

Client Alert

A report
for clients
and friends
of the Firm September 2007

IRS Finalizes 403(b) Regulations

On July 26, 2007, the Treasury Department issued the long-awaited final regulations under Section 403(b) (“Section 403(b)”) of the Internal Revenue Code of 1986, as amended (the “Code”). The final regulations maintain most of the provisions included in the proposed regulations issued in November of 2004, with some refinements and clarifications based in part on comments received from the public. The final regulations expressly supersede many previous IRS rulings and much of the past guidance that has been issued under Section 403(b), and are the first comprehensive regulations on Section 403(b) plans that the IRS has published since the publication of the first rules on tax-sheltered annuities in 1964.

Section 403(b) tax-sheltered annuity plans provide tax-favored treatment for public school employees, employees of tax-exempt organizations under Section 501(c)(3) of the Code, and certain ministers with respect to contributions made on behalf of such individuals. There are three categories of funding arrangements to which Section 403(b) applies: (1) annuity contracts that are issued by an insurance company; (2) custodial accounts that are invested in mutual funds; and (3) retirement income accounts which are only permitted for certain ministers and church employees. Pursuant to Section 403(b), employer non-elective contributions (including matching contributions) and pre-tax elective deferrals to a Section 403(b) plan will be excluded from gross income. Section 403(b) plans also may include designated Roth contributions (made on an after-tax basis).

The final regulations are generally effective for taxable years beginning after December 31, 2008; however, certain transition rules apply (including earlier effective dates) with respect to certain provisions and certain groups of employers. All Section 403(b) plans are likely

to have to be revised by such date and Section 403(b) plans not subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), will have to have written documentation for the first time.

Written Plan Requirement

The final regulations maintain the written plan requirement included in the proposed regulations. Pursuant to this written plan requirement, a Section 403(b) plan must include all material provisions regarding eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form of payment for distributions under the plan. The final regulations clarify that this requirement does not necessitate that a plan be a single document and that a document can incorporate by reference other documents, including an insurance policy or custodial account, as long as the documents do not conflict. If so incorporated, such other documents would become part of the written plan. However, if there are multiple issuers, the employer will be expected to adopt a single master plan document to coordinate administration among the issuers and the various separate documents can be referred to therein.

In requiring a written plan, the Internal Revenue Service has taken the position that the existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract and other parties involved in implementing the plan. In addition, the plan document enables government agencies to determine whether the arrangement satisfies applicable law and also benefits employees by clarifying eligibility.

In response to concerns about the administrative burden of requiring a written plan, the final regulations clarify that the plan may allocate to the employer or another person the responsibilities for performing functions to administer the plan including functions to comply with Section 403(b). The allocation must identify who is responsible to comply with Section 403(b) in relation to the aggregated contracts issued to a participant, including loans under Section 72(p) of the Code and hardship withdrawals. The preamble to the final regulations

stresses that allocation of these responsibilities to the employee is inappropriate as the employee may be interested in the transaction or unaware of the importance of complying with the tax requirements.

To accommodate certain employers, such as public schools, that currently do not have an existing written plan document or a requirement to have one, the IRS has indicated that it will publish guidance which will include model plan provisions that may be adopted for written plan purposes.

Nondiscrimination Requirements

As anticipated, the final regulations do not adopt the good faith reasonable standard and the safe harbor of IRS Notice 89-23 for purposes of satisfying the nondiscrimination requirements of Section 403(b). As of January 1, 2009, Section 403(b) plans may not be tested under these safe harbors. The final regulations specify that the nondiscrimination requirements applicable to qualified plans apply to Section 403(b) plans, including the rules relating to nondiscrimination in contributions, benefits and coverage under Sections 401(a)(4) and 410(b), the compensation limit under Section 401(a)(17) and the average contribution percentage rules under Section 401(m). The nondiscrimination rules apply on a controlled group basis. This means that any Section 403(b) plan that relies on IRS Notice 89-23 will need to be tested under the traditional method and may need to be redesigned to satisfy the general nondiscrimination requirements under the Code since they do not allow for a higher level of contributions for highly compensated employees as permitted by IRS Notice 89-23.

Universal Availability

The nondiscrimination rules discussed above do not apply to elective deferrals under a Section 403(b) plan. Instead the universal availability of Section 403(b)(12)(A)(ii) provides that all employees of the eligible employer must be permitted to make elective deferrals under a Section 403(b) plan if any employee of the employer is eligible to make elective deferrals. The final regulations extend the universal availability requirement to Section 403(b) plan elective deferrals that are designated Roth contributions so that if any employee of an eligible employer is eligible to make designated Roth contributions to a Section 403(b) plan, all employees of the employer must be permitted to do so.

The universal availability rule requires that an employee have meaningful notice of and an effective opportunity to make salary reduction contributions to a Section 403(b) plan. Effective opportunity means that at least once per year the employee must be given the opportunity to make or change a cash or deferred election and must be permitted to make the full amount of deferral permitted to him or her under the Code, including the special Section 403(b) and the age 50 catch-up provisions, if applicable. In addition, there is a rule similar to the anti-conditioning rule that applies to Code Section 401(k) plans,

providing that no other benefit (other than matching contributions) may be conditioned on the making of elective contributions to a Section 403(b) plan.

Interim guidance in IRS Notice 89-23 allowed certain groups of employees to be excluded from the universal availability requirement for elective deferrals. These included (1) employees who make a one-time election to participate in a governmental plan, (2) employees covered by a collective bargaining agreement, (3) visiting professors and (4) employees affiliated with a religious order who have taken a vow of poverty. In the proposed regulations, the IRS requested comments on whether these exclusions should continue. The IRS concluded that the exclusions of these groups is inconsistent with the statute and, accordingly, the final regulations reflect that the exclusions for the one-time electing governmental employees, collectively bargained employees, visiting professors, and employees who have taken a vow of poverty are no longer permitted. However, employees who have taken a vow of poverty can continue to be excluded from Section 403(b) participation if they are treated as “non-employees” under pre-existing rules relating to wage withholding. Visiting professors may make elective contributions to their home university’s Section 403(b) plan if they continue to be paid by the home university while temporarily teaching at another institution. Transitional rules are provided for plans that may have previously excluded employees covered by a collective bargaining agreement or employees making a one-time election to participate in a governmental plan.

While the exclusions from universal availability permitted under the guidance of IRS Notice 89-23 are eliminated in the final regulations, the statutory exclusions for employees identified in Code Section 403(b)(12) remain. These are (1) employees who are eligible under another Section 403(b) plan or a Section 457(b) governmental plan, (2) employees who are eligible to make a cash or deferred election under a Section 401(k) plan of the employer, (3) employees who are non-resident aliens, (4) students performing certain specified services, and (5) employees who normally work fewer than 20 hours per week.

The 20-hour per week exclusion is retained in the final regulations, but the Code Section 403(b)(12) exception for employees who normally work fewer than 20 hours per week is not applicable to Section 403(b) plans that are ERISA plans according to the final regulations. ERISA Section 403(b) plans are required to comply with the ERISA provision that prohibits the exclusion from participation of part-time employees who work 1,000 hours or more in a plan year.

Catch-up Contributions

A special catch-up contribution provision applies to employees of certain qualified organizations (schools, hospitals, welfare service agencies and church-related organizations) who have at least 15 years of service with the qualified organization maintaining the plan. The proposed regulations for the first time defines “health and welfare service agency” for purposes of this

special catch-up contribution. A health and welfare service agency is either an organization whose primary activity is to provide medical care (such as a hospice) or a Section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals or that provides substantial services to the needy. In response to public comments to the proposed regulations, the final regulations expand the definition of “health and welfare service agency” to specifically include an adoption agency or an agency that provides either home health services or assistance to individuals with substance abuse problems or that provides help to the disabled.

Section 403(b) plan participants who have attained age 50 also are eligible to make catch-up contributions in accordance with Section 414(v) of the Code. Any catch-up contributions for an employee who is eligible for both the age 50 catch-up and the special 403(b) catch-up must first be applied to the special 403(b) catch-up to the maximum extent it is available, and then any excess may be applied to the employee’s age 50 catch-up. This ordering rule will require careful recordkeeping to ensure the employee achieves the maximum benefit from both catch-up provisions.

Plan Distributions

Distributions of amounts attributable to elective deferrals may not be paid earlier than upon a participant’s severance from employment or upon hardship, disability or attainment of age 59½. However, under a grandfather provision, Section 403(b) elective deferrals contributed prior to January 1, 1989 (but not the earnings thereon) are not subject to this rule. Amounts held in a custodial account attributable to employer contributions (not elective deferrals) may not be distributed prior to the participant’s severance from employment, disability or attainment of age 59½. The regulations now provide new rules with respect to amounts attributable to employer contributions that are not held in a Section 403(b) custodial contract, providing that such amounts may not be paid to a participant before the participant’s severance from employment, the attainment of a stated age, disability, or upon the prior occurrence of some “stated event” such as a fixed number of years, similar to the distribution rules that have applied to qualified defined contribution plans that are not money purchase pension plans. In response to comments on the proposed regulations, the Service has decided to grandfather insurance contracts issued before January 1, 2009 from the stated event requirement, and provides a special rule for the adoption of conforming amendments for plans subject to ERISA and funded by such pre-2009 insurance contracts.

The final regulations provide for the distribution of after-tax contributions to a Section 403(b) plan that are designated Roth contributions and clarify that designated Roth contributions are not subject to any in-service distribution restrictions.

If an insurance contract funding a Section 403(b) plan provides for the continuation of contributions in the event of disability, the final regulations treat that benefit as a permitted incidental benefit so long as they satisfy the incidental benefit requirements applicable to qualified plans.

The final regulations clarify that a distribution from a Section 403(b) plan pursuant to a Qualified Domestic Relations Order (“QDRO”) under Code Section 414(p) is treated the same as a distribution pursuant to a QDRO under a qualified plan.

Severance from Employment

The final regulations generally define severance from employment with reference to the regulations under Section 401(k) of the Code. However, the final regulations provide that a severance from service also occurs for a Section 403(b) plan participant on any date on which the employee ceases to be employed by an eligible employer that maintains a Section 403(b) plan. This means that if a Section 403(b) plan participant transfers to employment with an employer who is not an eligible Section 403(b) employer, the employee will have a severance from service for purposes of Section 403(b), even if he or she continues to be employed within the same controlled group. This would occur, for example, if an employee transfers from a Code Section 501(c)(3) organization to a for-profit subsidiary of such organization.

Timeliness Requirement for Contributions

Section 403(b) plans that are subject to ERISA must comply with plan asset rules requiring employee contributions to be contributed to the plan as of the earliest day on which the contributions can reasonably be segregated from the employer’s general assets, but in no event later than the 15th business day of the month following the month in which the amounts would otherwise have been paid to participants. Under the final regulations, Section 403(b) employee salary reduction contributions to non-ERISA plans must be transferred to providers within a period that is “no longer than is reasonable for the proper administration of the plan.” The example of proper plan administration in the final regulations tracks the ERISA rule and calls for transferring of Section 403(b) elective deferrals to providers within 15 business days following the month in which the amounts would otherwise have been paid to the participant. The Department of Labor has consistently focused on the “earliest” criteria above and not merely contribution by the latest permitted date.

Contract Exchanges and Plan-to-Plan Transfers

Historically, pursuant to Revenue Ruling 90-24, a Section 403(b) contract could be exchanged without income inclusion so long as the successor contract includes restrictions that are the same or more stringent than those under the contract being exchanged. This was commonly used by non-ERISA plan participants to invest with providers who were not part of their employer’s payroll bucket. The final regulations effectively

revoke Revenue Ruling 90-24 as of September 24, 2007 and provide that the exchange of one Section 403(b) contract for a new Section 403(b) contract will be regarded as the non-taxable change of an investment option if the second contract has the same distribution restrictions as the original contract and the employer enters into an agreement with the new issuer to exchange information on such matters as termination of employment, hardship withdrawals and plan loans. The final regulations also authorize the IRS to issue guidance of general applicability allowing exchanges of contracts in other cases.

A transfer occurring after September 24, 2007 may only be made to a provider who has a written agreement with the sponsoring employer to share information for compliance purposes. While such written documentation need not be in place until January 1, 2009, if it is not in place on January 1, 2009, the transfer prior to that date will not be treated as having been a tax-free transfer and will create a tax issue for the participant and potentially for the transferring and receiving providers.

The final regulations expand on the proposed regulations with respect to plan-to-plan transfers, permitting such transfers if the participant whose assets are being transferred is an employee or former employee of the employer or business of the employer that maintains the receiving plan and certain additional requirements are met.

The final regulations retain the rule that prohibits plan-to-plan transfers from a Section 403(b) plan to any plan that is not a Section 403(b) plan, except where the transfer of assets is to purchase permissive service credit or to make a repayment to a defined benefit governmental plan.

Section 403(b) Plan Terminations

The final regulations provide rules for the termination of Section 403(b) plans similar to the process for terminating a Section 401(k) plan. The proposed regulations for the first time provided guidance on the termination of a Section 403(b) plan. Prior to the proposed regulations, many employers who wished to terminate their Section 403(b) plans had to freeze them instead and continue to update their plans for changes in the law and continue to file annual reports. A Section 403(b) plan now may be terminated with a resulting distribution of accumulated benefits to all participants so long as the employer does not make a contribution to another Section 403(b) plan for a period of 12 months before or after the termination. This rule tracks the rule for termination of a Section 401(k) plan including the *de minimis* rule so that, if during the 12-month period before or after the Section 403(b) plan termination, fewer than 2 percent of employees who were eligible under the terminated plan as of the date of termination are covered by an alternative plan, the alternative plan will be disregarded in determining if there has been an effective termination of the employer's original Section 403(b) plan.

Effect of Failure To Satisfy Section 403(b)

Code Section 403(b)(5) provides that all contracts purchased for an employee by an employer are treated as a single contract for purposes of Section 403(b). In general, if a contract fails to satisfy the requirements of the final regulations, all contracts purchased for that individual by an employer would fail to qualify for tax deferral under Section 403(b). However, if an operational failure is solely within a specific contract, e.g., excess deferrals of an employee under Code Section 402(g), the failure would adversely affect the contracts issued by the employer to the employee for whom the excess deferrals were made, but would not adversely affect any other employee's contracts.

The final regulations also clarify that if a contract is not established pursuant to a written plan, the contract does not satisfy Section 403(b). Accordingly, if an employer fails to have a written plan, any contract purchased by that employer would not qualify for tax deferral under Section 403(b).

Treatment of Controlled Groups

Prior to the proposed regulations, not-for-profit entities relied on informal guidance in determining their controlled groups for nondiscrimination testing. The final regulations retain the basic rules under the proposed regulations whereby two or more organizations are considered a controlled group if 80% or more of the directors or trustees overlap, or if 80% or more of the directors or trustees of one organization are representatives of, or are directly or indirectly controlled by, another organization. These controlled group rules not only apply to a tax-exempt entity's Section 403(b) plans, but are more broadly applicable to determine when a tax-exempt entity will be treated as a single employer with other tax-exempt entities or for-profit entities for purposes of nondiscrimination testing of a Section 401(a) qualified plan in which employees of the tax-exempt entity participate. The final regulations provide that two or more Code Section 501(c)(3) tax-exempt organizations may choose to be aggregated if they maintain a single plan covering one or more employees from each organization and the organizations regularly coordinate their day-to-day exempt activities. This "permissive aggregation" applies for purposes of the nondiscrimination rules, the Section 415 limits, the special catch-up rules and the minimum distribution rules, subject to an anti-abuse rule if aggregation is used to avoid the requirements of Section 403(b). The final regulations provide examples of when the anti-abuse rule applies and clarify that a tax-exempt entity and a for-profit entity may be aggregated.

In response to comments in favor of expanding the category of entities that may utilize permissive aggregation, the IRS will issue published guidance permitting other types of combinations of entities that include Code Section 501(c)(3) tax-exempt entities to elect to be treated as under common control for one or more specified purposes. The expectation is this will occur only in instances where the IRS determines that the organizations are so integrated in their operations as to effectively constitute a

single coordinated employer for purposes of Code Section 414(b), (c), (m) and (o), including common employee benefit plans.

The controlled group rules do not apply to church entities under Code Section 3121(w)(3) and state or local government public schools which may continue to rely on the reasonable good faith standard of IRS Notice 89-23 to determine the controlled group.

Effect of Final Regulations on Department of Labor Safe Harbor

The requirements set forth in the final regulations, particularly the written plan requirement, raised concerns as to whether employers who previously maintained non-ERISA Section 403(b) plans could continue to rely on the safe harbor included in the Department of Labor (“DOL”) regulations under 29 CFR § 2510.3-2(f). This concern was addressed by Field Assistance Bulletin 2007-2 (“FAB 2007-2”) issued by DOL in conjunction with the release of the final regulations.

The DOL safe harbor excludes from Title 1 of ERISA Section 403(b) plans funded solely by employee deferrals in which the employer’s involvement in the arrangement is limited and certain other requirements are met. The DOL takes the position that given the flexibility of the Section 403(b) final regulations with respect to the employer’s functions, compliance with the final regulations, including the written plan requirement, will not alone cause an arrangement to fall outside the safe harbor.

FAB 2007-2 provides that if an employer adopts a separate document to specify eligibility and to coordinate the compliance activities of the various providers, the employer and the participant (although the final Section 403(b) regulations explicitly limit the compliance role of the employee), this will not cause the Section 403(b) arrangement to become subject to ERISA. It also is consistent with the safe harbor for an employer to limit a participant’s transfers among investments, as provided in the final Section 403(b) regulations, to those providers who adopt the employer’s written plan or who agree to the employer’s allocation of compliance responsibility. However, if an employer negotiates with a provider on such matters as the design of the loan or hardship provisions or makes discretionary administrative decisions such as plan-to-plan transfers, these activities would exceed the safe harbor.

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Client Alert

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