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Compliance Essential

Questions and Answers

Solutions for Private Tax-Exempt 403(b) Organizations

403(b)

The arrival of final 403(b) regulations has many plan sponsors concerned about the potential impact on their responsibilities. That's why we compiled these frequently asked questions and answered them with the most up-to-date information available.

Q: What is the background of the final 403(b) regulations?

A: The Internal Revenue Service (IRS) and the Department of the Treasury released final 403(b) regulations on July 24, 2007, which were published in the Federal Register on July 26, 2007, more than 2½ years after publication of proposed regulations in November 2004. The final regulations essentially follow the course set forth in the proposed regulations, with some modifications that were generally favorable to plan sponsors, plan participants and plan providers.

Coincident with the release of the final 403(b) regulations, the Department of Labor (DOL) released a Field Assistance Bulletin (2007-02) addressing the impact of the regulations on a private tax-exempt employer's ability to continue to maintain a non-ERISA voluntary 403(b) program. The DOL guidance confirmed that agency's belief that it remains possible to satisfy applicable IRS requirements without causing the plan to become subject to the requirements of Title I of ERISA.

Plans already subject to the requirements of Title I of ERISA, and other larger plans with centralized administration may need very little change as a result of the final regulations. Many non-ERISA plans, including 403(b) plans sponsored by public school districts, public colleges and universities, as well as voluntary non-ERISA 403(b) programs of private tax-exempt employers, likely will require more significant changes to comply with the new requirements.

Q: How comprehensive are the regulation changes?

A: The 403(b) regulations are comprehensive and thus address a wide range of issues relating to 403(b) plans. This Q & A will focus on a few key elements of the final 403(b) regulations and the related DOL guidance, along with some key topics. The following topics will be addressed:

- Effective date
- Written plan
- Transfers and exchanges
- Consequence of defects
- Universal availability and other nondiscrimination requirements
- Distributions and loans
- Contribution limits
- Vesting
- Plan termination
- Timing of contribution remittance
- Title I of ERISA

Q: What is the effective date of the final 403(b) regulations?

A: The regulations are generally effective January 1, 2009, but also contain some earlier effective dates and a number of delayed effective dates as well as grandfathering provisions. Plans are also permitted to adopt the new regulations before January 1, 2009, provided that they adopt them in their entirety. Early adopters are still not required to have a written plan before January 1, 2009.

Q: Are the final regulations a “one-size-fits-all” set of requirements?

A: The final regulations preserved most, if not all, of the flexibility described in the proposed regulations, permitting plan sponsors to structure their plans and allocate plan responsibilities as most appropriate for their specific plans. Responsibilities can be allocated among the plan sponsor itself, the plan providers and, if desired, additional service providers. Thus, contrary to some previous market speculation, the final regulations do not set forth a “one-size-fits-all” set of requirements.

Q: Will the final 403(b) regulations include written plan requirements?

A: All 403(b) plans must be maintained pursuant to a written plan. This requirement brings 403(b) plans in line with similar employer-sponsored plans, but also retains much of the typical flexibility for governmental plans. The written plan must include basic provisions, such as the following:

- Eligibility
- Benefits
- Limitations
- Available contracts and accounts
- Time and form of distributions
- Roles and responsibilities under the plan

Q: Can multiple plans be sponsored and will multiple documents satisfy the written plan requirement?

A: While the regulations anticipate a single document per plan, they allow for the possibility that an employer may sponsor multiple 403(b) plans. They also allow that a collection of documents may potentially constitute the plan. This collection of documents can include the following:

- A formal plan document
- State statutes and regulations
- Administrative procedures
- Annuity contracts and custodial agreements
- Lists of authorized providers and products
- Service agreements setting forth the administrative responsibilities of authorized providers

Even employers seeking to establish a single written plan document are likely to rely on outside documents as part of the plan, including the contracts and accounts authorized under the plan as well as the lists of authorized providers. In any event, the key to satisfying the requirement with a collection of documents is, simply, to actually collect the documents into one place to demonstrate to concerned parties (and to the IRS in the event of an audit) that the requirements are satisfied.

Employees can expect many of their providers, and other parties as well, to offer up sample plan documents. NOTE: Any references to “prototype 403(b) documents” would be inaccurate, as there is no program today for the IRS to approve prototype 403(b) documents. However, stay tuned, because that could change. Documents offered by providers and other parties should be vendor-neutral to work with multiple 403(b) contracts and accounts.

The IRS has also issued model plan language for 403(b) plans sponsored by “public schools” which appears to apply to public colleges, universities, and community colleges as well as public primary and secondary (K-12) schools. A public school that incorporates some or all of the model language into its plan can obtain reliance to the extent of the model language incorporated. The same guidance addressed questions regarding which contracts the employer must include in its plan, in order to avoid adverse tax consequences for these contracts.

Q: Will the written plan subject the arrangement to Title I of ERISA?

A: One frequent question prior to the release of the final 403(b) regulations was whether the written plan would subject the arrangement to Title I of ERISA or to similar fiduciary obligations. Of course, governmental plans (including plans of public school districts, public colleges and universities, and public hospitals) and nonelecting church plans are exempt from Title I of ERISA. Moreover, while state-defined benefit pension systems are frequently subject to fiduciary standards under state law, those specific pension system statutes rarely if ever apply to voluntary 403(b) programs available to employees who participate in those same state pension systems. (Of course, plan sponsors should always consult their organization's legal counsel for guidance on specific state and local laws and regulations applicable to their plans.) In the case of private tax-exempt employers, the DOL has released guidance on the application of Title I of ERISA to plans sponsored by those organizations in light of the final 403(b) regulations.

In general, that guidance expressed the DOL's view that an employer could satisfy the requirements of the final 403(b) regulations while still preserving the plan's exemption from Title I of ERISA, provided that care was taken to avoid the creation of employer discretionary authority, such as making decisions about withdrawals or loans, or otherwise exercising or limiting the exercise of a participant's rights under the investment product they had selected. A document may require, among other things, that providers under the plan coordinate with each other with respect to certain transactions, including loans and financial hardship withdrawals, for those participants maintaining accounts with more than one provider under the plan.

Q: What are the transfers and exchanges restrictions within the final 403(b) regulations?

A: The regulations restrict transfers to three types.

Transfers within the plan — referred to as "exchanges"

These transfers may only be made to contracts and accounts identified under the plan. These can include contracts or accounts to which contributions may also be made, and they also can include contracts or accounts for which the provider has an agreement with the plan sponsor to provide compliance support, including relevant data sharing between the employer and the provider.

Transfers to another plan — referred to as "plan-to-plan transfers"

These transfers can be made to another plan maintained by a current or former employer of the participant.

Transfers to a state retirement system to purchase defined benefit plan service credits

These already exist in current law.

The first two transfer types listed on previous page are subject to specific requirements including:

- The sending and receiving plans must both permit the transfer (in the case of an intra-plan transfer, or exchange, both are the same).
- The transferred amount must be subject to distribution restrictions that are not less than those imposed under the previous plan, contract or account.
- The entire "accumulated benefit" (full or partial, and adjusted for applicable surrender charges, as appropriate) is transferred.

Q: When does revocation of Revenue Ruling 90-24 begin?

A: The regulations provide that Revenue Ruling 90-24 will not be revoked until the general effective date of the regulations, which is January 1, 2009. However, any transfer to another provider after September 24, 2007, will cause the receiving contract to become taxable on January 1, 2009, unless one of the following two conditions is satisfied:

- The provider and contract are approved by the employer and a part of the employer's plan on January 1, 2009, or
- The provider enters into an information-sharing agreement with the employer effective not later than January 1, 2009.

In other words, the IRS views the grandfather date of September 24, 2007, as only ensuring that a transfer on or before that date will continue to be treated as a qualifying transfer. The grandfathered contract is not protected from application of the new transfer rules. Thus, a grandfathered contract which receives a new transfer or exchange after September 24, 2007, will forfeit that grandfathering.

Q: Can you explain the information-sharing agreement further?

A: To satisfy the second condition, although it is not exactly clear what information will be required, the type of information that providers and employers will likely need to agree to share includes:

- Any information necessary for the receiving contract and other contracts in the plan to satisfy section 403(b), including
 - information concerning the participant's employment, such as whether a termination of employment has occurred
 - information taking into account other section 403(b) contracts or qualified employer plans, such as information necessary to determine compliance with applicable hardship distribution requirements
- Information necessary to satisfy other tax requirements, including whether a plan loan satisfies the applicable Internal Revenue Code provisions

Although the information-sharing agreements are not required to be in place until January 1, 2009, it is important that providers now contemplate their ability to enter into agreements to share the information required for purposes of compliance with 403(b) and other tax requirements (e.g., employment, loan and withdrawal information) before accepting post-September 24, 2007, transfers. Failure to enter into the agreement after receiving a post-September 24, 2007, transfer will pose the risk of adverse tax consequences come January 1, 2009.

The IRS has indicated, in Revenue Procedure 2007-71, that a transfer to an unapproved product (i.e., not in the plan, and no information-sharing agreement) after September 24, 2007, and before January 1, 2009, generally can be corrected by re-transferring to an approved product by June 30, 2009. The IRS has also provided additional guidance regarding accounts of former employees and beneficiaries, as well as accounts of current employees, with previously deselected products.

Q: What are the consequences of defects?

A: The final regulations clarify and confirm that the consequences of a defect in a participant's account – such as an uncorrected excess contribution or an impermissible distribution – do not extend to innocent participants. This does not change the rule, of course, that plan-level defects, such as documentation defects and discrimination defects, can affect every participant, nor does it change the rule today regarding what defects — whether individual or planwide — can be self-corrected under existing IRS guidance, though the regulations also indicate that revisions to this IRS guidance will be forthcoming.

Q: Have the universal availability requirements been clarified?

A: All 403(b) plans other than church plans (narrower definition than for ERISA purposes) are subject to the universal availability requirement, which provides that if the employer permits any employee to make elective deferrals to the plan, the employer must allow all employees to do so, with certain limited exceptions. Examples of exceptions include employees who normally work fewer than 20 hours per week, employees who are not willing to contribute at least \$200 in a year, and employees eligible to defer to another qualifying plan of the same employer. The final regulations include the simplified rule proposed in 2004 for the 20-hour exclusion, applying a 1,000-hour test to determine deferral eligibility. For existing employees who have been with the employer for at least a full year, the 1,000-hour test will be backward-looking, while with newer employees it will be a forward-looking test.

Q: Have the nondiscrimination rules changed?

A: Nondiscrimination rules, that went into effect in 1989, also apply to employer 403(b) contributions and nonelective employee 403(b) contributions made to plans sponsored by private tax-exempt employers (other than churches). Safe harbors (in Revenue Procedures 89-23) for complying with the requirements are eliminated under the final regulations, and the plans will need to comply with each of the designated qualified plan requirements.

Q: Will there be new provisions governing hardship distributions?

A: The final regulations included several new provisions governing distributions and loans, including the following on 403(b) plans. They are now officially subject to 401(k) hardship distribution rules. Until now, while legislative history from 1986 legislation had suggested the connection, there was no express rule in the statutes or regulations. The 401(k) rules include both safe harbor ("deemed") and general ("facts and circumstances") provisions for both tests, including:

- Determining whether the participant has an "immediate and heavy financial need" which qualifies as a hardship
- Determining whether the distribution is necessary to satisfy that immediate and heavy financial need, including whether the need can be met from other available resources

In reference to hardships, a distribution is deemed to satisfy the applicable hardship rules if the participant's deferrals are stopped for six months after receipt of the hardship withdrawal and if certain other requirements are satisfied, including reliance on the employee for information regarding other available resources. It is likely that many plan sponsors will adopt this deferral cessation rule, and thus require notification when a hardship distribution is taken (if the employer is not the party approving the hardship), rather than undertaking additional responsibilities to qualify the availability of other resources.

Q: What are the ramifications of the regulations on plan administration?

A: As was the case before the final regulations, rules governing distributions and loans apply across providers under the plan. The IRS made clear that an employer has an obligation to ensure that there is coordination in place to ensure that withdrawals and loans in the aggregate do not violate applicable rules. It is up to the employer to determine how the responsibilities are divided. However, it seems fairly clear that the plan cannot solely rely on certain information by the participant to satisfy these requirements. For example, it likely will not be sufficient for the participant to be the sole provider of information on defaulted loans or the existence of other loans under the plan, whether that information relates to:

- Investment providers within the plan
- Investment providers with information-sharing agreements with the employer including pre-existing contracts that do not qualify for grandfathering

Q: Will employer contributions to 403(b) annuity contracts now be subject to withdrawal restrictions?

A: Employer contributions (and nonelective employee contributions) to a 403(b) annuity contract become subject to new withdrawal restrictions (none apply today, unless in the plan). These new withdrawal restrictions, which generally allow a distribution only at a specified time or upon the occurrence of a specified event, will not apply to contracts issued before January 1, 2009, and in many cases will be satisfied by existing plan-imposed restrictions.

After-tax 403(b) contributions (other than Roth contributions) are not subject to withdrawal restrictions under the Code. This provided a clarification for custodial accounts and a confirmation for annuity contracts.

Q: Can the plan administrator assign compliance responsibility among various parties?

A: Plans with multiple investment providers can continue to require the investment providers to administer many of the compliance restrictions, the majority of which are necessarily included in the contracts or accounts. However, the plan will need to include a mechanism for applying rules such as loan eligibility and limitations, and hardship eligibility, across providers. Moreover, the plan cannot assign administrative duties to the participant.

Q: What is an example of information sharing that will be required under the rules?

A: Plan service providers should confirm a participant's severance of employment with the employer before processing a distribution rather than simply relying on the participant's representations that he or she has experienced such a severance. Thus, unless the employer is providing periodic updates to investment and/or service providers as to which employees have experienced such a severance, the employer might itself need to approve all such severance distributions.

Q: Did the regulations address QDROs?

A: Distributions pursuant to a qualified domestic relations order (QDRO) do not require satisfaction of a distributable event. While this is not a new conclusion, it has not previously been clearly delineated in final regulations.

Q: Have the contribution limitation rules changed?

A: The final 403(b) regulations provided a few clarifications and revisions regarding applicable contribution limitations. If there are contributions in excess of the Code Section 415(c) defined contribution plan limitations applicable to the total of employer and employee contributions, the entire contribution for the year (and not just the excess amount, as under current law) will be taxable to the participant. This rule will not apply, however, if the excess amount is separately identified and tracked as an after-tax balance [under Code Section 403(c)] for recordkeeping purposes from the time it is contributed.

Q: Do the regulations address post-separation and catch-up contributions?

A: The final regulations also clarify how post-separation and catch-up contributions must be applied. They restate that a participant must exhaust all contribution limits, including the increased contribution limit under Code Section 402(g)(7) (which generally allows certain participants who have 15+ years of service with a qualifying employer to contribute up to an additional \$3,000 per year up to a maximum \$15,000 during the course of their employment) before benefiting from the 50 or older age-based catch-up provision.

Q: What is a health or welfare agency?

A: The final regulations also provide a definition of "health and welfare service agency," for purposes of determining eligibility for special catch-up rules under Code Section 402(g) for this category of 501(c)(3) organizations, including the following:

- An organization in which the primary activity is to provide medical care (such as a hospice)
- An organization in which the primary activity is to prevent cruelty to people or animals, or to assist needy individuals
- Adoption agency
- Home health services agency
- An organization providing assistance to individuals with drug abuse problems or to the disabled

Q: May a 403(b) plan subject employer contributions to a vesting schedule?

A: A 403(b) plan can be subject to a vesting schedule, without violating the otherwise applicable nonforfeitability requirements under Code Section 403(b). However, any nonvested amounts should be accounted for separately as a balance under an account described in Code Section 403(c).

Q: Do the 403(b) regulations now provide for plan termination?

A: A 403(b) plan can be terminated, and accounts (or individual annuity contracts) can be distributed, without violating the withdrawal restrictions under Code Section 403(b), provided that certain requirements are satisfied. One of those requirements is that there be no contributions to that 403(b) plan or any other 403(b) plan for a period of at least twelve months from the termination, unless such contributions are considered *de minimus* as described in the regulation. Thus, for example, an employer sponsoring multiple 403(b) plans could not terminate just one of those plans under the new rules and continue contributions to the others.

Q: Do the new 403(b) regulations include timing requirements for contribution remittance?

A: The regulations require that the employer remit contributions to eligible contracts and accounts within a reasonable time following withholding from employees' pay. The employer must provide an example of remitting by the fifteenth day of the month following such withholding.

The regulation provisions do not appear to dictate how an employer must remit contributions, whether directly or through a third party. Nor do the regulations otherwise restrict an employer from combining contributions to reduce the number of remittances, provided that for each and every contribution the timing requirements are satisfied.

Q: Will I become a fiduciary?

A: There is nothing in the final 403(b) regulations that states or implies that employers are fiduciaries with respect to the 403(b) products purchased for their employees. Quite the contrary, voluntary 403(b) plans of private tax-exempt employers, which do not enjoy the governmental plan exemption from Title I of ERISA, may still be maintained with very limited employer involvement.

The Department of Labor confirmed this point in a Field Assistance Bulletin that discussed plans of private tax-exempt employees, noting that the continued availability of an existing exemption for voluntary deferral plans depends on the extent of the employer's involvement. However, depending on state law and the scope of the responsibilities that a public employer has elected to assume under the plan, that employer may take on new responsibilities (whether or not characterized as fiduciary responsibilities) that are greater than those imposed under the 403(b) regulations.

You may have read or heard analysis on this topic recently. In some cases the analysis addresses individual states, while in other cases the topic is addressed only very generically. It is always possible that a specific state's laws, regulations or common law could impose broad fiduciary or fiduciary-like responsibilities on a public employer sponsoring a 403(b) plan. Plan sponsors should consult legal counsel for specific advice regarding their plans. However, as a general matter, this topic presents several opportunities for confusion and misdirection. For example:

- It is true that most state-defined benefit pension and retirement systems, and some state 457(b) plans, are subject to explicit fiduciary duties under the governing state statutes and regulations. It is also true, however, that these same statutes and regulations generally do not apply to a public employer's 403(b) plan. Of course, specific duties and considerations may apply to the handling and timely remittance of contributions.

State or local procurement rules and similar rules may govern the process of provider review and selection. Identifying such duties, rules and considerations, however, generally is very different from imposing broad ERISA-like fiduciary duties on a public employer 403(b) plan sponsor.

- In a few states – including California, Texas and Ohio – a school district is specifically prohibited from excluding a provider or product from receiving new contributions under the plan as long as the provider and product satisfy applicable state requirements. As a general matter, those state requirements include satisfying the requirements of Code Section 403(b). In California and Texas, the requirements also include participation in a state registry of eligible providers and/or products. As a general matter, however, a school district is normally permitted to exclude a product which does not satisfy the requirements of Code Section 403(b).
- In some states, an employer that takes a more active role in reviewing the underlying products, over and above its review of the product's compliance with the requirements of Section 403(b), might itself trigger a heightened level of duty to participants. However, any discussion of potential liability that might be associated with narrowing the field of available products within the 403(b) plan should also consider the potential application of sovereign immunity principles to a public employer's plan, particularly in the absence of specific legal rules imposing a defined set of fiduciary obligations to that function.

In any case, if and to the extent state law imposes responsibilities on employers, those responsibilities are not changed or enlarged by the 403(b) regulations.

Of course, public employers are free to voluntarily assume fiduciary, or fiduciary-like, responsibilities under their 403(b) plan, assuming no restrictions on the assumption of such responsibilities under state law. However, it is important to distinguish among a public employer's tax compliance responsibilities, its legal responsibilities to employees under state law, and whatever non-legally mandated actions it chooses to take to provide a quality program for its employees. Fiduciary status could increase a plan sponsor's potential liabilities, and an employer should not take action that assumes or implies that it has such responsibilities without careful consideration and unbiased legal advice.

Q: Can life insurance be provided in a 403(b) plan?

A: Effective September 25, 2007, life insurance and similar incidental benefits are no longer permitted in 403(b) plans. The final regulations include a transition rule for policies issued before February 14, 2005.

**Separate FACT from FICTION when it comes
to the final 403(b) regulations.**

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