benefits if it occurs after a distributable event, or as a taxable conversion to a nonqualified annuity contract if there has been no distributable event.

STOP *This is a change from prior guidance.*

GO *Action Plan. Sponsoring employers must review the new restrictions to determine how to ensure that exchanges within their plan, or transfers to and from other plans, are practical and handled properly. Failure to follow these new exchange and transfer requirements could result in potentially adverse tax consequences to the participants.*

Contributions

Excess Contributions
One of the advantages to participants of participating in a 403(b) plan is to have their own contributions and/or contributions of their employers made to the plan without including such contributions in their gross income for the year. The Code imposes annual limits on how much can be contributed to a 403(b) plan each year and there are ramifications to the participant if those limits are exceeded. The Final Regulations changed the rules for the treatment of contributions in excess of those Code limits.

Generally, an annuity contract will not fail to receive the favorable tax treatment for 403(b) annuity contracts up to those Code limits if any excess contributions are held in a separate account within the annuity contract. The annuity contract can provide for a distribution of those excess contributions, with income, no later than April 15 of the following taxable year.

STOP *The rules on the treatment of excess contributions have changed.*

GO *Action Plan. Sponsoring employers and the contract issuers should monitor, at least annually, the contributions being made to annuity contracts on behalf of employees. If a participant has excess contributions, the annuity contracts purchased for that participant will be tainted, thus jeopardizing the tax-free status of all contributions within those contracts, unless the excess deferrals are segregated and/or distributed.*

LIMITS
The Final Regulations did not change the various contribution limits that apply to 403(b) plans, such as the annual dollar limit on elective deferrals ($15,500 for 2007), the annual dollar limit on age 50 and special catch-up contributions ($5,000 and $3,000 for 2007, respectively), or the annual additions limit ($45,000 for 2007).

REMITTANCE OF CONTRIBUTIONS
Elective deferral contributions must be transferred by the sponsoring employer within a period of time that is "not longer than is reasonable for the proper administration of the plan." By way of example, the Final Regulations say that a plan could provide for elective deferral contributions to be remitted within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

STOP *This is a new requirement.*

GO *Action Plan. Sponsoring employers must ensure that 403(b) elective deferrals are remitted to the provider of the annuity account, custodial account or retirement income account within a reasonable period of time after being withheld from the employee's wages. The sponsoring employer should work with its payroll department or payroll agent to ascertain the time needed to remit elective deferral contributions and set up procedures to make sure that those deferrals are remitted as soon as administratively possible. This requirement is a hot topic in the 401(k) world, and will presumably be closely monitored in the 403(b) world.*

Timing Of Distributions And Benefits

ELECTIVE DEFERRAL CONTRIBUTIONS
For elective deferral contributions, the Final Regulations clarify that hardship distributions are now subject to the same rules as 401(k) plans.[17] This generally means that hardship distributions must be made on account of an immediate and heavy financial need and must be necessary to satisfy the financial need. Those 401(k) hardship rules also have safe harbors which, if met, would deem a participant to have met the requirements necessary for a hardship distribution.

STOP *This is a new requirement.*

GO *Action Plan. Plans and contracts that allow for hardship withdrawals will have to be revised to comply with the hardship rules that exist under the 401(k) regulations. These new rules will impact the manner of determining eligibility for hardships and the amount of hardships. Sponsoring employers must understand who qualifies individuals for hardship distributions and ensure that their procedures reflect the 401(k) requirements for hardships.*

[17] The regulations governing hardships for 401(k) plans can be found at Treas. Reg. 1.401(k)-1(d)(3).

NONELECTIVE EMPLOYER CONTRIBUTIONS
For nonelective employer contributions, the Final Regulations impose new distribution rules, as summarized below.

Account/ Contribution Type	DISTRIBUTABLE EVENT				
	Severance from Employment*	Disability	Attainment of Age 59½	Hardship	Occurrence of Preestablished event
Elective Deferrals	X	X	X	X	
Custodial accounts with no elective deferrals	X	X	X		
Non-custodial account contracts with no elective deferrals	X	X			X

*Described more fully below

The Final Regulations consider a "severance from employment" to have occurred on any date on which an individual ceases to be an employee of an eligible employer. This is true even where the individual continues to be employed by another entity that is considered the same employer where either the other entity is not an eligible employer (such as transferring from a 501(c)(3) entity to a for-profit subsidiary of a 501(c)(3) organization) or in a capacity that is not employment with an eligible employer (such as ceasing work as a public school employee but continuing to work for the State in a different capacity).

The Final Regulations contain new requirements for when 403(b) plans can distribute nonelective employer contributions. Prior to the Final Regulations, the only restrictions on distributions were those created by the plan.

Action Plan. *Plans with nonelective employer contributions must work with their contract issuers to ensure that distributions are made only upon the allowable distributable events. If necessary, plan documents and contracts will have to be revised to reflect these new distributable events. It is also important for the sponsoring employer and the contract issuer to understand when a true "severance from employment" has occurred, especially when that is the event being cited as allowing a distribution.*

MINIMUM REQUIRED DISTRIBUTIONS
Regardless of other distribution events, the Final Regulations make it clear that section 403(b) plans must meet the Code's minimum distribution requirements, which generally require plan participants to begin receiving a distribution of plan benefits no later than the April 1st following the year in which the individual attains age 70½ or retires, whichever is later.[18] For non-governmental or non-church plans, distributions for a 5% owner would have to be begin not later than the April 1st following the year in which the 5% owner attains age 70½. Where an employee holds multiple contracts, the minimum distribution need not come out of each separate contract; instead, the minimum distribution amount required from each contract can be aggregated, and the total minimum distribution amount can be taken from one or more contracts. These rules will apply to benefits under 403(b) contracts that accrued after December 31, 1986 if the issuer or custodian kept records identifying the pre-1987 account balance. Without such records, the entire 403(b) contract is subject to these rules.

Minimum required distribution requirements apply to 403(b) plans and contracts and this is an area which the IRS reviews for compliance.

Action Plan. *Sponsoring employers should coordinate with their vendors to ensure that participants who still have money in the plan at age 70 ½ have begun to receive distributions from their contracts. It is very easy for a contract issuer to run a report, with participants who have attained a certain age, to determine whether or not distributions have been made. Where there are multiple issuers involved, this review will require coordination, since it is possible that the minimum required distributions for all contracts in the aggregate can be satisfied by taking distributions from one or more of those contracts.*

TAXATION OF DISTRIBUTIONS

Generally, amounts distributed from a 403(b) contract are includible in the recipient's gross income in the year in which the distribution occurs. Early distribution penalties will apply on amounts actually distributed.

However, distributions from 403(b) contracts can be considered "eligible rollover distributions" and therefore can be rolled over directly into other eligible retirement plans and avoid current taxation. The payor must provide the participant, within a reasonable time period before making a distribution, an explanation of his or her right to elect a direct rollover and the income tax withholding consequences of failing to elect a direct rollover.[19] If the participant chooses to take a taxable distribution rather than roll over the funds, the distribution is subject to mandatory 20% income tax withholding.[20]

Action required.

[18] With some variation, the minimum required distribution rules found in Code section 401(a)(9) are to be applied as if the 403(b) plan was an individual retirement annuity or individual retirement account under Code section 408.

[19] Code section 402(f).

[20] Code section 3405(c).

Action Plan. Sponsoring employers should determine who is responsible for processing distributions and withholding. In addition, as part of that process, they should ensure that participants are given advance notice of their rights to make eligible rollover distributions, and the withholding requirements for failure to make such rollover distribution.

FUNDING

INVESTMENTS

The Final Regulations describe three eligible investments allowed under section 403(b). Those investments include annuity contracts, certain custodial accounts and retirement income accounts.

INCIDENTAL DEATH BENEFITS

Section 403(b) plans cannot offer life insurance, endowment, health or accident insurance, property, casualty, or liability contracts as part of the plan, unless the benefit can qualify as an "incidental death benefit." The inclusion of more than "incidental" death benefits would cause the contract to lose its favorable tax treatment as a 403(b) contract.

This is a new restriction.

Action Plan: This new restriction applies to contracts issued on or after September 24, 2007. Sponsoring employers and their providers will have to determine whether any of the prohibited contracts (life, endowment, property, etc.) are being proposed under the plan going forward.

CONTROLLED GROUP RULES

The Final Regulations provide new guidance for 501(c)(3) organizations on how to determine whether an entity contributing to a 403(b) plan is within a controlled group. This new guidance does not apply to governmental or church plans, which can still rely on prior guidance in determining controlled group status.[21]

These controlled group rules, which are broad in scope, clearly impact a 501(c)(3) organization that makes contributions to a 403(b) plan. Controlled group status would be relevant for purposes of the nondiscrimination requirements, annual additions limitations, catch up contributions and minimum distribution rules discussed within this technical bulletin. Generally, the employer for a plan maintained by a 501(c)(3) organization would include not only that employer's employees who participate in the 403(b) plan, but also any other organization that is under common control. Common control exists between a tax-exempt organization and another organization if at least 80% of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization. In addition, the Final Regulations permit tax-exempt organizations that regularly coordinate their day-to-day exempt activities to aggregate as a single employer if they maintain a single plan covering one or more employees from each organization.

The rules for determining controlled group status for 501(c)(3) organizations changed as a result of the Final Regulations. Rather than relying on Notice 89-23, 501(c)(3) organizations must determine controlled group status based on Treasury Regulation §1.414(c)-5. However, governmental and church plans can still rely on Notice 89-23 to determine their controlled group status.

Action Plan. If you are a 501(c)(3) organization and potentially are a member of a controlled group of corporations, you will need to determine whether or not the Final Regulation impact your previous determination and, if so, how that will impact the administration of your 403(b) plan.

Church Plan Retirement Income Accounts

A "retirement income account" is treated as an annuity contract for purposes of Code section 403(b) if it satisfies the following requirements:

- It is a defined contribution program established or maintained by a church-related organization[22] under which:
    - There is separate accounting for the underlying assets,
    - Investment performance is based on gains and losses on those assets, and
    - The assets held in the account must be used for the exclusive benefit of the participants or their beneficiaries.
- It must be maintained pursuant to a written plan, which must state its intent to constitute a retirement income account.

This is new.

Action Plan. If the sponsoring employer is a church-related organization intending to maintain certain retirement income accounts as annuity contracts under 403(b), the sponsoring employer must make sure it satisfies these new requirements. Failure to do so will mean that the retirement income account will not be afforded the same treatment as a 403(b) annuity contract.

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[21] Until further guidance is issued, governmental and church plans can rely on Notice 89-23 in determining controlled group status.

[22] A "church-related organization" means a church, or a convention or association of churches.

GBS Retirement Services, Inc.

Applicability Dates

The Final Regulations are generally effective January 1, 2009, but there are various transition rules that apply, as follows:

For 403(b) plans maintained pursuant to collective bargaining agreements in effect on July 26, 2007:	The earlier of (1) the date on which the last collective bargaining agreement terminates, or (2) July 26, 2010.
For 403(b) plans maintained by a church, where authority to amend the plan is held by a church convention:	The beginning of the first plan year after December 31, 2009.
For plans with prohibited universal availability exceptions in place on July 26, 2007 under Notice 89-23:	The plan can continue the exclusions until taxable years beginning on or after January 1, 2010.
For plans that exclude collectively bargained employees on July 26, 2007 from making elective deferrals:	The plan can continue that exclusion until the later of (1) the first day of the first taxable year after December 31, 2008, or (2) the earlier of (a) the date such agreement terminates or (b) July 26, 2010.
For governmental plans where authority to amend the plan is held by a legislative body that meets in legislative session:	The plan can continue existing exclusions until the earlier of (1) the close of the first regular legislative session that begins on or after January 1, 2009 or (2) January 1, 2011.
For plans that allow distribution upon severance from employment or the occurrence of an event:	Such distributions cannot apply to contracts issued before January 1, 2009.
For 90-24 contract exchanges that occurred on or before September 24, 2007:	The Final Regulations do not apply, assuming the exchange satisfied rules in effect prior to the Final Regulations.

The Final Regulations make it clear that taxpayers can rely on these regulations prior to the appropriate applicability date, as long as the reliance is applied on a consistent and reasonable basis.

STOP *You should carefully review each of the above transition rules to understand the date by which you and your 403(b) plan must comply with the Final Regulations.*

GO *Action Plan. Sponsoring employers can begin to comply with the Final Regulations immediately, as long as their reliance is acted upon consistently and reasonably. You should work with your consultant and contract issuers to assess the impact of the Final Regulations on your 403(b) plan, and make sure all necessary action is taken within sufficient time to comply with the Final Regulations on or before the required date(s) of applicability.*

Conclusion

The Final Regulations impact various facets of 403(b) plans. In some instances they have upheld and clarified previous guidance, and in other instances they have completely changed the rules. In any event, it is important to understand the rules going forward to ensure the continued advantages of offering a 403(b) plan for both the sponsoring employer and the participants. Gallagher Retirement Services understands how 403(b) plans are expected to operate, and can work with sponsoring employers to make sure that their 403(b) plans satisfy, in both form and operation, the various requirements to which they are now subject as a result of the Final Regulations.

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