To Be or Not to 403(b): That Is The Question (and, After Years of Waiting, We Finally Have the Answers)

DrinkerBiddle

The Internal Revenue Service ("IRS") last issued extensive regulations under Internal Revenue Code ("Code") Section 403(b) on December 24, 1964. In November 2004, the IRS issued proposed regulations and now, more than two years later, the IRS has published an updated set of comprehensive final regulations concerning 403(b) programs (also commonly referred to as tax-sheltered or tax-deferred annuity plans), which are available to employees of Section 501(c)(3) organizations and public schools. The primary purposes of this newest set of regulations are to organize and consolidate the Section 403(b) guidance issued since 1964 and to override prior guidance that no longer applies. The final regulations also provide additional flexibility, introduce new restrictions and attempt to make 403(b) programs operate more like 401(k) plans, although key differences remain. Qualified 401(k) plans became available to Section 501(c) organizations in 1996, but 403(b) programs remain common among the organizations that are eligible to sponsor them.

Effective Date. The final regulations are generally effective for taxable years beginning after December 31, 2008. However, there are some exceptions. The regulations will not be effective for 403(b) programs offered by certain church-related organizations until plan years following December 31, 2009. With respect to any 403(b) program offered under a collective bargaining agreement that is ratified and in effect on July 26, 2007, the final regulations will not be effective before the earlier of the date on which the collective bargaining agreement terminates or July 26, 2010. There are also other special effective dates as noted below (including for the application of the universal availability rules under IRS Notice 89-23, and transfers under IRS Revenue Ruling 90-24). Employers can rely on these final regulations from July 26, 2007 until the actual effective date of the final regulations, if such reliance is done on a consistent and reasonable basis.

Comment: *For most employers these rules will be effective January 1, 2009. This is one year later than the effective date in the proposed regulations.*

Drinker Biddle will provide you with a more detailed explanation of these final regulations in the coming weeks. In the meantime, the following is a brief summary of some of the key provisions and highlights from the final 403(b) regulations:

The 403(b) Program Must Be In Writing. Under current law, only 403(b) programs that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA") are required to have a written plan document. The final regulations require that all 403(b) programs be maintained pursuant to a written plan. The written plan document must describe the allocation of plan related responsibilities among the employer, the entity offering the investment options (referred to as the "issuer") and any other party involved. Under the final regulations the plan must, in both form and operation, satisfy the requirements of Code Section 403(b) and the final regulations. In one helpful clarification, the final regulations provide that this plan document can incorporate by reference other related documents (such as the insurance policy or custodial account).

Comment: *Employers that currently treat existing 403(b) programs as subject to ERISA should have no problem complying with this new rule (because ERISA already requires a written plan document). However, many employers currently offer 403(b) programs that are not subject to ERISA (because of ERISA exceptions for government plans, church-related plans or plans with limited employer involvement by 501(c)(3) organizations). For these organizations, creating a written plan (even one that incorporates other documents by reference) could be challenging. The consequences of failing to have a written plan are severe, because the final regula-*

tions specifically provide that if "an employer fails to have a written plan, any contract purchased by that employer would not be a 403(b) contract." The Department of Labor also released a Field Assistance Bulletin 2007-02 discussing how to coordinate this plan document requirement with the limited employer involvement exception under ERISA.

403(b) Programs Can Now Be Terminated. Currently, an employer that no longer wants to offer a 403(b) program to its employees has only one real option: to freeze the 403(b) program and cease contributions. Under current law, it is not possible for a 403(b) program to be terminated and for all existing assets to be distributed as a result of the plan termination unless the participants also have a distributable event. The final regulations confirm that it will now be possible to terminate a 403(b) program.

The final regulations generally allow an employer to amend its 403(b) program to contain a provision that permits termination of the 403(b) program and authorizes distribution of all benefits accumulated under the 403(b) program on account of termination subject to specific conditions. Distributions on termination of a 403(b) program are permitted – for employee contributions and employer contributions to a custodial account – only if the employer (taking into account all entities that are treated as the employer under the controlled group rules on the date of termination) does not make contributions to an "alternative" 403(b) program within a specified period (generally 12 months after the date of termination). For a 403(b) program to be considered terminated, all accumulated benefits would need to be distributed to all participants and beneficiaries as soon as administratively practicable after the termination of the 403(b) program.

Comment: *This should be a very helpful provision. Virtually every eligible employer currently maintains some sort of 403(b) program (either active or frozen). When employers considered offering 401(k) plans instead of 403(b) programs during the past 11 years, many were discouraged from adopting 401(k) plans because there was no viable way to terminate their existing 403(b) programs and distribute plan assets. This new provision would for the first time allow an employer to amend its 403(b) program to provide for program termination, and permit the distribution of all program assets to employees (either in cash or by rollover to another 403(b) program, a 401(k) plan or an individual retirement account). There is also a special transition effective date rule for plan terminations providing that terminations can occur between July 27, 2007 and the actual effective date of the final regulations if the 403(b) arrangement satisfies all the requirements of the final regulations (except the in writing requirement).*

Universal Availability Standard is Clarified and Narrowed. 403(b) plans allowing employee contributions (generally referred to as elective deferrals) must satisfy the universal availability requirement. This rule provides that generally all employees of an employer that offers a 403(b) program must be permitted to make elective deferrals if any employee of the employer may make elective deferrals under the 403(b) program. However, the Code permits certain employees to be excluded:

- non-resident aliens;
- employees eligible for 457(b) deferrals;
- students; and
- employees who normally work fewer than 20 hours per week.

IRS Notice 89-23 permits additional exclusions:

- employees covered by a collective bargaining agreement;
- employees who make a one-time election to participate in a governmental plan instead of a 403(b) program;
- certain visiting professors; and
- employees of a religious order who have taken a vow of poverty.

The final regulations eliminate the IRS Notice 89-23 exceptions to this rule after various transition periods expire between now and 2010.

Comment: *Every employer that offers an employee the opportunity to make 403(b) contributions should review its plan to make sure that, subject to the limited exceptions listed above, all employees have the same opportunity to contribute to the 403(b) program.*

Controlled-Group Rules Are Clarified And May Be Expanded. Under Code Section 414(b) and (c), if two or more employers are linked by 80% or greater common ownership (i.e., brother-sister entities with a common parent or parent-subsidiary entities), regardless of whether the organizations are incorporated, they are treated for most employee benefits purposes as a single employer. Because of the lack of "common ownership" in the tax-exempt area, the IRS has issued internal guidance (through private letter rulings) in the past that 80% or more board control of the two entities would cause two tax exempt organizations to be treated as a single employer for a number of employee benefit purposes.

The final regulations specifically provide that the 80% board control test is applicable to identify members of the controlled group for 403(b) program purposes. In addition, the final regulations provide a new rule allowing exempt organizations that maintain a single plan covering one or more employees from each organization to treat themselves as being under common control for purposes of Section 414(c) if the organizations regularly coordinate their day-to-day exempt activities. This permissive aggregation rule applies even if the organizations are not linked by at least 80% board control. Both the 80% board control test and the permissive aggregation rule are written to apply broadly also to non-403(b) programs (such as tax-qualified retirement plans, health and welfare plans, and others).

Comment: *Tax-exempt employers can now be certain that the 80% board control test will be treated by the IRS as the actual aggregation test for 403(b) program purposes. The final regulations permit tax-exempt employers (that otherwise could not be aggregated under the 80% board control test or any other test) to treat themselves as one employer for 403(b) program purposes if they regularly coordinate their day-to-day activities. The final regulations also permit the IRS to issue additional aggregation guidance addressing situations in which tax exempt organizations may be related to other entities (presumably including other corporations, trusts or joint ventures).*

90-24 Type Contract Exchanges Can Continue (But With New Requirements). The 403(b) contract exchanges under IRS Revenue Ruling 90-24 have not been eliminated (as would have been the case under the 2004 proposed regulations), but new conditions have been added for making these transfers.

Comment: *On the basis of the proposed regulations, some of our clients were planning to issue communications to 403(b) program participants about the limited future availability of 90 24 transfers. Although 90-24 type transfers will not be going away, employers should now review the new restrictions under the final regulations to determine if these transfers are still practical. In addition, the final regulations provide that these new rules do not apply to exchanges occurring on or before September 24, 2007 (assuming the exchange satisfies the current 90-24 rules).*

Catch-up Contribution Coordination Is Confirmed. A 403(b) program can provide for (1) a catch-up contribution for a participant who is age 50 or older (up to $5,000 in 2007); and (2) an additional special catch-up contribution for a participant who has at least 15 years of service. The final regulations confirm that if a participant is eligible for both catch-up contributions, the special 15 years of service catch-up contribution should be applied first.

Comment: *Employers should review existing administrative practices to make sure this coordination is happening.*

Severance From Employment Is Defined For Purposes Of Making 403(b) Program Distributions. A participant is entitled to receive a distribution from a 403(b) program if he or she has a "severance from employment." The final regulations generally define "severance from employment" the same as for 401(k) plans with one key difference. In a 403(b) program, a severance from employment can occur when the participant no longer works for an employer eligible to sponsor a 403(b) program (even though the participant works for another related employer that is still part of the controlled group).

Comment: *This will be an issue for 501(c)(3) employers that also have for-profit subsidiaries or joint ventures, since employees could still work for one employer in the controlled group but may be considered separated from service for 403(b) program distribution rules. Defining distribution events will be a critical plan design issue for many employers.*

Roth Contributions Are Available Under 403(B) Programs. The final regulations confirm our expectation that Roth contributions can be made to a 403(b) program.

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