

# IRS Releases Final 403(b) Regulations

On July 26, 2007, the IRS published final 403(b) regulations, which apply to retirement savings arrangements sponsored by public schools and 501(c)(3) tax exempt organizations and will generally be effective starting on January 1, 2009. The final regulations provide a comprehensive update of 40 years of requirements under Section 403(b) and include various transition rules, which are discussed below. Generally, for periods following July 26, 2007 and before the applicable effective date, the preamble states that taxpayers can rely on these regulations as long as the reliance is on a consistent and reasonable basis.

The final regulations allocate increased responsibilities to the employer as the sponsor of the 403(b) plan and broaden employee participation. Employer responsibilities include the following:

- written plan documentation incorporating mandatory and optional plan features offered by the 403(b) plan, and
- entering into administrative agreements with providers issuing contracts offered as investment opportunities under the 403(b) plan to ensure that all IRS rules are met, including but not limited to, contribution limits, loans, distributions and qualified domestic relations orders.

While the final regulations generally defer the effective date for most provisions until January 1, 2009, employers will need to take the following actions to prepare for implementation:

- ✓ Determine what mandatory and optional plan features will be available under the 403(b) plan.
- ✓ Collect and update plan documentation.
- ✓ Identify eligible employees and develop an annual notice, if necessary.
- ✓ Allocate responsibility in writing for performing administrative functions consistent with the terms of the plan.
- ✓ Review collective bargaining agreements.
- ✓ Review enabling legislation pertinent to governmental entities.

## 403(b) Rules At A Glance

Following are highlights of the final 403(b) regulations:

- Written plan

A 403(b) sponsor is responsible for maintaining a written defined contribution plan document and operating the 403(b) plan in accordance with its terms. The plan document must contain all material provisions, including eligibility, benefits, applicable limits, contracts available under the plan, and the time and form under which benefit distributions would be made. The IRS notes that it is acceptable to incorporate these elements into the written plan by reference to other documents. These are *mandatory* features.

The plan document may contain certain *optional* features not required under section 403(b), as long as the optional provisions meet, in both form and operation, the relevant requirement under section 403(b). Optional features, which may also be referred to as *permissive*, include the following:

- hardship distributions,
- loans,
- plan-to-plan transfers
- contract exchanges, and
- acceptance of rollovers into the plan.

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According to the preamble to the final regulations, the IRS points to the need for one “central document for a comprehensive summary of responsibilities” among the sponsor, the vendors and any other entities (such as third party administrators (TPAs)) involved in implementing the 403(b) plan. As a result, the final regulations modify the written plan requirement of the proposed regulations by strongly suggesting that a 403(b) plan be operated under a single plan document, even in a multiple vendor environment. According to the preamble, the IRS and Treasury Department expect to publish guidance before the final regulations are effective which will include model plan provisions that may be used by public school employers.

For a 501(c)(3) organization (that is not a church or church-affiliated sponsor) that considers its 403(b) plan to be non-ERISA, the plan document requirement will not subject the plan to Title I of ERISA if the plan satisfies Department of Labor (DOL) requirements. Under Field Assistance Bulletin No. 2007-02, released July 24, 2007 <http://www.dol.gov/ebsa/newsroom/pr072407.html>, the DOL indicated that it will look at all facts and circumstances to determine whether the organization’s 403(b) plan now would become subject to ERISA.

- Notice to Eligible Employees to Meet "Universal Availability"

At least once during each plan year, the employer must provide employees with an “effective opportunity” to make or change an elective deferral election by providing notice of the availability of this election, the period of time during which this election may be made, and any other conditions on elections. The opportunity to make deferrals would include the employee’s right to contribute up to the lesser of the maximum allowable contribution.

The notice to be provided to all eligible employees regarding participation in the 403(b) plan must also remind employees that they can designate their contributions between Roth and pre-tax elective deferrals (to the extent permitted under the 403(b) plan).

In general, universal availability would apply separately to each entity sponsoring the 403(b) plan (for public schools, to the extent that there is not a common payroll).

A 403(b) plan can exclude the following employees from participating in the elective deferral component of the plan:

- employees who are eligible under another 403(b) plan or 457(b) eligible governmental plan of the employer, which permits an amount to be contributed or deferred at the employee’s election;
- employees who are eligible to make a cash or deferred election under an employer’s 401(k) plan;
- employees who are non-resident aliens;
- employees who are students meeting certain requirements; and
- subject to the nondiscrimination rules under Code Section 410(b)(4) (to the extent applicable), employees who normally work fewer than 20 hours per week or such lower number of hours specified in the plan document. An employee is considered to work fewer than 20 hours per week only if:
  - for the 12-month period beginning on the date the employee’s employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours per year in such period; and
  - for each plan year ending after the close of the 12-month period beginning on the date the employee’s employment commenced, the employee worked fewer than 1,000 hours of service in the preceding 12-month period.

The final regulations eliminated certain regulatory exceptions under Notice 89-23. Therefore, subject to transitional rules, the following employees must be permitted to participate in a 403(b) plan *and* must receive an annual notice informing them of that right with respect to elective deferrals and Roth 403(b) contributions (if permitted under the plan):

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- Employees covered under collective bargaining agreements;
- Employees who make a one-time election to participate in a governmental plan instead of a 403(b);
- Visiting professors for up to a year under certain circumstances; and
- Employees affiliated with a religious order who have taken a vow of poverty.

The *transitional rules* are as follows:

If a 403(b) plan excluded collectively bargained employees from 403(b) plan participation on July 26, 2007, it can continue to exclude these employees until the later of:

- the first day of the first taxable year that begins after December 31, 2008, or
- the earlier of (i) the date that the collective bargaining agreement terminates (disregarding any extension after July 26, 2007) and (ii) July 26, 2010.

If a plan excluded any of the other types of employees listed above under the discussion of Notice 89-23 on July 26, 2007, the exclusion can continue until the first day of the taxable year beginning after December 31, 2009.

In addition, if a 403(b) plan is maintained by a governmental entity, the final regulations provide that all of the employee exclusions may continue until the earlier of (i) the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009 or (ii) January 1, 2011.

- **Modification of Transfer Rules**

The final regulations obsolete IRS Revenue Ruling 90-24 effective January 1, 2009 and provide for plan-to-plan transfers and contract exchanges. Amounts transferred between 403(b) plans as well as contract exchanges must be subject to distribution rules at least as stringent as those of the transferring contract. Note that the final regulations permit transfers from a 403(b) plan to a governmental defined benefit plan for the purchase of permissive service credit or to make a repayment.

*Plan-to-plan transfers* between section 403(b) plans of any eligible 403(b) plan sponsor must meet the following criteria:

- the individual whose assets are being transferred is an employee or former employee of the employer of the receiving 403(b) plan or a beneficiary of a deceased employee who was an employee or former employee of the employer of the receiving 403(b) plan;
- both 403(b) plans provide for the transfer and receipt;
- transferred assets before the transfer equal those after the transfer; and
- if a portion of the 403(b) account is transferred, the receiving plan appropriately accounts for the amounts received (e.g., elective deferrals amounts vs. after-tax contributions).

*Contract exchanges* among vendors within the same employer's 403(b) plan must be explicitly permitted under the plan. In addition, exchanged assets before the exchange equal those after the exchange. The final regulations provide that the new contract exchange rules apply to transfers made on or after September 25, 2007 (which is 60 days following the date that the final regulations were published in the Federal Register). Any contract exchange made on or before September 24, 2007 does not have to meet the new contract exchange rules provided the transfer meets all of the applicable requirements (e.g., the transfers meets all of the requirements of Rev. Rul. 90-24).

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If a 403(b) plan permits contract exchanges, then the final regulations add an additional ongoing administrative requirement on both the employer and the vendor receiving the transfer. The employer and the vendor receiving the transfer must enter into an agreement, which would require that the employer and vendor provide each other with participant employment information on an ongoing basis, including:

- whether and when a severance of employment has occurred to determine whether the participant has a distributable event;
- information concerning other 403(b) contracts and "any other contract" to which the employer has made contributions for determining whether a participant is able to take a plan loan (since all plans of the employer are required to be aggregated in order to determine the maximum loan availability); and
- information concerning whether the hardship withdrawal rules have been satisfied.

- **Need for all 403(b) Contracts to Satisfy IRS Rules**

The final regulations note that all 403(b) contracts -- regardless of vendor -- are aggregated and treated as a single contract purchased for the employee by the sponsor. If any contract is operationally deficient and has not been corrected in accordance with IRS procedures, then the entire 403(b) account for that individual -- including all other contracts issued for the benefit of that employee -- will be considered disqualified.

- **Post-Termination Employer Contributions For Up to 5 Years**

These contributions cannot exceed includible compensation (based on the former employee's most recent one-year period of service) up to the applicable year's dollar amount under the 415(c) annual additions limit. If the former employee dies during the 5-year period of post-termination employer contributions, an example in the final regulations would permit employer contributions to be made to the 403(b) plan in a one-sum amount in the year of death, subject to the plan terms and other criteria. The example does not apparently permit employer contributions to be made beyond the year in which the participant died.

- **New Distribution Rules**

The final regulations make clear that employee self-certification for money-out transactions is insufficient and that "employer oversight" is critical to ensure accuracy.

Amounts attributable to employer contributions that are held in an annuity contract can only be distributed from a 403(b) contract upon severance from employment or the prior occurrence of an event (such as a fixed number of years, reaching a stated age, or disability). If the vendor does not segregate employee elective deferrals from other contributions, amounts could be distributed only at the later of the occurrence of a distributable event using the elective deferral rules or a distributable event using the non-salary reduction contribution rules. The final regulations specify that these revised rules pertaining to in-service distributions do not apply to a contract issued by an insurance company before January 1, 2009.

Any (non-Roth) *after-tax* contributions and attributable earnings may be distributed for any reason and at any time. Note that while this is the IRS rule, plan and/or contractual provisions may be more restrictive.

- **Separate Accounting**

If the plan has employer contributions subject to a vesting schedule, then the recordkeeping system must separately account for those amounts and attributable earnings.

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- Roth 403(b) Rules

The final regulations reference the rules relating to designated Roth contributions throughout; however, the final regulations do not address taxation of distribution of Roth amounts under a 403(b) contract. Instead, the final regulations refer to the April 2007 final Roth 401(k) distribution regulations.

- Rules for Bitaxual Entities

While the proposed regulations discussed bitaxual entities (i.e., those employers who have both governmental and non-profit status), the final regulations do not appear to address bitaxual entities.

- Plan Termination Permitted

The final regulations permit a plan sponsor to terminate its 403(b) plan. A distribution of assets from a terminated 403(b) plan can include a distribution to a participant or beneficiary or the delivery of a fully paid 403(b) individual annuity contract.

A 403(b) plan can be terminated and permit distribution of benefits as soon as administratively practicable upon plan termination. The IRS has previously taken the position that 403(b) salary reduction contributions and amounts contributed to a 403(b)(7) custodial account could not be distributed upon plan termination because there was insufficient authority to do so in the Internal Revenue Code. According to the preamble, from July 27, 2007 and before the 2009 effective date, the final regulations can be relied upon only if all of the contracts issued under the plan at the time of termination satisfy all of the applicable requirements of these regulations, except the written plan document requirement.

- Definition of “Health and Welfare Service Agency” for 15 year-catch-up rules

The final regulations expand the definition of “health and welfare service agency” to include an adoption agency. A health and welfare agency means:

- an organization whose primary activity is to provide medical care;
- a 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals;
- an adoption agency; or
- an agency which provides substantial personal services to the needy as part of its primary activity.

If an employee has performed at least 15 years of service with a health and welfare service agency, he may be eligible for this additional catch-up of up to \$3,000/year (subject to a \$15,000 lifetime maximum).

- Timing of contributions

Contributions must be remitted to the 403(b) plan's investment vehicle no later than is reasonable for the proper administration of the 403(b) plan. A plan may provide for 403(b) elective deferrals for a participant under the plan to be transferred to the annuity contract within a specified period after the date the amounts would otherwise have been paid to the participant.

*Example. A plan could provide for the 403(b) elective deferrals under the plan to be contributed within 15 business days following the month which these amounts would otherwise have been paid to the participant.*

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- Church plans

The final regulations provide for several special rules applicable to church plans. In general, a retirement income account used to fund a church's 403(b) plan is treated as an annuity contract for purposes of 403(b), even if it invests solely in stock of a regulated investment company. In addition, a retirement income account must be maintained in accordance with a written plan.

### **Additional Information from the IRS**

In conjunction with the release of the final 403(b) regulations, the IRS released the following:

- Final 403(b) Regulations <http://frwebgate3.access.gpo.gov/cgi-bin/waisgate.cgi?WAISdocID=46370432085+0+1+0&WAISaction=retrieve>
- *Employee Plans News - Special Edition - July 2007* [http://www.irs.gov/pub/irs-tege/se\\_0707.pdf](http://www.irs.gov/pub/irs-tege/se_0707.pdf)
- Overview of the Final Regulations <http://www.irs.gov/retirement/article/0,,id=172431,00.html>
- Questions and Answers from Bob Architect <http://www.irs.gov/retirement/article/0,,id=172433,00.html>
- PowerPoint Presentation of the Technical Highlights [http://www.irs.gov/pub/irs-tege/403b\\_technical\\_pres.pdf](http://www.irs.gov/pub/irs-tege/403b_technical_pres.pdf)
- PowerPoint Presentation for School Administrators [http://www.irs.gov/pub/irs-tege/403b\\_school\\_pres.pdf](http://www.irs.gov/pub/irs-tege/403b_school_pres.pdf)

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