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The Final 403(b) Regulations—An Extreme Makeover

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Section 403(b) arrangements, once arcane tax deferred saving accounts for employees of public schools and 501(c)(3) tax-exempt organizations, have been in the spotlight since the final 403(b) regulations were issued on July 26, 2007.

When the regulations are implemented, 403(b) plans will look more like their 401(k) and governmental 457(b) plan cousins (refer to the accompanying chart on page 21). This article discusses several of the major provisions of these regulations and widespread misconceptions associated with them.

Effective Dates

The final regulations are generally applicable for taxable years beginning after December 31, 2008. One common misconception is that all collectively bargained, church and government plans will have a longer period of time to implement the final regulations. Delayed effective dates for implementing the final regulations apply only in limited circumstances that require:

- Amendment of collective bargaining agreements;
- Legislative action for government plans; or
- Ratification by a convention of churches for church plans.

Otherwise, these 403(b) plans will have a January 1, 2009 applicability date except for specific transition rules for contract exchanges and transfers and separate life insurance contracts that apply to all 403(b) plans.



Written Plan

Prior to the final regulations, 403(b) arrangements, excluding plans covered under Title I of ERISA, were not required under the Code to have a written plan or plan document. After December 31, 2008, all 403(b) funding contracts, except annuity or custodial accounts issued for church plans [defined under IRC 414(e)], will have to be maintained pursuant to a written defined contribution plan. Church plans funded with retirement income accounts (RIAs) must also be maintained under a written defined contribution plan.

403(b), 401(k) and Governmental 457(b) Plan Comparison

Item	403(b)	401(k)	Governmental 457(b)	All
Sponsorship limited to certain types of employers*	✓	✓	✓	
Universal availability requirement for making salary deferrals	✓			
Special definition for includible compensation	✓			
Limited investment options	✓			
Separate life insurance contracts no longer permitted after 9/24/07	✓			
Post severance employer non elective contributions permitted	✓			
Eligible employees must be common law employees	✓			
Information Sharing Agreement requirement with vendors outside the plan	✓			
No aggregation with employer's non 403(b) defined contribution plans for 415 annual additions**	✓			
Operational/contract defects generally affect participant but not entire plan	✓			
Subject to 402(g) deferral and coordination limits	✓	✓		
Subject to 415 annual additions	✓	✓		
In service distribution of elective deferrals at age 59 1/2	✓	✓		
Roth deferral account available	✓	✓		
Employee after tax contributions permitted	✓	✓		
Non discrimination testing for employer contributions (non government plans)	✓	✓		
Application of 10% early distribution tax***	✓	✓		
Application of controlled group rules (non government plans)	✓	✓		
ADP test for elective salary deferrals****		✓		
May be combined with defined benefit plan		✓		
Coordination of deferrals with 457 plans only			✓	
Employer contribution subject to FICA			✓	
Vested employer contributions reduce deferral limits			✓	
Limited timing restriction for making salary deferral election			✓	
Participation of independent contractors permitted			✓	
In service distributions for permissive service credit purchases in a governmental defined benefit plan	✓		✓	
Special catch-ups for under deferrals in prior years	✓		✓	
Auto rollover for mandatory distributions of small account balances				✓
Automatic enrollment permitted				✓
Deferral contributions subject to FICA taxes*****				✓
Deemed IRAs permitted				✓
Withdrawals for financial hardship/unforeseeable emergencies				✓
Participant loans				✓
IRC 417 limit on compensation				✓
Age 50 catch-up permitted				✓
Direct rollovers for non spousal beneficiaries to inherited IRAs				✓
Direct rollovers to Roth IRAs				✓
In service distributions from rollover accounts				✓
Plan termination				✓
Savers Credit available				✓
Post severance elective deferral contributions				✓
Subject to USERRA				✓
Inclusion of deferential pay in definition of compensation				✓
Written plan or plan document required				✓
402(f) notices required for distributions eligible for rollover				✓
1099R tax reporting for distributions				✓

* Governmental employers may not adopt new 401(k) plans but may continue to maintain existing plans.

** Defined contribution plans of the employer sponsoring the 403(b) plan are not aggregated for 415 purposes. However, if a 403(b) participant is in control of more than 50% of an outside business that maintains a defined contribution plan, both the participant's 403(b) plan and the outside plan are aggregated for 415 purposes.

*** Applies only to rollovers from qualified plan and IRAs to the 457 plan.

**** Governmental 401(k) plans are not subject to nondiscrimination testing.

***** Applies only if employment is covered under Social Security. Medicare taxes would still apply.

Written plans must contain all the material terms and conditions for eligibility, benefits, applicable limitations, time and form of distribution options, any optional provisions offered under the plan such as loans and hardships and plan to plan transfers. All plan provisions must comply in form and operation with Section 403(b). For this purpose, all contracts purchased for an employee will be treated as a single contract. If any contract fails to meet the requirements of 403(b), all contracts purchased for that employee would not qualify for tax deferral.

The written plan may be a single plan document or consist of a number of documents. The plan may incorporate by reference other documents such as the annuity contracts, custodial agreements and loan policies, which then become part of the plan. If there is a discrepancy between the plan and a document incorporated by reference, the plan will govern. For example, if the funding contract permits loans and the plan does not, the contract cannot make loans despite the loan provision in the contract.

The plan may delegate certain tax compliance and administrative functions to product vendors or other third parties but not to employees unless they are significantly involved in the administration of the plan. Service agreements between the employer (or plan sponsor) and those responsible for administration and tax compliance, as a best practice, should include the exchange of information so that each party can perform their assigned duties under the plan. Service provider agreements should not be confused with information sharing agreements (ISA) between employers and investment product providers.

To help defray the cost of adopting a written plan, the IRS issued Rev. Proc. 2007-71 containing model plan language developed specifically for public schools to use in adopting a written plan or amending a current plan. The model language adopted as is or in substantially similar terms will give school districts the same form reliance as a private letter ruling. The model language may be modified by public schools and 501(c)(3) organizations but the plan will not have form reliance without a private letter ruling.

Currently there is no IRS pre-approved prototype program for 403(b) plans but a pre-approved prototype program is expected sometime next summer. The IRS is developing LRMs for a 403(b) pre-approved prototype program that will incorporate some of the public comments it has received for the model plan language published in Rev. Proc. 2007-71.

Fiduciary Obligations and the Final Regulations

403(b) plans are either ERISA or non-ERISA plans. Implementing the final 403(b) regulations does not automatically impose new fiduciary duties on employers where none existed previously. For example, 403(b) plans for public schools are government plans and therefore are never subject to Title I of ERISA, including its fiduciary requirements—regardless of employer actions, discretionary or otherwise. Likewise, non-church and non-governmental 403(b) plans are not subject to Title 1 of ERISA, but only if the plan is limited to elective salary deferrals and employer involvement with the plan is limited to actions described in the ERISA safe harbor regulation [29 C.F.R. 2510.3-2(f)]. Ultimately, fiduciary obligations and liabilities for non-ERISA plans are determined by the state in which the plan is maintained according to any state enabling statutes, state attorney general opinions, relevant case law or state trust law [if 403(b) contracts are held in a trust]. It is imperative that plan sponsors consult with their own legal counsel to determine what fiduciary responsibilities they may have for their non-ERISA 403(b) plans.

In Field Assistance Bulletin (FAB) 2007-2, the Department of Labor confirms that implementation of the final regulations will not necessarily cause a non-ERISA plan to become an ERISA plan. ERISA coverage continues to be a facts and circumstances determination. According to the FAB, 403(b) plan sponsors can keep their plans within the DOL safe harbor if they:

- Adopt a written 403(b) plan;
- Compile information about vendor products and terms for employees to review and analyze;
- Limit mutual fund or annuity contractors who may approach employees to a number that gives employees a reasonable selection of products;
- Limit contract transfers and exchanges to vendors that are part of the plan;
- Provide information to vendors about employees, such as name, address, compensation or doctor's certification of employee's health condition;
- Review the plan for conflicting provisions and compliance with Section 403(b); and
- Take steps to keep the plan tax compliant (including correcting plan failures under EPCRS); or
- Terminate the plan.

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To avoid ERISA coverage, according to the FAB, the plan may assign discretionary decisions such as loan eligibility, hardship determinations, plan transfer decisions and QDRO determinations to someone other than the employer. The plan should accurately describe the employer's limited role and the delegation of discretionary determinations to third parties. The FAB cautions employers to carefully review the FAB to determine if their actions in implementing the final 403(b) regulations stay within the DOL safe harbor regulation.

Funding 403(b) Plans

Funding products (contracts) for 403(b) plans are limited to annuity contracts issued by state licensed insurance companies and custodial accounts funded exclusively with mutual fund shares held by a bank trustee or an IRS-approved non bank custodian for the exclusive benefit of plan participant and beneficiaries. RIAs for church plans are treated as annuity contracts, even if funded with mutual fund shares, and may be commingled with other church assets for investment purposes if 403(b) contributions and earnings are accounted for separately from other church assets.

Contract Requirements

Funding contracts (both annuity and custodial account contracts) must comply with section 403(b) and the regulations and are required to contain language that:

- Requires contracts to be nonforfeitable (except for the payment of future premiums);
- Limits elective deferrals to the 402(g) and catch-up limits;
- Provides for rollovers to other eligible retirement plans;
- Requires annuity contracts to be nontransferable;
- Limits annuity contracts that provide life insurance protection and disability benefits to the incidental benefit limitations; and
- Satisfies the minimum distribution requirements of IRC 401(a)(9).

Contracts must also separately account for non-vested amounts and amounts in excess of the 415 annual additions limit. These amounts are treated as if they were made to a 403(c) contract (*i.e.*, a nonqualified contract). Contracts that do not meet these requirements are not valid 403(b) contracts even if purchased pursuant to a written plan.

Say Goodbye to 90-24 Transfers

Nothing in the final regulations has caused more anxiety than the impending demise on January 1,

2009 of the popular 90-24 transfer. Participants and beneficiaries used 90-24 transfers to move money from one 403(b) contract to another, including to contracts that were not part of the employer's plan. Employers were usually unaware of these transfers and the overall tax compliance was severely compromised.

The final regulations address this situation by revamping 90-24 transfers into nontaxable transactions that are either contract exchanges or plan to plan transfers. Contract exchanges are exchanges between contracts within the same plan. Plan to plan transfers may be transfers to another 403(b) plan in which participants are employees or former employees of the employer sponsoring the receiving plan, or transfers from the 403(b) plan to a governmental defined benefit plan for the purchase of permissive service credits or to repay the value of cashed-out defined benefit service credits. Except for the purchase of permissive service credits in a governmental defined benefit plan, plan to plan transfers are not permitted to or from qualified, governmental 457(b) or any non 403(b) plan.

Plan to plan transfers and contract exchanges require that:

- Both plans agree to the transfer/exchange;
- The receiving plan, except for the transfers to a governmental defined benefit plan, must impose distribution restrictions that are no less stringent than those of the transferring plan; and
- Amounts are not reduced because of the transfer/exchange.

Under the final regulations, 90-24 transfers made before September 25, 2007 are grandfathered: they remain subject to the old rules under Rev. Proc. 90-24 and do not require Information Sharing Agreements (ISAs). Transfers made after September 24, 2007 to a contract vendor outside the plan are subject to the final regulations. Post September 24, 2007 exchanges will not be part of the employer's plan beginning as of January 1, 2009 unless the employer and the product vendor have an ISA to provide each other with information necessary for that contract and any other contract to which contributions have been made to satisfy section 403(b). Shared information includes participant employment status and information about other contracts and the employer's qualified plans, including compliance with any applicable hardship withdrawal rules, the \$50,000 cap on participant loans and any other tax requirements. The ISA permits the outside contract to be treated as part of the employer's written plan, thus excluding future contributions from gross income and allowing distributions to be eligible for rollover.

Orphan Contracts

“Orphan contract” is a term coined by the 403(b) community. It refers to a contract issued before January 1, 2009 that has not received contributions from the plan in a year after the contract was issued because:

- The vendor is no longer eligible to receive contributions (was deselected); or
- The contract was issued in an exchange after September 24, 2007 (which met the requirements of Rev. Rul. 90-24).

Orphan contracts may still be treated as part of the employer’s plan if the employer makes a good faith attempt to include these contracts as part of its plan. A good faith attempt requires an employer to collect information about vendors and then provide these vendors with the contact information about the person responsible for administering the plan. As long as the employer makes a good faith attempt and memorializes that attempt, transitional relief applies even if the good faith attempt is not successful.

Alternatively, the contract vendor may make a good faith attempt to contact the employer to exchange participant information before making a distribution from the contract. Neither the employer nor the vendor is required to make these good faith efforts for contracts that ceased receiving contributions before January 1, 2005.

The transitional relief provided in Rev. Proc. 2007-71 applies to contracts issued between 2005 and 2008 inclusively. If neither the contract vendor nor the employer makes a good faith attempt, the contract ceases to be a 403(b) contract on January 1, 2009 and future contributions will be included in gross income. Contracts without an ISA may be treated as part of the employer’s plan if they are exchanged by July 1, 2009 for a contract under the employer’s plan or to a contract that has an ISA with the employer.

Contracts issued to former employees and beneficiaries prior to January 1, 2009 are still subject to the rules and regulations governing 403(b) plans even if the employer no longer exists, the vendor has been deselected or the vendor issued the contract after September 24, 2007. It is up to the vendor to make a reasonable attempt to determine if a participant or beneficiary has any outstanding loans from the employer’s qualified plans and the highest outstanding loan balance for these loans for the past 12 months before making a loan. If a participant is not a current employee as of January 1, 2009, the vendor may rely on the participant’s representation about his or her status as a former employee.

Plan Termination—Easier Said Than Done

The final regulations permit employers to do what they couldn’t do in the past—terminate their 403(b) plans. Plan termination is possible only if:

- The employer or related employer do not make contributions to any successor 403(b) contracts beginning on the date of termination and for 12 months after all distributions are made from the plan; and
- All 403(b) plan assets are distributed to all participants. Any distributions from partially terminated plans are not eligible for rollover to another retirement plan.

Plan termination for many 403(b) sponsors becomes a “catch-22.” The majority of 403(b) plans are funded with individual contracts that do not permit distributions from these contracts without participant consent. High termination fees and charges deter many participants from terminating their individual contracts. Although the final regulations permit plan sponsors to terminate their plans, it will still be difficult in practice to terminate 403(b) plans as quickly and easily as 401(k) plans.

Plan termination may be a more viable option if the plan is funded exclusively with annuity contracts. Annuity contracts, but not custodial accounts, may permit contract issuers to distribute fully paid individual insurance annuity contracts which may be subsequently rolled into an IRA. Distributions from paid up contracts are taxed when distributed. Administration and tax reporting of distributions from paid up contracts is handled by the contract issuer. The IRS has indicated that fully paid contracts will follow the same rules that apply to annuities distributed from qualified plans.

Plan Sponsor “To Do” List

The implementation date for the final 403(b) regulations plan is imminent—January 1, 2009. Here is a list of projects that 403(b) plan sponsors will need to complete before next year.

Implement course of action to maintain, consolidate, freeze or terminate current plans.

Plan sponsors should, if they haven’t already, engage experienced 403(b) advisors who recognize that 403(b) plans are not just glorified 401(k) plans for tax-exempts and public schools. These plans have been evolving since 1958 to reflect the diverse needs of this niche market.

Address the written plan requirement.

Plan sponsors will need to select plan provisions, decide if they want to use any or all of the IRS model language or adopt a prototype

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or individually designed plan. Existing plan documents will need to be amended to reflect the final regulations.

Select vendors that will provide investment products to the plan.

Plan sponsors will need to reach out to contract vendors who cannot accept future contributions to find out if they will agree to an ISA.

Take advantage of the transitional relief under Rev. Proc. 2007-71 for orphan plans.

There is no reason not to do this—all it requires is a good faith effort. Taking advantage of this relief protects employees from potential tax consequences for future contributions and distributions from orphan contracts.

Weigh the pros and cons of ERISA coverage.

Private sector 403(b) sponsors whose plans are not currently covered under ERISA should evaluate if any of their actions could trigger ERISA coverage, keeping in mind that ERISA coverage is not necessarily a bad thing. ERISA protections can limit fiduciary liability, whereas state law may not provide these kinds of protections for fiduciary missteps. Smaller employers may find the costs associated with the ERISA reporting and disclosure requirements prohibitive and will want to maintain their plan's non ERISA status.


Implement an effective employee communication plan.

Meaningful employee communications are more crucial than ever. A well conceived and executed communication program can mitigate employee backlash to changes that employees consider negative, such as changes in investment providers, a plan freeze or termination or the adoption of a new 403(b) plan. Communications that are designed to inform or educate participants about the plan can do double duty as a tool to encourage them to increase their deferrals and to spur employees who are not participating in the plan to start making deferrals.

The Post Regulatory World

While some employers consider plan termination, others are attempting to reduce (or deselect) the number of investment product providers. Deselection for non-ERISA plans may be difficult because some states, such as Ohio, Texas and California, make restricting the number of product providers difficult. Before deselecting

vendors, employers should consider that one size may not fit all. Employees who are investment do-it-yourselfers may find low cost products fit the bill. Those needing more individualized attention may need higher cost products that provide these services, while others may need a mix of fixed and variable investment products.

Two things are certain—403(b) funding contracts of the future will look more like 401(k) group annuity and custodial accounts and 403(b)s will continue to evolve. Although the new regulations bring some compliance hurdles, they provide an opportunity to make 403(b) plans more effective in helping participants save for retirement. Now is the ideal time for plan sponsors to take a comprehensive look at their 403(b) plans. 

Editor's Note: The ASPPA Education and Examination Committee is currently developing the requirements for an ASPPA 403(b) certification program and a 403(b) credential. .

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Resources:

403(b) Final Regulations
<http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-3649.pdf>

FAB 2007-2
www.dol.gov/PrinterFriendly/PrinterVersion.aspx?url=http://www.dol.gov/ebsa/regs/fab2007-2.html

Rev. Proc. 2007-71
www.irs.gov/pub/irs-irbs/irb07-51.pdf

