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# Management Alert

## Final 403(b) Regulations Released

On July 26, 2007, the Treasury Department released final comprehensive regulations governing tax-sheltered 403(b) programs, which cover employees of public schools, churches and certain tax-exempt organizations. The new regulations represent a wake up call to sponsors of 403(b) plans that have for decades enjoyed loose regulation and tax enforcement. Sponsors of 403(b) plans beware—those days are coming to an end. For the first time, each and every 403(b) sponsor must set forth the material terms of its tax annuity program in writing, and will be held accountable for enforcing such terms, even if the 403(b) arrangement encompasses multiple vendors.

Simultaneous with the issuance of the 403(b) final regulations, the Department of Labor issued a Field Assistance Bulletin (FAB 2007-02) to clarify that the written plan document requirement contained in the regulations will not cause a plan to be automatically covered by ERISA (the Federal employment law governing employee benefits). The regulations also provide explanation regarding the impact of the controlled group rules and the penalties for failure to satisfy 403(b). The effective date for the final regulations is the taxable year beginning after *December 31, 2008.*

This Management Alert summarizes the significant aspects of the 403(b) final regulations, and the Department of Labor's Bulletin, and provides guidance to achieve plan compliance.

### Written Plan Document Requirement

#### *All Mandatory Terms Included*

The final regulations retain the requirement from the 2004 proposed regulations that a section 403(b) contract be issued pursuant to a written plan which, in both form and operation, satisfies the requirements of section 403(b) and the final regulations. Specifically, a 403(b) document must include the material terms and conditions for eligibility, benefits, applicable limitations, funding media and distributions. The inclusion of optional plan features, *e.g.* hardship withdrawals, must also be documented.

The plan document requirement will present a significant undertaking for many sponsors of 403(b) plans for two reasons. First, under current rules, many sponsors of 403(b) plans have done little, if anything, by way of formal documentation. Second, many sponsors of 403(b) plans use multiple vendors. The final regulations charge sponsors with the task of distilling the terms of the disparate contracts and/or custodial accounts (or specifically incorporating them by reference) into a consolidated, 403(b)-compliant plan document—a daunting task for many sponsors of 403(b) plans.

The existence of a written plan provides a central locus to coordinate all administrative functions, and benefits participants by setting forth their rights under the plan. The final regulations indicate that government agencies will use the plan document to determine if the program meets compliance requirements under 403(b) and the regulations, including the universal eligibility requirement (described in detail below).

While a section 403(b) contract issued to an employee can provide for the issuer to perform many of these functions, the contract by itself cannot satisfy the function of setting forth the eligibility criteria for other employees, nor can the issuer by itself coordinate those Code requirements that depend on other contracts, such as the loan limitations under section 72(p). The issuer must rely on information or representations provided by either the employer or the employee for employment-based

information that is essential for compliance with section 403(b) provisions, such as the limitations on elective deferrals in section 402(g) and the requirements of section 72(p)(2) for a plan loan that is not a taxable deemed distribution.

### *Compliance Responsibility*

The written plan may provide for allocation of plan administration responsibilities among the employer, the issuer of the contract or parties involved in implementing the plan. Any such allocation must identify who is responsible for compliance with the requirements of the Code that apply based on the aggregated contracts issued to a participant, including loans under section 72(p) and the requirements for obtaining a hardship withdrawal under §1.403(b)-6 of these regulations. Designation is important for accountability and to eliminate the risk that administrative responsibilities will not be provided for.

### *No Conflicting Terms from Vendors*

The plan, although a single document, may incorporate a wide variety of other documents by specific reference. However, the employer must ensure that there are no conflicts with other documents that are incorporated by reference. If a plan does incorporate other documents by reference, then, in the event of a conflict with another document, generally, the plan would govern. In the case of a plan that is funded through multiple issuers, it is expected that an employer would adopt a single plan document to coordinate administration among the issuers, rather than maintaining a separate document for each issuer.

### *Model Plans*

The IRS and Treasury Department expect to publish guidance which includes model plan provisions that may be used by public school employers for this purpose. Because the requirement for a written plan will not go into effect until the taxable year beginning after December 31, 2008, employers would be expected to adopt a written plan which complies with 403(b) (including applicable amendments) no later than such date.

### *ERISA Not Triggered*

Under the proposed rules, an open issue with respect to nongovernmental employers was whether a plan document would necessitate a level of employer involvement that would cause the arrangement to be covered by ERISA. The Department of Labor has indicated in Field Assistance Bulletin 2007-02 that its "safe harbor" regulation governing 403(b) programs still applies. Hence, compliance with the 403(b) regulations will not cause a 403(b) arrangement to be covered by Title I of ERISA per se. Sponsors of 403(b) plans are cautioned, however, that there is inherent tension between tax and labor regulations. Specifically, with respect to non-ERISA 403(b) programs, employers must set forth in writing the terms of a 403(b) program over which it has no control. As a result, sponsors who have adopted the Department of Labor safe harbor may wish to rethink this strategy.

### *Failure to Comply: Taxation*

Failure to comply with the written plan requirement will cause each and every affected contract and/or custodial account to become immediately taxable, including contributions and earnings.

## Additional 403(b) Compliance Requirements

### *Treatment of Controlled Groups that Include Tax-Exempt Entities*

The final regulations retain the basic rules in the 2004 proposed regulations regarding controlled groups for entities that are tax-exempt under section 501(a), but with a number of modifications. As in the 2004 proposed regulations, these rules are not limited to section 403(b) plans, but apply more broadly for purposes of determining when tax-exempt entities are treated as a single employer under section 414(b), (c), (m), and (o). Thus, for example, these rules apply for purposes of plans maintained by a tax-exempt entity that are intended to be qualified under section 401(a).

The final regulations provide that two section 501(c) organizations are treated as a single employer, or a section 501(c) organization and a non-section 501(c) organization as a single employer, if the organizations are under common

control. For this purpose, common control would exist between a tax-exempt organization and another organization if at least 80 percent of the directors or trustees of one organization were either representatives of, or directly or indirectly controlled by, the other organization.

These rules would be generally relevant for purposes of the nondiscrimination requirements, as well as for the section 415 contribution limitations, the special section 403(b) catch-up contributions, and the section 401(a)(9) minimum distribution rules.

The regulations permit tax-exempt organizations to choose to be aggregated (permissive aggregation) if they maintain a single plan covering one or more employees from each organization and the organizations regularly coordinated their day-to-day exempt activities. These rules continue to be subject to an overall anti-abuse rule.

The IRS is authorized to issue published guidance permitting other types of combinations of entities that include tax-exempt entities to elect to be treated as under common control for one or more specified purposes. This authority is limited to situations in which there are substantial business reasons for maintaining each entity in a separate trust, corporation, or other form, and under which common control treatment would be consistent with the anti-abuse standards in the regulations.

Failure to comply with the controlled group rules which affect the plan's compliance with the discrimination, the contribution and distribution rules could cause a significant impact to the participants and the employer.

### *Catch-up Contributions Clarified*

A 403(b) plan may provide for two types of catch-up contributions: (1) a catch-up contribution for a participant who is age 50 or older (up to $5,000 in 2007); and (2) a special catch-up contribution for a participant who has at least 15 years of service (available only to 403(b) plan participants.) The final regulations confirm that if a participant is eligible for both catch-up contributions, the special 15 years of service contribution should be applied before the age 50 catch-up contribution.

Employers should verify that both the plan document and the administration of the plan comport with these coordination rules.

### *Universal Availability for Elective Deferrals*

By way of background, the universal availability requirement under section 403(b) generally provides that all employees of the eligible employer must be permitted to elect to have section 403(b) elective deferrals contributed on their behalf.

The final regulations provide that the employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions.

Sponsors of 403(b) plans are cautioned that the final regulations have eliminated several exclusions from the universal availability rule which were permitted under transitional guidance, *e.g.*, employees under a collective bargaining agreement, and professors on sabbatical must now be included. However, the regulations maintain certain exclusions from the universal availability rule and provide transition relief for the exclusions which are being eliminated.

### *"Severance from Employment" Definition*

Participants in a 403(b) plan are entitled to take a distribution upon a severance of employment. The final regulations, like the proposed regulations, adopt the definition of "severance from employment" from the 401(k) plan regulations. However, the final rules add that a severance from employment also includes the participant ceasing to be employed by an eligible employer that maintains the Section 403(b) plan. For example, a severance from employment will occur when an employee transfers from a parent Section 501(c)(3) organization to its for-profit subsidiary. Upon transfer, the employee will have a "severance from employment" and thus be eligible for a plan distribution.

Employers must verify that the 403(b) plan is in administrative compliance when employees transfer between organizations.

### *Termination of a Section 403(b) Plan*

The final regulations permit an employer to amend its section 403(b) plan to eliminate future contributions for existing participants. The final regulations further permit an employer to terminate a plan and effect distribution of accumulated benefits, with the associated right to roll over eligible rollover distributions to an eligible retirement plan, such as an individual retirement account or annuity (IRA).

In general, the distribution of accumulated benefits is permitted under these regulations only if the employer (including all entities that are treated as a single employer on the date of termination) does not make contributions to any section 403(b) contract and/or custodial account that is not part of the plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. The final regulations specify that this provision is effective if at all times during the period beginning 12 months before the termination and ending 12 months after distribution of all assets from the terminated plan, fewer than two percent of the employees who were eligible under the terminated plan are eligible under the alternative section 403(b) contract and/or custodial account.

### *Contract Exchanges/Plan-to-Plan Transfers and Purchase of Permissive Service Credit*

The final regulations, like the proposed regulations, provide for three types of non-taxable exchanges or transfers of amounts in section 403(b) contracts. A non-taxable transfer is permissible if: (1) it is a mere change in investment within the same plan/contract; (2) it constitutes a plan-to-plan transfer; or (3) it is a transfer for the purpose of purchasing permissive service credit. If the exchange fits within these three exceptions, the exchange will not be treated as a distribution.

The final regulations did not adopt the elimination of contract exchanges as provided for in the proposed regulations. Instead, the final regulations retain the contract exchange exclusion, with additional requirements. Additionally, the regulations authorize the IRS to issue guidance on contract exchanges. Employers who put contract exchanges on hold pursuant to the proposed regulations may want to revisit the issue.

The final regulations expand on the proposed regulations under which plan-to-plan transfers would be permitted only if the participant was an employee of the employer maintaining the receiving plan. Under the final regulations, plan-to-plan transfers are allowed if the participant whose assets are being transferred is an employee or former employer of the employer. The final regulations did, however, retain from the proposed regulations the plan-to-plan transfer restrictions to and from qualified plans. Employers should review plan documents to verify compliance with these rules.

The final regulations, like the proposed regulations, include an exception permitting a section 403(b) plan to provide for the transfer of its assets to a qualified plan to purchase permissive service credits under a defined benefit governmental plan.

### *Application of Roth Contributions*

The final regulations adopted the proposed regulations issued in 2006 with regard to Roth contributions to a 403(b) plan. Employers wishing to allow participants to designate contributions as Roth contributions should amend their 403(b) plans accordingly.

### *Distributions*

The final regulations retain the requirement that distributions on elective deferrals may not be paid to a participant earlier than when the participant has a severance from employment, has a hardship, becomes disabled, or attains age 59-1/2. Contracts and custodial accounts issued before January 1, 2009 are grandfathered, and relief from the ERISA Title I anti-cutback rules is provided for pre-2009 amendments to conform with these rules.

The final regulations, however, clarify that after-tax employee contributions are not subject to any in-service distribution restrictions.

The final regulations also require Section 403(b) plans to make automatic rollovers of certain mandatory distributions in the same manner as qualified plans.

Also, the final regulations clarify that distributions made pursuant to a QDRO must follow the ERISA QDRO rules.

### *Loans*

The final regulations maintain the same requirements as the proposed regulations for loans from Section 403(b) plans. Loans must be analyzed in light of all of the facts and circumstances to determine whether they are constructive distributions or otherwise might violate any of the requirements of Section 403(b), including "whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere."

### *Vesting*

The final regulations maintain the same requirements as the proposed regulations for vesting of Section 403(b) contributions. Section 403(b) requires that the employee's rights under the contract are nonforfeitable, meaning that the employee's benefits are fully vested. If the employee's benefits are not vested, then the contract is considered a nonqualified annuity subject to Section 403(c). Additionally, the final regulations allow for partial vesting where only a portion of an employee's interest becomes nonforfeitable in a year, in which case that portion is subject to Section 403(b).

## Effect Of Failure to Satisfy 403(b)

The tax penalties incurred for failing to satisfy the requirements under the regulations will be depend on the type of defect. If there is an operational failure on the part of the plan such as a discrimination defect, none of the contracts issued under the plan would satisfy the 403(b) requirements and all contributions and earnings would be taxable. If the defect relates to the contract of an individual such as an excess contribution, all contracts purchased for that individual by the employer will be considered to fail to satisfy 403(b). Therefore, it is important to distinguish the type of defect, the participants affected and the resulting potential penalties.

## Action Steps to Comply With 403(b) Regulations

Because the plan document requirement represents the first requirement of its kind, many sponsors of 403(b) plans are faced with the daunting task of distilling the material terms of disparate annuity contracts and custodial accounts to a single document. Where should sponsors of 403(b) plans begin? We've identified the following discrete action steps to assist sponsors of 403(b) plans in this significant undertaking:

- Inventory vendor relationships
- Obtain copies of the individual contracts and/or custodial agreements and related materials from vendors.
- Obtain employee communications, summary plan descriptions and prospectuses from vendors.
- Review the material terms and conditions for eligibility, benefits, applicable limitations, funding media and distributions based on plan documents and contracts.
- Identify conflict in terms, administration and related plan agreements
- Review existing vendor contracts and relationships and identify designated services.
- Consider consolidation, if multiple issuers of contracts and/or custodial accounts.
- With respect to governmental employers, review existing state and local legislation for compliance. (Legislative action may be required to comply with the new rules.)

In addition, to achieve compliance with the final regulations, sponsors of 403(b) plans should take the following actions:

- Conduct controlled group analysis of employer and other related entities to determine if the entities are under common control.
- Review the 403(b) plan or plans of the controlled group entities.
- Conduct due diligence operational review.
- Review discrimination tests, contribution limitations, other reports, if available, including internal control procedures.
- Develop a plan to achieve compliance.

*If you have questions about the final 403(b) regulations or any other employee benefits matter, please contact your Seyfarth Shaw attorney or any Seyfarth attorney on our website at www.seyfarth.com.*

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