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TechUpdate

A Review and Discussion of the Final 403(b) Regulations

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The Internal Revenue Service ("IRS") issued final 403(b) regulations on July 24th, 2007. The regulations were originally proposed on November 15, 2004. (See our *TechUpdates* dated May 16, 2005, August 2007 and September 2007). The IRS had not issued 403(b) regulations since 1964 and many of the current requirements for 403(b) plans are reflected in numerous revenue rulings and notices or incorporated by reference in other IRS regulations. The final regulations consolidate all of the current 403(b) rules, while adding some significant new provisions as requirements for 403(b) plans. In addition, many of the current requirements have been more clearly interpreted in the final regulations.

In general, the effective date of the regulations will be January 1, 2009, but certain provisions have different effective dates, as explained below. For employers sponsoring 403(b) plans subject to collective bargaining agreements ("CBAs") in effect on July 26, 2007, the regulations are generally effective on the earlier of: the last day the CBA terminates (determined without regard to any extension after July 26, 2007) or July 26, 2010. For 403(b) plans maintained by a church-related organization for which the authority to amend the plan is held by a church convention, the regulations do not apply before the first day of the first plan year that begins after December 31, 2009. Employers can rely on the final regulations effective July 26, 2007, but in that case, all the requirements in the final regulations must be applied on a consistent and reasonable basis. A discussion of the impact of the various provisions contained in the new regulations is also included in this article, including the new rule on 403(b) contract exchanges within the same 403(b) plan, which became effective September 25, 2007.

Written Plan Document Required

By January 1, 2009, generally all employers who sponsor a 403(b) plan must have adopted a written plan that in form and operation, complies with the final 403(b) regulations, including language for eligibility, benefits and distribution provisions (including hardship and loan withdrawals). (As stated above, certain church plans and plans maintained pursuant to CBAs have a different effective date.) The issuer(s) of all contracts which hold any plan participant's assets generally must also be identified in the plan document. The document may be incorporated with other documents by reference, such as a list (that is periodically updated) of the annuity contract and/or custodial account

vendors. A plan document may assign to the employer or a third party the responsibility of administering the plan in compliance with the final IRS requirements. For public schools, the IRS has published model plan provisions to facilitate meeting the plan requirement.

In addition, the Department of Labor ("DOL") has issued guidance stating that a written plan may continue to comply with the safe harbor requirements (as defined under DOL regulation 2510.3-2(f)) in order not to be subject to Title I of the Employee Retirement Income Security Act ("ERISA"), if the 403(b) program is funded solely by salary deferrals. The DOL also stated that the new regulations

might lead to the need for greater employer involvement (beyond the safe harbor rules) and could result in a previously exempt 403(b) program being subject to ERISA, but such a determination would be decided by the DOL on a case-by-case basis.

Discussion

Although it is common for plans subject to the requirements of ERISA to have a written plan document, this is the first time the IRS has formally taken a position that a plan document is a requirement for all 403(b) programs (including non-ERISA plans, as well). The model language recently published by the IRS for public schools may, with some modification, also be useful for other non-ERISA programs, such as those sponsored by hospitals and other 501(c)(3) not-for-profit organizations.

Diversified will draft a plan document that employers may utilize in order to meet the January 1, 2009 plan adoption deadline (more details will follow later this year concerning the plan document requirements).

Timing Requirements for Deposit of Employee Contributions

The final regulations state the following with regard to acceptable time-frames for remitting deferrals to a 403(b) funding vehicle: "...within a period that is not longer than is reasonable for the proper administration of the plan."

Non-ERISA Plans

The regulations recommend a specified period be established by the employer, such as the example provided in the regulations: within 15 business days following the month in which deferrals would have been paid to the participant.

ERISA Plans

ERISA plans are subject to the DOL rules in effect since 1997 that require the plan sponsor to transfer employee contributions to the entity holding the assets of the plan as soon as administratively possible, but no later than 15 business days following the month the payments would have been made to the participants. (The 15 business day rule is not a DOL "safe harbor" period, but the absolute maximum time-frame available, assuming the employer could demonstrate the need for the maximum period.)

Discussion

The new timing rules contained in the final regulations will have little

if any impact on ERISA-covered plans because they are already subject to the more stringent DOL timing rules. However, the new regulations will place additional obligations on the employer offering a non-ERISA program to remit contributions to the vendor as soon as administratively practicable.

Nondiscrimination Requirements

The final regulations have introduced more stringent nondiscrimination rules, including the elimination of the safe harbors found in IRS Notice 89-23 (IRS guidelines issued in 1989 covering certain nondiscrimination rules applicable to 403(b) plans), which currently permit a more liberal application of the IRS' coverage nondiscrimination rules for employer non-elective contributions made to 403(b) plans. In addition, related guidance has been provided regarding the elimination of certain Notice 89-23 safe harbor exclusions from the universal availability rule. The final regulations also clarify that an employee's right to make salary deferrals also includes the right to designate deferrals as Roth contributions if Roth 403(b) contributions are offered to any employee of the employer.

Employer Contributions

The final regulations have a definite impact on the nondiscrimination rules applicable to 403(b) non-elective employer contributions. Notice 89-23 provides employers with a more liberal coverage test and benefits test. In accordance with the final regulations, non-elective contribution benefit formulas will be subject to the stricter minimum coverage test under Internal Revenue Code Section ("Code Section") 410(b) and if applicable, the benefits test under Code Section 401(a)(4). Essentially, this will bring 403(b) plans in-line with qualified plans in terms of testing requirements for non-elective contributions. (Employer match contributions made to a 403(b) plan continue to be subject to the coverage and benefits tests as well as the actual contribution percentage test ("ACP" test).)

Discussion

Tax-exempt employers that currently apply the more liberal coverage and benefit limits for non-elective contributions (as permitted under Notice 89-23), will have to review and perhaps, amend their employer contribution plan formula by 2009 in order to pass the more restrictive nondiscrimination testing applicable under the 410(b) coverage and 401(a)(4) benefits tests currently applicable to qualified plans. If applicable, Diversified will contact you to discuss your employer contribution plan design options in mid-2008.

Universal Availability Requirement

Under the universal availability rule, with certain limited exceptions, all employees must be eligible to make salary deferrals of at least \$200 annually to a 403(b) plan. The final regulations indicate that a 403(b) plan satisfies the universal availability rule if employees are given an “effective opportunity” to begin salary deferrals or to make a change at least once during the plan year. An effective opportunity must include a notification to the employee regarding their eligibility for the plan, a time period in which an election may be made and any other factors impacting the ability to make an election to contribute salary deferrals. An effective opportunity is not provided if there are any conditions that result when a participant elects or fails to elect to make a 403(b) salary deferral. The universal availability requirement applies separately to each common law entity, i.e., each separate 501(c)(3) organization. In situations where a 403(b) plan covers employees of more than one state entity, the requirement applies separately to each entity not part of a common payroll system. Employers that have historically treated distinct units of its organization in various geographic locations as separate for employee benefit purposes may continue to do so if each unit is operated independently on a day-to-day basis. This would not apply to employers with units within the same metropolitan area.

Permitted Exclusions from the Universal Availability Rule

Under the final regulations, there are several categories of employees that may be excluded from the opportunity to defer 403(b) salary deferrals. See below:

- Employees who are eligible to participate in another 403(b) plan of the employer;
- Employees who are eligible to participate in their employer-sponsored eligible governmental 457(b) plan or 401(k) plan;
- Employees who are non-resident aliens described in Code Section 410(b)(3)(c);
- Employees who are students performing services as described in Code Section 3121(b)(10);
- Employees who normally work fewer than 20 hours per week; and
- Individuals working for an institution controlled by a church organization and whose compensation is not treated as wages for purposes of income tax withholding (as permitted under IRS rules).

If any employee listed in the categories of “works fewer than 20 hours per week” or “student” has the right to have 403(b) salary deferrals made on his or her behalf, then no employees in that specific category may be excluded.

The following exclusions (which were included in Notice 89-23) are being eliminated in the final regulations:

- Employees covered by a collective bargaining agreement;
- Certain visiting professors (can be excluded for up to one year under certain circumstances);
- Employees affiliated with a religious order who have taken a vow of poverty where the religious order provides for the support of the employees in their retirement; and
- Employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan.

The statutory exclusion for employees who “normally work fewer than 20 hours per week” has often been confusing in its practical application to part-time employees and other work schedules that are typically not considered full-time. The final regulations provide more guidance than previously covered in Notice 89-23. The final regulations apply the following criteria in defining employees who normally work fewer than 20 hours per week:

- For the 12-month period commencing on the employee’s date of hire, the employer “reasonably expects” the employee to work fewer than 1000 hours of service; and
- For each plan year ending after the close of that first 12-month period, the employee worked fewer than 1000 hours of service in the preceding 12-month period.

Note: ERISA-covered 403(b) plans must continue to comply with ERISA section 202 (minimum participation standard), which is applicable to plans subject to Title 1 of ERISA.

Discussion

The IRS has now clearly defined the “fewer than 20 hours per week” rule and employers should review their payroll records to be certain that employees working over 1000 hours per year have not been excluded from the 403(b) plan for purposes of contributing salary deferral contributions. Another major change reflected in the final regulations concerns union employees. This category of employees is no longer a permissible exclusion for 403(b) salary deferrals. Under the final regulations, a plan is permitted to exclude union employees for salary deferrals until the later of (i) the first taxable year that begins after December 31, 2008 or (ii) the earlier of the date the current collective bargaining agreement terminates (without any extensions after July 26, 2007) or July 26, 2010.

In addition, if on July 26, 2007, the four Notice 89-23 exclusions (see above) that are to be eliminated are still being applied as permitted under Notice 89-23, employers generally may continue to exclude these four groups until January 1, 2010. Certain governmental 403(b) plans have a transitional effective date.

Catch-up Contributions Must Be Coordinated

Where an employee is eligible for both the age 50 catch-up and the special Section 403(b) 15-year catch-up limitations in the same year, the final rules require that the 15-year catch-up provision must be applied first to any deferrals exceeding the annual 402(g) limit. This impacts how the \$15,000 lifetime maximum available for the 15-year catch-up (\$3,000 is the maximum that can be contributed in any given tax year as a 15-year catch-up contribution) is utilized and reduced until the \$15,000 lifetime maximum has been exhausted. Any deferral contributions above the annual limit and 15-year catch-up limit (if applicable) would be treated as age 50 catch-up contributions. For example, in 2009, a participant age 50 or older, in a 403(b) plan which allows age 50 catch-up contributions, with 15 years of service contributes \$15,500 (2008 402(g) limit) and \$3,000 in additional salary deferrals. If the participant is eligible for the 15-year catch-up provision, the \$3,000 contributed above the 402(g) limit would reduce the lifetime maximum limit of \$15,000 to a remaining lifetime balance of \$12,000 under the 15-year catch-up rules. If the participant contributed catch-up contributions totaling \$5,000 in 2009, \$3,000 would apply towards the 15-year catch-up and \$2,000 towards the age 50 catch-up. If the participant is eligible for the 15-year catch-up and the age 50 catch-up provision, the maximum contributions for 2009 would be: \$15,500, assuming no change from the 2008 402(g) limit, plus \$3,000 (15-year catch-up limitation), plus \$5,000 (using in our example, the 2008 age 50 catch-up limit) for a total of \$23,500 in 403(b) salary deferral contributions for 2009.

Note: The 15-year catch-up provision is available to certain employees who work for a "qualified organization", including: an educational organization described in Code Section 170(b)(1)(A)(ii), a hospital, a church or church organization described in Code Section 414(e), or a health and welfare service agency which is defined as an organization whose primary activity is to provide services for medical care, such as a hospice, an organization whose primary activity is to prevent cruelty to individuals or animals, an adoption agency or an organization whose primary activity is to provide meals to the needy, acts as a home health service agency, helps individuals with substance abuse or helps the disabled. (The final regulations expand

the list of "qualified organizations" listed in the proposed regulations.)

Discussion

The coordination rules impact how a participant will contribute amounts in excess of the 402(g) limit each year. For a participant who is age 50 with 15 years of service, the participant must determine if he/she is eligible for the 15-year catch-up provision. If eligible, he/she must first utilize the maximum available annual 15-year catch-up limitation (\$3,000) prior to contributing any deferrals pertaining to the age 50 catch-up provision.

Restrictions on Transfers

Prior to the issuance of the final regulations and in accordance with IRS Revenue Ruling 90-24, a 403(b) participant's account was eligible for a direct transfer to another 403(b) contract provided that the benefit was not reduced and the transferee contract imposed restrictions on distributions no less stringent than those imposed by the transferor contract. Such 403(b) account transfers were not considered distributions and could be made while still working for the current employer and prior to any other distributable event. 403(b) transfers are very commonly used with non-ERISA 403(b) accounts and prior to the release of the final regulations, such transfers could be made to another 403(b) contract where the service provider had a contractual relationship with the participant's employer or was instead an outside service provider that sponsored an alternative 403(b) product.

Note: The final regulations retain the rule that such transfers may not be made to a 401(k), 457(b) or any other plan that is not a 403(b) plan.

403(b) Contract Exchanges Within the Same Plan (effective September 25, 2007)

Under the final regulations, participants may transfer (or exchange) their account balance from one 403(b) contract to another 403(b) contract (e.g., group annuity contract or custodial 403(b)(7) mutual fund agreement) within the same 403(b) plan if after the exchange, the accumulated benefit transferred is at least equal to the amount of the benefit prior to the exchange, the receiving contract has the same or greater distribution restrictions as the transferring contract and the plan under which the contract is issued provides for the exchange.

The final regulations also require that, in order for such exchange to be permissible, the employer must enter into an information sharing agreement with the issuer of the receiving contract to share information (on an ongoing basis), including whether benefit limits, severance

of employment, loans, hardship and required minimum distribution rules are met. This requirement applies to contract exchanges that occur after September 24, 2007. [Contract exchanges made prior to September 25, 2007 were grandfathered and therefore, did not need to satisfy the new requirements.] Contract exchanges not made in accordance with these new provisions can become fully taxable to the participant beginning on January 1, 2009. It is unknown at this time whether employers will be willing to enter into information sharing agreements with vendors of individual 403(b) contracts.

The purpose of the information sharing agreement is to enable the 403(b) employer (or another designated party) to monitor the IRS requirements (such as those referenced above) that continue to be applicable to any transferred plan assets. The IRS has stated that the information sharing agreements are generally not required to be in place until January 1, 2009 (i.e., signed no later than December 31, 2008).

Discussion

Prior to the final regulations, transfers were often processed from one 403(b) vendor to another 403(b) vendor and after the transfer occurred, the 403(b) transferor plan no longer monitored the compliance requirements applicable to the transferred assets. During audits, the IRS found numerous violations of the 403(b) rules (such as improper distributions, including inappropriate hardship withdrawals and violations of the IRS loan rules or required minimum distributions that were not timely distributed) when participants used 403(b) investment products that were unrelated to the 403(b) employer. The new rules applicable to contract exchanges are not as restrictive as outlined in the proposed regulations, but do require the employer (or a third-party assigned by the employer) to monitor compliance requirements by means of an information sharing agreement between the employer and the issuer of the transferee contract in order to coordinate all of the IRS rules applicable to the 403(b) plan assets. The information sharing agreement generally is not required until January 1, 2009. (The IRS commented in the preamble of the final regulations that it does not think it is adequate to use procedures that would rely on participant certification in order to adhere to the compliance requirements due to the lack of employer oversight and accuracy of the controls.)

Many employers will find it difficult to coordinate compliance with the IRS rules between numerous 403(b) funding vehicles and one solution may be to make a non-ERISA program subject to ERISA so that the employer can more easily control and monitor all contracts offered

under the employer's plan. Being subject to ERISA would require filing a Form 5500 each year, having to provide summary plan descriptions, and compliance with ERISA's fiduciary requirements. The employer with a non-ERISA 403(b) "safe harbor" program will have to consider how likely it is to fail to comply with the ERISA safe harbor in its effort to comply with the new 403(b) rules. The DOL has released Field Assistance Bulletin 2007-02 as commentary on these issues. If feasible, employers may also wish to consolidate the number of 403(b) vendors available to their employees, in order to simplify the coordination effort needed to honor the 403(b) rules at the plan level.

Plan-to-Plan Transfers

The final regulations state that a transfer by a participant or beneficiary from one employer's plan to another employer's plan must be on behalf of an employee or beneficiary of the employer sponsoring the receiving plan. In addition, the final regulations permit transfers by former employees of the employer that maintains the receiving plan. The amount of the accumulated benefit immediately after the transfer must be at least equal to the accumulated benefit prior to the transfer and the recipient plan must impose restrictions on distributions to the participant or beneficiary that are not less stringent than those imposed on the transferor plan.

Discussion

Under a plan-to-plan transfer, if a distributable event has occurred, the employer may wish to limit transfers and require that a rollover be initiated when moving funds to another 403(b) plan.

Purchase of Permissive Service Credits

Employees are permitted to transfer assets from their 403(b) accounts to a defined benefit plan sponsored by a governmental entity. The transfer of 403(b) assets allows employees to purchase permissive service credits under the governmental defined benefit plan or to repay a prior cashout under such plan.

Plan Terminations Now an Option

Prior to the final regulations, the IRS had not provided guidance with regard to 403(b) plan terminations other than to permit the employer to cease future contributions by participants and maintain a frozen plan until all accounts were distributed. Under the final regulations, employers will be allowed to terminate a 403(b) plan and distribute account balances to participants. This will be permitted if the employer and all other employers in the same controlled group do not make contributions to another 403(b) plan under which 2% or more of the

employees in the terminated plan participate within 12 months before or after the date of the plan termination. To effectively terminate the 403(b) plan, all benefits in the 403(b) plan must be distributed (including rollovers) to all participants and beneficiaries as soon as administratively feasible after the termination. A distribution includes delivery of a fully paid individual annuity contract. For an employer who is no longer eligible to sponsor a 403(b) plan due to a change in its legal status (e.g., it is no longer a 501(c)(3) entity), the 403(b) plan can either be frozen or terminated.

Discussion

Depending on the specific circumstances, employers may now have the opportunity to eliminate the ongoing administration and costs of a frozen plan. It should be noted that when a 403(b) plan is terminated, employees must be given individual choices regarding rollovers or distributions. At plan termination, all employer contributions must be 100% vested.

Employers may not want to allow their employees access to their 403(b) funds (or 100% vest the employer contributions) for fear the funds may be used unwisely rather than towards retirement funding.

Controlled Groups are More Clearly Defined

The final regulations apply the controlled group rules defined under Code Section 414(c) to all organizations exempt from taxation under Section 501(a), such as 501(c)(3) organizations, generally effective for the 2009 Plan Year. The definition of a controlled group for tax-exempt entities includes the organization sponsoring the 403(b) plan and all other tax-exempt organizations that are under common control of the employer. Common control exists where 80% or more of the directors or trustees of one entity are either representatives of or directly or indirectly controlled by the other organization. The existence of control is determined based on a facts and circumstances test. A trustee or director is controlled by another organization if the other organization has the power to remove such trustee or director and designate a new trustee or director. The rules pertaining to controlled groups are not limited to 403(b) plans, but apply more broadly to tax-exempt entities offering qualified plans, as well.

The regulations also allow permissive aggregation with organizations that have a common tax-exempt purpose. Organizations may consider themselves as part of a controlled group if they regularly coordinate their operations. The final regulations provide an example whereby two independent organizations provide emergency services or medical serv-

ices but they coordinate their day-to-day activities. These organizations could voluntarily treat themselves as a controlled group with respect to providing a 403(b) plan to eligible employees of both organizations.

The controlled group regulations allow churches covered under Code Section 3121(w)(3)(A) and governmental entities to continue to rely on the rules in Notice 89-23 for determining their controlled group status.

The final regulations contain an "anti-abuse rule" to insure that organizations are not "avoiding or evading" the applicable rules covering organizations under common control. The regulations include an example of when the anti-abuse rule would be applied: two hypothetical organizations do not meet the regulation's numerical threshold with respect to the 80% director/trustee representation requirement, but one organization has the power to replace and appoint trustees of the other organization. Based on these facts, the two organizations would be viewed as under common control.

Discussion

The rules that determine whether or not a controlled group exists are important since they impact certain IRS compliance requirements, including: nondiscrimination testing, 415 limits, the 15-year catch-up provision and required minimum distribution rules. If Diversified is currently providing any nondiscrimination testing services to your organization, and you believe that you may now be part of a controlled group based on these new rules, please contact your Diversified Representative to discuss additional nondiscrimination tests that may be required for your plan beginning with the 2009 plan year.

In-Service Distributions

Employer contributions

A 403(b)(1) annuity contract issued January 1, 2009 or later may not permit distributions of employer contributions earlier than severance of employment or some specific event such as a fixed number of years, attainment of a stated age or disability. Currently (based on the provisions of the employer's plan), employer contributions made to an annuity contract may be eligible for distribution at any time.

Salary deferrals contributed to annuity contracts after 1988 as well as salary deferrals and employer contributions made to 403(b)(7) custodial mutual fund accounts continue to be subject to the stricter distribution rules currently in effect. The final regulations also state that after-tax employee contributions and their earnings may be distributed at any time.

Discussion

A 403(b)(1) annuity contract issued prior to January 1, 2009 that currently permits in-service withdrawals of employer contributions at any time may continue to permit such distributions with no additional restrictions. (Although some employer contributions may continue to be eligible for in-service distribution, they are generally subject to the 10% excise tax on early distributions where the employee has not yet attained age 59 1/2.) The final regulations also state that an employer may adopt an amendment to restrict in-service distributions prior to 2009 without violating ERISA's anti-cutback rules with regard to benefit distribution rights if the 403(b) plan is subject to ERISA.

Hardship Distributions

The final regulations confirm that the 403(b) rules for hardship distributions are adopted from the requirements stipulated in the 401(k) regulations. Generally, this is the practice that has been routinely applied to 403(b) hardship withdrawals in the past. The final 401(k) regulations adopted three additional safe harbor hardship events which, under the final 403(b) regulations may also be applied to 403(b) safe harbor hardship provisions (funeral or burial expenses for the employee's deceased parent, spouse, children or dependents; expenses necessary for the repair of damage to the employee's principal residence that qualifies for a casualty deduction under Code Section 165; and expenses for the medical care of a non-custodial child).

In addition, the expanded voluntary hardship provision under the Pension Protection Act of 2006 to include the participant's primary beneficiary(s) for certain safe harbor hardship events also applies to 403(b) plans.

Severance of Employment

The final regulations provide guidance on severance from employment from an eligible employer maintaining a 403(b) plan. If an individual ceases to be an employee of an eligible employer but is then employed by a for-profit subsidiary as part of a controlled group, the employee will be considered to have a severance from employment. Conversely, a severance from employment is not triggered when an employee transfers from one 501(c)(3) entity to another 501(c)(3) entity that is treated as the same employer, or from one public school to another public school of the same State employer.

Discussion

When a controlled group employer transfers employees from a not-for-profit entity to a for-profit entity, employees may have the opportunity to take a distribution from their 403(b) account and roll over their 403(b) plan account balance to another eligible retirement plan in order to consolidate their retirement plan savings.

Life Insurance

Life insurance may no longer be an investment option for 403(b) contributions, but the rule does not apply to life insurance contracts issued before September 24, 2007.

Conclusion

It is the stated intent of the IRS to diminish the extent to which rules governing 403(b) plans differ from the rules governing other salary deferral-based retirement plans (such as 401(k) plans). The final regulations provide much needed clarification of many of the requirements for 403(b) plans, including written plan document requirements, new nondiscrimination testing rules and distribution rules. Other areas of the final regulations will be more difficult to put into practice, especially the new rules covering contract exchanges.

Diversified will play an active role as we all navigate this new territory, by informing our clients of any forthcoming guidance and offering viable solutions that will enable plan sponsors to timely comply with the final 403(b) regulations.

If you have any questions regarding this article, please contact your Diversified Representative.

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