



403(b)s Brace for Big Changes The New Rules

Introduction

For decades, the 403(b) retirement plans market has operated in relative obscurity while Congress and the federal agencies charged with enforcing retirement plan laws focused the lion's share of their attention on the 403(b)'s larger, faster-growing cousin, the 401(k) plan. All that changed, recently, with the release of the Department of Treasury's long-awaited final 403(b) regulations.

While many of the provisions contained in the final regulations merely represent a consolidation and clarification of long-standing IRS interpretations and policies, the final regulations also contain new compliance requirements that will substantively change the 403(b) landscape for providers, sponsors and participants alike. While there are numerous exceptions, compliance with the new regulations is generally mandatory for plan years beginning on or after January 1, 2009.

Background

Initially written into federal law in 1958, section 403(b) of the Internal Revenue Code (IRC) was designed to provide a tax-sheltered retirement savings alternative to employees of certain public schools and tax-exempt organizations. As originally written, the only permissible funding program for a 403(b) arrangement was an annuity product offered through an insurance company (i.e., a "403(b)(1) tax-sheltered annuity"). In 1974, however, Congress added section 403(b)(7), thereby opening the door for investment of 403(b) assets in mutual fund shares (via a "403(b)(7) custodial account").

Types of 403(b) Arrangements

Alongside 403(b)(1) tax-sheltered annuities and 403(b)(7) custodial accounts is a third type of 403(b) arrangement known as a retirement income account which is only available to churches and certain church-related organizations. The retirement income account is primarily distinguished from other types of 403(b) arrangements by the fact that investments within a 403(b) retirement income account are not restricted to annuities or mutual funds.

Title I versus Non-Title I Arrangements

While one way of distinguishing 403(b) arrangements is by the type of funding vehicle, another common way of distinguishing 403(b) arrangements is by their status as "Title I" and "non-Title I" arrangements, with the Title I in question representing Title I of the Employee Retirement Income Security Act of 1974 (ERISA). While ERISA attorneys and certain other retirement plan specialists have become accustomed to casually tossing these terms around as if they were common nomenclature, the reality is that the entire concept of Title I and non-Title I 403(b) arrangements has been a source of virtually endless consternation for both sponsors and 403(b) providers.

Much of this confusion, no doubt, stems from the fact that as with all good federal rules, the rules governing Title I status have exceptions. And, as with all good rules with exceptions, the exceptions have exceptions. Without getting into great depth and intricacy, the basic issue concerning Title I status can be summarized as follows.

1. Retirement arrangements that fall under Title I of ERISA are subject to, among other things, certain federal fiduciary requirements and federal reporting requirements (e.g., Form 5500).
2. As a general rule, employers have historically tried to avoid Title I status, whenever possible, to minimize overall program cost and complexity.
3. 403(b) arrangements sponsored by some categories of employers are automatically exempt, under federal statute, from Title I of ERISA (namely, arrangements sponsored by governmental agencies including public schools and state-sponsored universities).
4. 403(b) arrangements sponsored by other categories of employers are potentially eligible for a Department of Labor (DOL) safe-harbor exemption from Title I of ERISA provided the 403(b) arrangement is *funded exclusively through employee salary deferral contributions* (namely, arrangements sponsored by Section 501(c)(3) nonprofit organizations), and other requirements are met.
5. Lastly, 403(b) arrangements sponsored by churches and qualified church-controlled organizations as defined under IRC Sec. 414(e) are automatically exempt, under federal statute, from Title I of ERISA unless the sponsoring church or church-controlled organization expressly elects to have its arrangement fall under Title I.

As addressed later in this article, while the final regulations do not impact the statutory exemption from Title I enjoyed by certain types of sponsors, the new administrative requirements contained in the final 403(b) regulations will potentially affect the Title I status of various 501(c)(3) sponsored 403(b) arrangements currently operating as a non-Title I arrangement under the DOL safe harbor.

Fundamental Changes

As mentioned at the beginning of this article, much of the final 403(b) regulations are comprised of formal consolidation and clarification of various long-standing IRS interpretations and rulings. Several requirements found in the final regulations, however, represent new “bright line” requirements which must be incorporated into existing 403(b) arrangements in a timely fashion to ensure the arrangements’ ongoing tax-sheltered status.

Written Plan Requirement

While sponsors of Title I 403(b) arrangements are accustomed to the need to have a written, employer-level plan document outlining the various elements of their 403(b) arrangements (similar to the types of employer-level plan documents executed by sponsors of 401(k) plans and defined benefit pension plans), the IRS has never expressly mandated an employer-level plan

document in the non-Title I 403(b) arena. As a consequence, few non-Title I 403(b) arrangements have typically included any type of formal employer-level plan documentation. Rather, the necessary qualifying language has been dealt with primarily within the individual annuity contracts and custodial accounts executed by plan participants.

Under the final 403(b) regulations, however, all employers will need to maintain a written plan that outlines various key provisions of the 403(b) arrangement including, among other things, all material terms and conditions regarding eligibility and benefits, applicable limits, available funding vehicles, and the time and form of benefit payments. According to the preamble to the final 403(b) regulations, the written plan requirement, which “implements the statutory requirements of section 403(b)(1)(D),” will serve to facilitate “the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan.”

While the final regulations stipulate that the employer-level written plan may incorporate, via reference, language contained in the arrangement’s underlying participant-level annuity contracts and custodial accounts, the ultimate impact of the regulations, nonetheless, is to place the onus on the employer-level written plan to ensure plan-wide continuity of the various provisions. Furthermore, as is evidenced by language contained in the preamble to the final regulations, the IRS clearly is envisioning an environment in which an employer’s 403(b) arrangement is represented by one employer-level written plan document regardless of the number of investment providers the employer authorizes under the 403(b) arrangement.

In the case of a plan that is funded through multiple issuers, it is expected that the employer would adopt a single plan document to coordinate administration among the issuers, rather than having a separate document for each issuer.

To ease the burden of complying with the new regulations, the IRS recently issued model 403(b) plan language (see IRS Revenue Procedure 2007-71) that public school employers may use to meet the new employer-level, written plan requirements. While the recently-released model 403(b) plan language may also be used by employers that are not public schools, the IRS cautions that employers other than public schools will not be afforded the same type of guaranteed reliance as will public schools.

For many 501(c)(3) organizations that have historically operated within the Title I safe harbor provided by the Department of Labor (see DOL Reg. 2510.3-2(f)), the new employer-level, written plan requirement may pose unique challenges. In Field Assistance Bulletin 2007-02 issued by the DOL within days of when the final 403(b) regulations were issued by the Treasury Department, the DOL outlines its position on how compliance with the final 403(b) regulations may potentially impact the non-Title I status of 403(b) arrangements operation under the DOL’s safe-harbor exemption. According to the DOL, a number of the explicit administrative requirements which must be assigned to either the employer or a third party within the written plan have the potential to cause an arrangement to fall outside of the DOL safe harbor in cases where responsibility for administering various plan provisions falls on the shoulders of the employer.

New Restrictions on Transfers and Exchanges

Another way in which 403(b) arrangements have historically varied from qualified plans such as 401(k) plans is the relative portability freedom afforded to 403(b) participants under many 403(b) annuity contracts and custodial accounts. Operating under the provisions of an IRS ruling issued almost two decades ago (Revenue Ruling 90-24), most non-Title I 403(b) annuity contracts and custodial accounts currently in force throughout the country contain provisions allowing a participant—while still employed—to electively transfer his or her 403(b) balance to another 403(b) investment provider of his or her choosing provided certain minimal criteria are met. As a direct consequence of Revenue Ruling 90-24, so-called “90-24 transfers” have flourished over the past 18 years, with countless participants electively transferring 403(b) assets to investment providers with whom the participant’s employer has no connection whatsoever.

Under the final 403(b) regulations, the liberal 403(b) transfer rules found under Revenue Ruling 90-24 were repealed as of September 25, 2007 (60 days following the issuance of the final regulations) and replaced with a potentially much more restrictive set of rules that will govern participant-initiated transfers (and exchanges) going forward. Under the new regulations, the term “transfer” is used specifically to define a transaction in which assets are transferred from one employer’s 403(b) arrangement to a 403(b) arrangement sponsored by another employer. On the other hand, the term “exchange” is used to define a transaction in which a participant moves assets from one 403(b) contract/account to another within the same overarching 403(b) arrangement.

Whereas, in the past, participants were often eligible to transfer 403(b) assets to any qualified 403(b) investment provider of his or her choosing (provided the transaction met the requirements outlined in Revenue Ruling 90-24), under the new regulatory framework, participants are limited to those 403(b) investment providers with whom his or her employer has entered into an “information sharing agreement.” Given the new written plan requirement imposed by the regulations and the corresponding requirement for assigned administrative responsibilities, it is not all that surprising that the IRS wanted to reign in the virtually unlimited portability previously enjoyed by 403(b) participants.

Example: Two of the compliance-related administrative responsibilities that must be addressed in the written 403(b) plan relate to the monitoring and administration of participant loans and the monitoring and enforcement of the plan’s distribution triggering events such as separation from service. Under the old paradigm, participants were often free to transfer their plan balances to 403(b) investment providers with whom their employers did not have any relationship or ongoing communications. As a result, when it came time for the 403(b) investment provider to process a loan or distribution request, it was oftentimes virtually impossible for the investment provider to ascertain whether the participant was or was not eligible for the requested transaction. To make matters worse, in many circumstances it was unclear what party was even responsible for ensuring that the participant was indeed eligible for a given transaction.

The new regulations require that administrative responsibilities such as these be explicitly assigned to

specific party(ies) (e.g., the employer or third-party administrator) within the 403(b) written plan. Furthermore, the regulations restrict participant transfers (now referred to as exchanges) to those 403(b) investment providers with whom the employer has entered into an information sharing agreement, thereby attempting to ensure that the party(ies) responsible for administering the plan will have ongoing access to the information necessary to make valid administrative decisions.

Nondiscrimination Requirements

Ever since the passage of the Tax Reform Act of 1986, 403(b) arrangements have technically been subject to many of the same nondiscrimination requirements as qualified plans. While various safe harbor compliance alternatives found in IRS Notice 89-23 have historically allowed sponsors to sidestep many of the more complex nondiscrimination testing requirements, the new regulations set a new course.

With respect to employer contributions, 403(b) arrangements (except for arrangements sponsored by churches or state/local governments) have technically been subject to the same nondiscrimination requirements as qualified plans (e.g., section 401(a)(4) general nondiscrimination testing and section 410(b) minimum coverage testing). For the past 18 years, however, these arrangements have generally been exempt from many of the actual testing requirements outlined under the treasury regulations pursuant to several safe harbor options outlined by the IRS in Notice 89-23. The final 403(b) regulations do away with the nondiscrimination safe harbors in Notice 89-23 meaning that many employer-funded 403(b) arrangements (except those sponsored by state/local governments or churches) will be subject to the same nondiscrimination testing requirements as qualified plans. (Note: While 403(b) arrangements maintained by state/local governments are generally exempt from the nondiscrimination requirement regarding employer contributions, they nonetheless are subject to the nondiscrimination requirements regarding compensation found under IRC Sec. 401(a)(17).)

With respect to employee salary deferral contributions, IRC Sec. 403(b)(12) generally requires that if one or more employees of an organization are permitted to defer into a 403(b) arrangement, then all employees of the organization (with some limited exceptions) must be permitted to defer. This nondiscrimination requirement specific to employee salary deferral contributions is generally referred to as the “universal availability rule.” Under the “transitional” guidance issued by the IRS in 1989 (in Notice 89-23), employers were generally able to disregard certain classes of employees in determining whether the universal availability rule was being satisfied. While commentators requested that the IRS carry these exclusions forward into the final regulations, the IRS chose not to incorporate them into the final regulation, meaning that all 403(b) sponsors should make plans to review their salary deferral eligibility criteria in light of the new regulations.

Miscellaneous Provisions

As mentioned earlier, in addition to some of the more substantive changes contained in the final regulations, the regulations also consolidate and clarify a number of IRS positions on various 403(b) administration and qualification issues. Some (but not all) of these provisions are summarized briefly below.

Separate Accounting for Excess Annual Additions

IRC Sec. 415 outlines overall limits on the amount which may be allocated, in aggregate, to any one participant's 403(b) contracts/accounts for a given plan year under a given employer arrangement. The final regulations stipulate that a 403(b) contract/account will fail to satisfy the requirements of section 403(b) unless the "issuer" of the 403(b) contract/account separately accounts for any allocations which exceed the section 415 limits.

Catch-Up Contributions

When the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a catch-up contribution option for participants age 50 or older, participants of 403(b) arrangements sponsored by certain qualifying organizations found themselves potentially eligible for two distinct catch-up contribution options (the age 50 catch-up option as well as the catch-up option available under some arrangements for employees with 15 or more years of service). The final regulations contain guidance on the manner in which these two catch-up contributions are to be applied in situations where an employee qualifies for both catch-up options (basically requiring that the 15-years of service option be used up before applying the age 50 catch-up option).

Timing of Benefit Distributions

The final regulations contain a number of provisions regarding the timing of benefit distributions. For example, the regulations confirm that the criteria to qualify for a hardship distribution from a 403(b) arrangement is generally determined using the same criteria as under the applicable 401(k) regulations. Another example includes the inclusion of a new "stated event" requirement generally applicable to distributions of employer-contributed amounts held in a 403(b)(1) annuity contract. Under the final regulations, employer contributions within a 403(b)(1) annuity contract will only be distributed upon the occurrence of a stated event (as defined in the written plan document). Examples of permissible "stated events" outlined in the regulation's preamble include distribution upon completion of a fixed number of years (such as five years of participation), the attainment of a stated age, or upon the occurrence of some other identified event such as the occurrence of a financial need. (Note: Annuity contracts issued prior to January 1, 2009 are generally exempt from the stated event requirement.)

Special Rules for Church-Sponsored Retirement Income Accounts

Under IRC Sec. 403(b)(9), certain 403(b) arrangements maintained by a qualified church-related organization are allowed to make investments beyond the traditional scope of investments permitted under 403(b)(1) annuity contracts and 403(b)(7) custodial accounts. These specially designed 403(b) arrangements, referred to as "retirement income accounts" are subject to an array of special rules. The final regulations contain a number of provisions specific to retirement income accounts including rules regarding the potential loss of tax-qualified status if assets are improperly owned/used by plan participants or beneficiaries and rules regarding the payment of life annuity payments to be made directly from a retirement income account provided certain criteria are satisfied.

403(b) Plan Terminations

The regulations also include a provision clarifying that an employer can terminate a 403(b) arrangement by following

procedures similar to those that apply to 401(k) plan terminations. To qualify as a termination, the regulations generally require that the employer not make any contributions to a 403(b) arrangement for a minimum period of 12 months following the plan termination and that all participant benefits under the terminating 403(b) arrangement be distributed as soon as administratively practicable following termination of the plan.

This provision opens the door for 403(b) plan participants to take distributions from an existing 403(b) contract/account using plan termination as the distribution triggering event. Such distributions, in many cases, will subsequently be eligible for rollover treatment by the plan participant, either into another tax-qualified, employer-sponsored plan such as a 401(k) plan, or into a rollover IRA.

Controlled Group Rules for Tax-Exempt Organizations

The final regulations include fairly extensive rules relating to the application of the controlled group rules under IRC Sec. 414 to tax-exempt entities. Under the final rules, two or more 501(c) organizations under common control may be required to be treated as a single employer. Likewise, a 501(c) organization and a non-501(c) organization that are considered to be under common control also may be required to be treated as a single employer.

Roth 403(b) Guidance

As anticipated, the final 403(b) regulations also contain guidance regarding the Roth 403(b) alternative. Not surprisingly, the 403(b) regulations incorporate, via cross reference, the existing Roth 401(k) regulations. In addition, the final 403(b) regulations clarify that Roth 403(b) elective deferrals are subject to the same required minimum distribution rules as well as the same distribution restrictions as pre-tax 403(b) elective deferrals.

Effective Date

As a general rule, the final 403(b) regulations are applicable for taxable years beginning after December 31, 2008. However, as mentioned earlier in this article, the regulations contain accelerated effective dates for certain changes (e.g., the transfer rules under Revenue Ruling 90-24 were revoked effective September 25, 2007). In addition, the regulations contain potential delayed effective dates for arrangements maintained pursuant to a collective bargaining agreement as well as arrangements maintained by a church convention.

Next Steps

As with the release of any major regulatory initiative, many questions still remain unanswered and it is unclear whether the IRS will issue any additional formal guidance between now and the end of the year. While additional guidance will no doubt be welcomed, it is not too early for plan sponsors to familiarize themselves with new regulations and begin assessing what changes will be needed.

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