EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION PRACTICE GROUP
July 2008

Alert

Final 403(b) Regulations

The Internal Revenue Service in July 2007 issued new, comprehensive regulations under Internal Revenue Code Section 403(b). The new Regulations, which generally take effect on January 1, 2009,[1] require significant changes to the rules that apply to tax-exempt organizations, public schools and churches that maintain 403(b) arrangements, and in most instances will require employers to amend and update their 403(b) plans and consider modifications to their related administrative practices.

Among the more significant requirements imposed by the new Section 403(b) Regulations (the "Regulations") are the following:

Written Plan: The Regulations require written plan documents for all 403(b) plans (including non-ERISA plans) that contain all material terms regarding eligibility, benefits, contribution limits, available contracts, time and form of benefit distributions, and optional plan features (*e.g.*, withdrawals, loans, plan-to-plan transfers, acceptance of rollovers, etc.) and clearly identify the parties with various administrative responsibilities. While the Regulations do not generally require one single document to satisfy the written plan document requirement (*i.e.*, several documents can be incorporated by reference), in the case of plans funded through multiple vendors, the Regulations indicate that employers should adopt a single plan document to coordinate administration among the vendors.

Nondiscrimination Testing: The Regulations repeal the nondiscrimination safe harbors of IRS Notice 89-23, and generally impose the nondiscrimination rules that apply for qualified plans on all employer contributions and after-tax employee contributions to 403(b) plans. Thus, with some very limited exceptions (*e.g.*, governmental plans and certain church plans are generally not subject to these rules), minimum coverage tests, rules regarding nondiscrimination in contributions and Internal Revenue Code Section 401(m) "average contribution percentage" testing (relevant for after-tax and matching contributions) will generally apply to 403(b) plans. Employee elective deferrals will continue to be exempt from nondiscrimination testing, but are subject to universal availability requirements as noted below.

Universal Availability: With only limited exceptions (*e.g.*, certain church plans are not subject to these rules), elective deferrals to a 403(b) plan are subject to a universal availability rule. The universal availability rule requires that if any employee of an employer is permitted to make elective deferrals into the 403(b) plan, then all employees of the employer must be permitted to do so. The following employees, however, may be excluded from making elective deferrals under a 403(b) plan:

- those who are eligible to make elective deferrals under another 403(b) plan, a 401(k) plan, or 457(b) plan of the same employer;
- certain non-resident aliens;

- students performing certain services; and
- those who normally work fewer than 20 hours per week. (Notably, while this rule is couched as permitting the exclusion of employees who work fewer than 20 hours per week, the Regulations actually only permit exclusion of employees who actually worked fewer than *1,000 hours in the prior year* (with special rules for the first year of service), which can prevent employers from excluding some employees who normally work fewer than 20 hours per week.)

Certain categories of employees who were formerly permitted under IRS Notice 89-23 to be excluded from plan participation, must now be offered plan participation (*e.g.*, certain visiting professors, employees affiliated with a religious order who have taken a poverty vow, employees covered by a collective bargaining agreement, and employees who make a one-time election to participate in a governmental plan in lieu of a 403(b) plan). In addition, universal availability rules require that employees receive an annual notice of eligibility for the 403(b) plan.

Distribution Restrictions: The Regulations impose distribution restrictions that may require changes for some plans that have historically had liberal in-service distribution rules. The new rules vary, in some respects, depending on the nature of the contributions and whether they are held in annuity contracts or custodial accounts.

- *Elective Deferrals*: Distributions attributable to elective deferrals cannot be made earlier than when the participant has a severance from employment, incurs a hardship, attains age 59½, becomes disabled or dies.
- *Employer Contributions held in Custodial Accounts*: Distributions from custodial accounts that are not attributable to elective deferrals may not be paid before severance from employment, death, disability, or attainment of age 59½.
- *Employer Contributions held in Annuity Contracts*: Distribution from contracts other than custodial accounts (*i.e.*, annuity contracts) that are not attributable to elective deferrals may not be distributed earlier than the participant's severance from employment or the occurrence of a stated event (*e.g.*, a fixed number of years, the attainment of a staged age, or disability).

After-tax employee contributions and rollover contributions to a 403(b) plan are generally not subject to the in-service distribution restrictions. Also, a "severance from employment" as a triggering event for distributions has a special definition under the Regulations.

Plan-to-Plan Transfers and Contract Exchanges: The Regulations provide specific new rules that must be met in order for a 403(b) plan to permit plan-to-plan transfers and/or contract exchanges. If the intent is to permit such transfers and/or exchanges, it must be specifically provided for in the written plan document. In certain situations, permitting contract exchanges will necessitate additional actions such as information sharing agreements with certain vendors.

Special Rules for Church Plans: The Regulations provide specific technical rules for church plans, including, but not limited to, special rules for retirement income accounts, specific plan document requirements, rules concerning asset commingling, and limitations on payment of annuity benefits.

Miscellaneous Clarifications: The Regulations clarify many other 403(b) plan rules, including the following:

- Amounts contributed to a 403(b) contract must not exceed annual deferral limits.
- Employers will continue to be able to make non-elective employer contributions for former employees for up to five years after severance from employment, but those contributions are subject to nondiscrimination testing rules and applicable annual limits.
- 403(b) plans can be terminated and distributions can be made upon such plan termination.
- The rules for loans, qualified domestic relations orders (QDROs), hardship distributions and minimum distribution requirements for 403(b) plans are similar to those for 401(k) plans.

New Controlled Group Rules for Tax-Exempts: The Regulations also include, for the first time in IRS regulations, controlled group rules for tax-exempt entities under Internal Revenue Code Section 414. These rules provide that the "employer" for a plan maintained by a tax-exempt entity, includes not only the organization whose employees participate in the plan, but also any other organization that is under common control. Common control exists, pursuant to the Regulations, when 80 percent or more of the directors and trustees of one entity are either representatives of, or directly or indirectly controlled by, the other organization. For 403(b) plans maintained by tax-exempt entities, the new controlled group rules will likely impact many aspects of 403(b) plan rules, including, for example, nondiscrimination testing rules, application of maximum contribution limits, and permissible conditions for plan terminations.

The failure of 403(b) plans to timely comply with the Regulations in both form and operation could result in considerable adverse tax consequences for individual participants and/or the entire plan. We suggest that employers act now to identify all current 403(b) arrangements and make certain that plan documents are reviewed and revised as necessary. For employers whose 403(b) plans have previously been maintained without a plan document or have used a funding vehicle's document, we suggest that the employer contact their 403(b) plan vendor(s) to inquire about the availability of new plan documents and administrative support to ensure timely documentary and operational compliance with the Regulations.

We are available to assist in reviewing 403(b) documents (including those provided by the 403(b) funding vehicle(s)), and in drafting 403(b) plan documents for those arrangements that have previously operated without one. We are also available to help plan sponsors implement procedures to bring 403(b) arrangements into compliance with the Regulations.

Endnotes

[1] The Regulations are generally applicable for taxable years beginning after December 31, 2008. Certain employers and/or certain types of 403(b) arrangements, however, have later effective dates by which they must comply with the Regulations (*e.g.*, plans maintained pursuant to collective bargaining agreements, plans maintained by certain church-related organizations). Furthermore, certain provisions are given special effective dates, and may be applicable prior to January 1, 2009.

This alert is for general informational purposes only and should not be construed as specific legal advice.

If you would like to discuss the Regulations and how they impact your 403(b) plan(s), please contact any of the attorneys in our Executive Compensation and Employee Benefits Practice Group listed below.

David M. Glaser	**212.336.2624**	**dmglaser@pbwt.com**
Brian F. O'Hare	**212.336.2613**	**bfohare@pbwt.com**
Bruce L. Wolff	**212.336.2959**	**blwolff@pbwt.com**
Jessica S. Carter	**212.336.2885**	**jcarter@pbwt.com**
Carrie L. Mitnick	**212.336.2415**	**cmitnick@pbwt.com**
Meridith Bogart Krell	**212.336.2361**	**mkrell@pbwt.com**

IRS Circular 230 disclosure: Any tax advice contained in this communication (including any attachments or enclosures) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication. (The foregoing disclaimer has been affixed pursuant to U.S. Treasury regulations governing tax practitioners.)

To subscribe to any of our publications, call us at 212.336.2329, email: info@pbwt.com, or sign up on our website, www.pbwt.com/resources/publications.