A Timely Analysis of Legal Developments

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The IRS recently issued final regulations governing Section 403(b) retirement plans, which frequently are sponsored by charitable organizations, public schools and universities. The final regulations make significant changes to the 403(b) playing field and generally are effective January 1, 2009, with a "written plan documentation requirement" and a "reasonable interpretation of the regulations" standard extending to December 31, 2009.

Changing the Playing Field: A Look at the Major Provisions Of the Final 403(b) Regulations Impacting 403(b) Plans

By Nancy L. Ober and J. René Toadvine

Charitable organizations, public schools and universities may sponsor retirement plans that are governed by Section 403(b) of the Internal Revenue Code ("Section 403(b)"). The rules under Section 403(b) are different than the rules governing other types of retirement plans. In July 2007, the Internal Revenue Service (IRS) and the Department of Treasury issued final regulations governing these arrangements. The regulations comprise the first comprehensive Section 403(b) plan guidance in over 40 years and make major changes to the 403(b) playing field. The final regulations incorporate previous section 403(b) guidance made during the intervening years that significantly narrowed the differences between 403(b) plans and other tax-qualified retirement arrangements, especially 401(k) plans. The final regulations generally became effective January 1, 2009. However, the IRS issued guidance at the end of 2008 (Notice 2009-3) extending a "written plan documentation" requirement to December 31, 2009, and providing that 403(b) plan sponsors may operate their plans under a "reasonable interpretation" of the 403(b) rules, including the final regulations, during 2009. Additionally, Notice 2009-3 provides a means by which employers may make retroactive correction of certain 403(b) plan operational failures. The following is a summary of some of the major provisions of the final regulations that will require employer attention before the end of 2009.

Employers Must Have a Written Plan Document

Historically, certain types of 403(b) plans have not been required to be embodied in written documents in the same manner as other types of retirement plans. However, effective January 1, 2010, 403(b) plan sponsors must have a written plan document containing all material terms of the 403(b) arrangement, including eligibility for participation, the types of contributions permitted (*e.g.*, employee salary deferrals, employer matching and/or nonelective contributions), the form and time of distributions, 415 limitations, identification of the contracts or mutual funds available for investment under the plan (Section 403(b) plans must be funded through annuity contracts issued by an insurance company or custodial accounts invested in mutual funds) and allocation

of responsibilities between the employer and the annuity contract provider or custodian and any other parties involved in implementing the plan. Because a 403(b) plan may be comprised of disparate elements such as insurance documents and annuity contracts, a plan sponsor may wish to utilize a "wrap plan," which incorporates the contracts and other documents into a separate plan document. Pursuant to the final regulations, the 403(b) documents and contracts must also include provisions regarding nontransferability, nonforfeitability, deferral limits, minimum required distributions and incidental benefit limitations.

The written plan document requirement has become a significant issue for employers that sponsor "non-ERISA" 403(b) plans, as prior to the issuance of the final regulations, only ERISA-governed 403(b) plans were required to be embodied in a written plan document. ERISA does not cover plans sponsored by state and local governmental entities, such as public schools, or church plans that do not elect to be covered. In addition, Department of Labor (DOL) regulations historically have exempted from ERISA's requirements (including the written documentation requirement) 403(b) plans with solely a salary deferral feature and minimal employer involvement in plan administration. Such "non-ERISA" plans will now be required to have a written plan document in order to satisfy the requirements under Code Section 403(b). In a bit of good news, the DOL issued Field Assistance Bulletin 2007-02, in which the DOL announced that merely adopting a written plan document to comply with the final regulations will not cause a "non-ERISA" plan to become subject to ERISA. However, there are certain administrative aspects set forth in the final regulations that, if performed by the employer-plan sponsor, could result in the plan becoming subject to ERISA if the employer becomes more than "minimally involved" with the plan. We understand that some 403(b) contract providers are requiring plan sponsors to assume the role of plan administrator, which may result in a previously "non-ERISA" plan becoming subject to ERISA. As a result, employers who sponsor "non-ERISA" plans are encouraged to review the ERISA-status issue with competent ERISA counsel.

"Universal Availability" and Nondiscrimination Rules

With the exception of church plans, employee elective salary deferrals under a 403(b) plan historically have been subject to Section 403(b)'s "universal availability" rule that requires that an employer allow all employees normally working more than 20 hours per week to make elective deferrals of at least $200 if any employee is permitted to make deferrals, with limited exceptions. The final regulations change these limited exceptions and most notably remove the exception that permitted employers to exclude collectively bargained employees. However, under a transition rule, employers are permitted to continue the current exclusion of collectively bargained employees until the later of January 1, 2009, or the termination date of the bargaining agreement in effect on July 26, 2007 (without regard to extensions) but not later than July 26, 2010.

In addition, the final regulations repeal the nondiscrimination safe harbors provided under IRS Notice 89-23 and generally require the same nondiscrimination testing on all employer contributions made under a 403(b) plan (other than employee salary deferrals) that apply to qualified retirement plans. In particular, employer matching and nonelective contributions made to nongovernmental plans are subject to the same nondiscrimination requirements that apply to qualified retirement plans, including the requirement that the plan cover a minimum number of nonhighly compensated employees. Matching contributions and after-tax employee contributions must satisfy the same nondiscrimination test (the average contribution percentage or "ACP test") that applies to matching contributions and after-tax employee contributions under a 401(k) plan.

The nondiscrimination tests must be performed on a controlled group basis. Prior guidance employed a "reasonable, good faith" standard for determining which entities were in a controlled group. However, the final regulations generally have changed this standard for tax-exempt entities and now provide new, objective rules for determining whether a controlled group exists (certain church entities and state or local government public schools may still employ the "reasonable, good faith" standard). Under the final regulations, organizations under common control are treated as a single employer for purposes of applying these nondiscrimination rules, as well as the section 415(c) limits on contributions. Common control between two or more organizations exists when 80% or more of the directors or trustees of one organization are either representatives of, or are directly or indirectly controlled by, another organization.

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Changes to Deferral Elections Must Be Permitted

Under the final regulations, employees must have the right to make, stop or modify deferrals at least once a year and must be notified of the availability of this election.

Deferrals Must Be Forwarded Promptly

The final regulations require employers to forward employees' elective deferrals to the plan within a period that is no longer than reasonable for plan administration. A period of 15 business days following the end of the month in which the deferral would have been paid to the participant is provided in the regulations as an example of how this rule could be applied. However, if the government interprets these rules in a manner similar to the DOL's interpretation of DOL regulations regarding the timing of deposits of employees' elective deferrals to 401(k) plans, it is possible that plan sponsors could be informed by the government that reasonable periods will differ depending upon the ability of a payroll provider to expeditiously transfer the deferred funds to the plan.

Distributions Are Permitted Only Upon the Occurrence of a Stated Event

Historically, elective deferrals to Section 403(b) annuity contracts and all contributions (employee elective deferrals and employer contributions other than elective contributions) made to a 403(b) custodial account have been subject to the same restrictions on distribution as elective deferrals under 401(k) plans, *i.e.*, distribution is permitted only upon severance from employment, death, disability, financial hardship or attainment of age 59-1/2 (with a grandfather rule in effect for account balances as of December 31, 1988). However, the final regulations now subject non-elective employer contributions made to Section 403(b) plan annuity contracts generally to the more restrictive rules that govern distributions from non-401(k) defined contribution plans, *i.e.*, distribution permitted only upon severance from employment or the occurrence of a stated event, such as completion of a fixed number of years (generally at least 2 years), the attainment of a stated age, death or disability. Employee after-tax contributions may be distributed at any time, consistent with plan provisions.

No severance from employment occurs for purposes of these distribution rules if an employee of a tax-exempt organization continues to work for another employer in the controlled group that is eligible to sponsor a 403(b) plan, or if a public school employee transfers to another public school in the same state.

Contract Exchanges May Be Treated as Nontaxable Changes of Investments

Previously, a Section 403(b) plan participant could exchange annuity contracts without any tax consequences so long as the successor contract had distribution restrictions at least as stringent as the predecessor contract. Effective after September 24, 2007, participants may exchange one annuity contract for another within the same plan, and the exchange will be treated as a nontaxable change in investment, rather than a taxable distribution, provided certain requirements are satisfied. First, the plan by its terms must permit the exchange. Second, the participant's accumulated benefit must not be reduced by the exchange, and the transferee contract must have distribution restrictions at least as stringent as the transferor contract. Third, the employer and the annuity contract provider must agree to provide each other with information about the participant's employment status and other information necessary to maintain the tax-deferred status of the plan.

In-Service Plan-to-Plan Asset Transfers

The final regulations also permit nontaxable plan-to-plan transfers of accumulated benefits between 403(b) plans while the participant is still employed if the participant is either an employee or a former employee of the employer sponsoring the receiving plan. In addition, in order to effect the transfer: (1) the transferor plan must provide for the transfer and the transferee plan must accept the transfer;

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(2) the participant's accumulated benefit must not be reduced by the transfer; and (3) the transferee plan must impose restrictions on distributions at least as stringent as those of the transferor plan.

Plan Termination

In an extremely positive move, the final regulations permit an employer for the first time to terminate a Section 403(b) plan and distribute the benefits upon plan termination. However, the final regulations restrict the distribution of benefits under a Section 403(b) plan under rules similar to those governing 401(k) plans; namely, distribution and rollover of elective deferrals are permitted only if an employer within the controlled group does not contribute to another 403(b) plan within one year before and after termination of the plan under which two percent or more of the employees in the terminated plan participate. Additionally, full vesting of employer contributions is required upon plan termination.

What Employers Should Do Now:

1. Review 403(b) plan documents, including annuity contracts, custodial accounts, summary plan descriptions, services agreements, and other related documents to determine whether revisions are necessary to comply with the final regulations. Also, review with vendors whether movement to a "prototype" document is appropriate.
2. With respect to "non-ERISA" plans, analyze the impact of the final regulations and discuss with 403(b) plan providers and counsel whether continued "non-ERISA" plan status is still desired and/or viable.
3. Review the organizational structure of the sponsoring entity and related entities to determine controlled group status.
4. Review the eligibility provisions and employer contribution data to ensure compliance with the "universal availability" and nondiscrimination rules.

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