ASPPA
WORKING FOR AMERICA'S RETIREMENT

Comments to the Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts

as revised March 10, 2005

Department of the Treasury
Internal Revenue Service

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The American Society of Pension Professionals and Actuaries (ASPPA) commends the Treasury and Internal Revenue Service (IRS) on its issuance of temporary and proposed regulations (Proposed Regulations) under Internal Revenue Code (IRC) §403(b). ASPPA welcomes the opportunity to provide comments on these Proposed Regulations.

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the private pension system. Its membership consists of more than 5,500 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans and tax-sheltered annuities, especially for small to mid-size employers.

Summary of Issues

These comments address the following issues, which are described in greater detail below.

A. Requirement for a written plan document.

B. Coverage under Title I of ERISA.

C. Non-statutory exceptions to universal availability requirement.

D. Year-by-year exclusion of permissible categories of employees.

E. Transfers of assets among plans and contracts.

F. Definition of compensation.

G. Timing of contributions.

H. Controlled group and employer aggregation rules.

I. Distribution restrictions of amounts attributable to rollover contributions.

J. Effective date of the regulations for governmental employers.

K. Accounting for excess contributions.

L. Nonforfeitability, partial vesting requirements and separate accounts.

M. Distribution restrictions on annuity contract amounts not attributable to IRC §403(b) elective deferrals.

N. Year of service calculations.

O. Definition of health and welfare service agency.

Discussion of Issues

A. Requirement for a written plan document

ASPPA believes that a written plan requirement will promote compliance with IRC §403(b) and increased usage of the IRS Employee Plans Compliance Resolution System (EPCRS). In addition, it is hoped that this requirement will lead the IRS to develop a determination letter program for 403(b) plans. However, the following are concerns with the written plan document requirement.

1. Many 403(b) plans are exempt from Title I of ERISA because there is limited employer involvement with the plan. It is imperative that the written plan requirement be coordinated with Department of Labor (DOL) guidance regarding the application of ERISA Title I to 403(b) plans. In particular, guidance is needed from the DOL to confirm that a 403(b) plan will not be subject to Title I merely because the terms of the plan are in writing (see Section B. below for a further discussion of this issue).

ASPPA recommends that the effective date of the written plan requirement be delayed until after the DOL issues guidance providing that adopting and maintaining a written plan document does not, by itself, subject the plan to Title I of ERISA. In addition, once this requirement is effective, ASPPA recommends that the Service provide a model 403(b) plan document, similar to those provided for SEPs and SIMPLE IRAs, that would satisfy the plan document requirement in form and that would not necessarily result in ERISA coverage.

2. The Preamble to the Proposed Regulations provides that the plan document rule does not require that there be a single plan document. This is particularly helpful because many 403(b) programs offer contracts with multiple vendors, which may not be easily covered by a single document. However, the Proposed Regulations do not provide details on the extent to which multiple documents and contracts may be utilized.

ASPPA recommends that the final regulations provide additional guidance regarding the use of multiple documents to satisfy the written plan requirement. For example, the regulations might provide that a group of vendor contracts may comprise a "written defined contribution plan" for purposes of Prop. Reg. §1.403 (b)-3(b)(3) if each contract contains all the provisions required under that section. The final regulations could also provide that an employer may satisfy the plan document requirement by adopting a "wrap" plan that incorporates by reference the provisions of the various vendor contracts.

3. Treas. Reg. §1.401(b)-1 sets forth a correction period during which qualified retirement plans may generally be updated for any disqualifying defects (referred to as the "remedial amendment period"). There is no similar provision in the Proposed Regulations addressing a remedial amendment period for 403(b) plans.

ASPPA recommends that, as part of the written plan requirement, the IRS establish a remedial amendment period to permit the retroactive amendment of 403(b) plans to comply with the regulations or with any other statutory or regulatory changes affecting the written plan requirement.

ASPPA also recommends that the final regulations provide that the written plan requirement does not supersede the current rules under which the consequence of an operational failure is limited to the participants affected by that failure.

B. Coverage under Title I of ERISA

The plan document requirement discussed above, and other duties placed on employers under the Proposed Regulations, makes it essential for the DOL to provide specific guidance about what types and degree of employer involvement will subject a plan to Title I of ERISA. Existing guidance provided in DOL Reg. §2510.3-2(f) indicates that Title I coverage of a 403(b) plan is related to the level of employer involvement with the plan. The regulation does not specifically address whether the following activities by the employer (which appear to be anticipated by the Proposed Regulations) will trigger Title I of ERISA coverage:

- Adopting and maintaining a plan document;
- Ensuring that annuity contracts and custodial agreements contain required contract provisions (and rejecting contracts that do not contain such provisions);
- Monitoring operational compliance on a plan level, or hiring a third party to do so;
- Overseeing distributions, loans and similar transactions;
- Authorizing transfers among plans and contracts; and
- Selecting investment vendors and limiting their number.

ASPPA recommends that the Service coordinate issuance of the final regulations with issuance of DOL guidance ensuring private sector employers that they will not cause their plans to be subject to Title I simply because they oversee compliance with the requirements of the 403(b) regulations.

ASPPA also recommends that the IRS encourage the DOL to issue guidance clarifying whether a plan that is subject to Title I of ERISA will cease to be so if the employer activity that led to such coverage ends.

C. Non-statutory exceptions to universal availability requirement

The Proposed Regulations eliminate four non-statutory groups of employees that were permitted, pursuant to IRS Notice 89-23, to be excluded from a 403(b) plan without violating the universal availability requirement of IRC §403(b)(12)(A)(ii). The four groups are: employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan; employees covered by a collective bargaining agreement; visiting professors for up to one year under certain circumstances; and employees affiliated with a religious order who have taken a vow of poverty.

Below are reasons as to why the ability to exclude each of these four categories of employees is important.

Several states (*e.g.,* Texas) allow their employees to choose to participate in either a state retirement plan or a 403(b) plan, but not both. If the exception for employees who make a one-time election to participate in a governmental plan is not retained, such states may be required to change their retirement plan structure to cover employees under both plans.

Many sponsors of 403(b) plans employ individuals who are members of a collective bargaining unit under which retirement benefits were the subject of good-faith bargaining. In some cases, unions seek coverage of their members through a separate 403(b) plan or 401(k) plan that includes funding vehicles or other features different from the 403(b) program for other employees of the same employer. Eliminating the exception for collectively bargained employees could require employers to cover union employees under multiple plans, and could limit employers' ability to negotiate with unions about retirement and other benefits. Congress has consistently recognized collectively bargained employees as a separate group by permitting their exclusion from coverage under qualified plans, SEPs and SIMPLE plans and, historically, 403(b) programs.

The exclusions for visiting professors and employees who have taken a vow of poverty are recognition of the categories of employees unique to the public and tax-exempt sector. Extension of eligibility to such employees, who are unlikely to participate for extended periods, if it all, may unnecessarily increase administrative and compliance responsibilities. Moreover, qualified plans under IRC §401(a) may satisfy applicable coverage and nondiscrimination tests if they exclude such employees; under the Proposed Regulations, 403(b) plans would automatically fail IRC §403(b)(12)(A)(ii), absent another basis for exclusion.

ASPPA recommends that the final regulations retain the exclusions permitted under Notice 89-23.

D. Year-by-year exclusion of permissible categories of employees

Prop. Reg. §1.403(b)-5(b)(4)(i) provides that if any employee in an excludable category is given the option to make elective deferrals, then no other employees in that category may be excluded. However, the Proposed Regulations do not address whether an excludable category of employees who have been included in one year may be excluded in a later year. The universal availability rule is a nondiscrimination requirement, and compliance with nondiscrimination requirements in other contexts, such as IRC §§401(a)(4), 410(b) and 401(m), must be applied each year. Presumably, the universal availability rule would be applied on a year-by-year basis.

ASPPA recommends that the final regulations clarify that the universal availability requirement is applied separately to each plan year and that the inclusion of a group that could otherwise have been excluded will not preclude the exclusion of all members of such group in a later plan year.

E. Transfers of assets among plans and contracts

The Proposed Regulations do not require that a participant consent to a transfer of assets held for his or her benefit under one 403(b) plan or contract to another 403(b) plan or contract. Thus, it appears that an employer may unilaterally decide whether to make such transfers. Furthermore, it is apparently up to the employer to monitor transfers at the plan level to ensure they comply with the IRC §403(b) regulations. As discussed in Section B. above, imposing duties on an employer or granting decision-making authority to an employer may subject a plan to coverage under Title I of ERISA.

Prop. Reg. §1.403(b)-10(b)(3)(i) also provides that a participant's benefits under a 403(b) plan may be transferred to another plan only if the receiving plan is provided by the participant's employer. However, the regulation does not address the treatment of former employees who have not received a distribution of benefits from the 403(b) plan.

ASPPA recommends that the following issues relating to transfers among plans and contracts be addressed:

- The final regulations should clarify the responsibilities and authority of employers and participants with respect to transfers and provide examples of permissible transfers.
- The final regulations should permit the transfer of assets held for the benefit of former employees. For example, it should be permissible to transfer a former employee's undistributed benefits from one plan to a second plan that includes different investment options.
- The final regulations should specifically provide that transfers permitted pursuant to Revenue Ruling 90-24 continue to be permitted.
- Furthermore, ASPPA encourages the IRS to request that the DOL issue guidance regarding the level of control an employer may exercise without subjecting a plan to Title I of ERISA.

F. Definition of compensation

The definition of includible compensation in IRC §403(b)(3) creates administrative difficulties. Includible compensation under IRC §403(b)(3) is determined with reference to a five-year look-back period, which creates administrative complexities in monitoring compensation of part-time employees. In addition, using the definition is problematic where an individual participates in both a 403(b) plan and a sole proprietorship defined contribution plan and must aggregate contributions under both plans for IRC §415 testing purposes. Measuring compensation in the same way for both plans would substantially simplify the rules, and thereby promote compliance in these situations.

ASPPA recommends that, to the extent the Treasury and IRS have the authority, 403(b) plans be permitted to use the definition of compensation under IRC §415(c)(3), without regard to IRC §415(c)(3)(E), in lieu of the definition of "includible compensation" under IRC §403(b)(3). ASPPA is not taking a position with respect to the authority of the Treasury or IRS to implement such a change, but if permitted, to support the change.

G. Timing of contributions

Prop. Reg. §1.403(b)-8(b) requires that contributions to a 403(b) plan be transferred to a funding vehicle within a period that is no longer than is reasonable for proper plan administration. That section further states that a plan could provide that 403(b) elective deferrals for a participant be transferred within a specified time after they would otherwise have been paid to the participant. A requirement that deferrals be contributed within 15 business days after the end of the month in which the amounts would otherwise have been paid to the participant is given as an example of a permissible provision.

DOL Regulation §2510.3-102(a) and (b)(1) provide rules regarding the timing of contributing "plan assets" under ERISA. Under those rules, participant contributions must generally be contributed to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets, but in no event later than the 15th business day of the month following the month in which such amounts would have otherwise been payable to the participant in cash.

ASPPA recommends that the following issues relating to the timing of contributions be addressed:

1. The Regulation should provide that the timing requirement is deemed to be satisfied if the timing requirement set forth in DOL Regulation §2510.3-10(a) and (b)(1) is satisfied.

2. The example in the Proposed Regulations should be clarified to provide that the use of a 15-day period will always be deemed to be "reasonable for the proper administration of the plan."

3. Including examples to illustrate "a period that is not longer than is reasonable for the proper administration of the plan" would be helpful for those plans that are not subject to Title I of ERISA. These could be similar to the examples included in DOL Regulation §2510.3-102 regarding the application of the rule that participant contributions become plan assets "as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets."

4. Governmental 403(b) plans may be subject to more restrictive funding timeframes, and the regulations should acknowledge that they do not supersede applicable state or local law requirements.

H. Controlled group and employer aggregation rules

ASPPA welcomes the introduction of these rules, which will give tax-exempt employers more certainty about which employees must be covered under a 403 (b) program.

ASPPA recommends that the final regulations include an example of the application of the 80% rule to a tax-exempt organization that controls another tax-exempt organization.

I. Distribution restrictions of amounts attributable to rollover contributions

In Revenue Ruling 2004-12, the IRS held that if a tax-sheltered annuity plan described in IRC §403(b)(7) or (11) receives rollover contributions, amounts attributable to rollovers that are maintained in separate accounts may be distributed at any time even though distribution of other amounts under the plan or contract is restricted. Although Prop. Reg. §1.403(b)-6 sets out special rules for the timing of distributions from a 403(b) contract, the Proposed Regulations do not include or acknowledge the early distribution features which Revenue Ruling 2004-12 allows, and therefore could be construed not to permit these distributions.

ASPPA recommends that the final regulations incorporate the holding of Revenue Ruling 2004-12 as it applies to 403(b) contracts, or otherwise affirm that the holding continues to apply to 403(b) plans.

J. Effective date of the regulations for governmental employers

Although the Proposed Regulations provide phase-in periods for collectively bargained and church plans, no similar period is provided for governmental plans.

ASPPA recommends that the final regulations extend the phase-in of the effective date of the regulations to governmental plans, particularly in view of the fact that many governmental employers may need to take legislative action to bring their plans into compliance.

K. Accounting for excess contributions

The Proposed Regulations include rules for the treatment of certain excess contributions, among them a provision that the portion of a 403(b) contract that includes an excess annual addition (within the meaning of IRC §415) will be treated as a contract to which IRC §403(c) applies.

ASPPA recommends that, in the case of any contribution greater than an applicable limit (including "maximum exclusion allowance" excesses carried over from earlier years), any requirement for separate accounts be satisfied if there is separate bookkeeping accounting for the excess, without the need for actual segregation of the excess, similar to the manner in which the separate accounting requirement may be satisfied under Treas. Reg. §1.401 (a)(9) -8, Q&A 3.

L. Nonforfeitability, partial vesting requirements and separate accounts

The Proposed Regulations provide that non-vested amounts contributed to 403 (b) contracts and custodial accounts will be treated as separate contracts and accounts and subject to the requirements of IRC §403(c). Current state and federal laws do not require that non-vested 403(b) contributions be divided in such a way that would require the establishment of separate contracts or accounts for vested and non-vested contributions.

ASPPA is concerned that the requirement to hold non-vested contributions in IRC §403(c) contracts/accounts could:

- Subject non-vested contributions to IRC §409A, resulting in potential adverse tax consequences to participants or additional reporting requirements;
- Add additional administrative complexity between individual deferral plans and plans with vesting schedules making IRC §403(b) compliance efforts more difficult;
- Conflict with various insurance and security laws; and
- Increase costs that will ultimately be passed on to participants.

ASPPA recommends that the vesting rules in the proposed regulations be modified to require insurers and custodians to account for non-vested amounts in a separate notational account within the 403(b) contracts and custodial accounts without actually segregating these amounts into separate contracts or accounts or subjecting them to IRC §403(c).

M. Distribution restrictions on annuity contract amounts not attributable to IRC §403(b) elective deferrals

Under Prop. Reg. §1.403(b)-6(b), a Section 403(b) contract may distribute retirement benefits, other than amounts in a custodial account or attributable to IRC §403(b) elective deferrals, upon a participant's severance from employment or upon the occurrence of some event, such as the end of a specified time period, the attainment of a specified age or disability. That section refers to Treas. Reg. §1.401-1(b)(1)(ii), which includes corresponding early distribution restrictions for benefits under IRC §401(a) profit sharing plans, for additional guidance.

Before the Proposed Regulations were issued, there were no statutory or regulatory restrictions on early distribution of such amounts. The IRS's audit guidelines do not mention any such restrictions, even though they state restrictions on amounts held in a custodial account or attributable to IRC §403(b) elective deferrals. Consequently, these amounts usually have been contributed and held under contracts that contain no such restrictions. Application of the proposed restrictions to amounts contributed before the effective date of the final regulations would not only be inconsistent with the terms under which they were contributed, but, in the case of a 403(b) plan subject to Title I of ERISA, would also violate the anti-cutback protections of ERISA §204(g)(2)(B).

ASPPA recommends that the final regulations expressly grandfather from these distribution restrictions amounts attributable to contributions before the effective date of the regulations.

N. Year of service calculations

The Proposed Regulations provide that a year of service for purposes of the special IRC §403(b) catch-up limit and contributions for former employees be calculated based on a "work period," which may be shorter than 12 months (*e.g.*, a nine-month school year).

ASPPA recommends that the final regulations clarify whether the "work-period" concept also applies for purposes of the exclusion of certain employees under the universal availability rules. For example, the regulation should clarify that if a schoolteacher works nine months, which is the normal work period instead of 12 months, then the 1,000-hour requirement in Prop. Reg. §1.403(b)-5(b)(4)(ii)(E)(1) is reduced to 750 hours to reflect the shorter work period.

O. Definition of health and welfare service agency

The definition of a "health and welfare service agency" in Prop. Reg. §1.403(b)-4(c)(3)(ii)(B) does not include organizations such as substance abuse counseling agencies, adoption agencies and organizations that assist the disabled. The policy reasons for extending the special IRC §403(b) catch-up provision to employees of agencies that provide medical care, anti-cruelty organizations or agencies that care for the needy would apply equally to the types of agencies listed above.

ASPPA recommends that the definition of a "health and welfare service agency" in Prop. Reg. §1.403(b)-4(c)(3)(ii)(B) be broadened to include other organizations providing health or social services, such as substance abuse counseling agencies, adoption agencies and organizations that assist the disabled.

These comments were prepared by ASPPA's Tax Exempt and Government Plans subcommittee of the Government Affairs Committee, L. Joann Albrecht, CPC, QPA, Chair, and primarily authored by Kathleen M. Meagher, APM, Vice-chair, and Amiram J. Givon, APM, former Chair. Please contact us if you have any comments or questions regarding the matters discussed above.

Sincerely,

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