

Internal Revenue Service final 403(b) regulations

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Overview

The Internal Revenue Service (IRS) issued the final regulations for 403(b) tax-sheltered annuity plans on July 26, 2007. Compliance with these changes is crucial. Failure to comply could result in substantial IRS and/or Department of Labor (DOL) penalties, which potentially could be imposed not only on the organization itself, but also on the individuals at the organization who are responsible for the plan's management and oversight. Additionally, failure to comply with the IRS rules could result in adverse tax consequences to employees who participate in the 403(b) plan.

These regulations finalize rules proposed in November 2004 and provide the first comprehensive guidance issued for 403(b) arrangements since December 1964. Like the proposed rules, the 403(b) final regulations consolidate statutory changes, previous IRS rulings, and administrative practice into one set of guidance. The 403(b) final rules apply to all types of 403(b) plans, including those which receive only employee salary deferral contributions.

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Effective dates of final rules

The final rules are effective for taxable years beginning after 12/31/2008. There are other specific provisions with different effective dates and those will be listed when applicable.

What has changed?

Employer obligations

The written plan requirement

For the first time, IRS rules **REQUIRE ALL** 403(b) plans to operate according to a written plan. The written plan must be adopted by December 31, 2009. In general, 403(b) plans that allow only employee salary deferral contributions, for which employer involvement is essentially limited to transmitting the employee contributions to the investment vehicles, are not subject to ERISA.

There was some concern that the new written plan requirement would now subject such plans to ERISA. According to a July 24, 2007 Department of Labor (DOL) Field Assistance Bulletin, the DOL is of the view that employee salary deferral-only 403(b) plans should be able to comply with the new 403(b) regulations and still meet the criteria for the ERISA exemption. However, the DOL does note that the new 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement under a 403(b) plan.

The central plan document must include all material provisions regarding eligibility, benefits, contribution limits, available investment contracts and accounts, loans, hardship withdrawals, distributions, fund transfers, rollovers, and allocation of responsibilities between the employer, the service providers, and the participants. The plan may incorporate, by reference, other documents furnished by vendors; but, employers must ensure the other documents do not conflict with the central plan document. The central plan document will control the plan at all times.

Note: The IRS released model plan provisions that public schools may use and rely upon.

Funding requirements

As has always been the case, a 403(b) plan may be funded through an annuity contract from an insurance company, a custodial account with mutual funds, or a retirement income account for churches and church-related organizations. *Because different rules may apply depending on how the plan is funded, the final rules require plan documents to describe the type of funding vehicle.* A 403(b) custodial account will be treated as a qualified retirement plan under section 401(a) of the Internal Revenue Code for purposes of applicable governmental reporting requirements. If incidental benefits (e.g., life insurance) are offered in a plan, they must satisfy the incidental benefit requirements of Section 401(a).

Nondiscrimination rules

The application of the nondiscrimination rules to employer and employee after tax contributions are similar to that applied to profit-sharing plans. Matching contributions would be subject to Actual Contribution Percentage (ACP) test of Code §401(m). There would be no Actual Deferral Percentage (ADP) testing of §403(b) deferrals as long as the universal availability requirements are satisfied.

Universal availability requirement

As mentioned above, 403(b) plans do not have a nondiscrimination test applicable to employee salary deferrals. The Code's price for this exemption from testing is under what is known as the universal availability rule. Employers sponsoring a 403(b) plan are required to offer to all employees the opportunity to make a cash or deferred election with limited exceptions (i.e., non-resident aliens, certain students, employees who normally work fewer than 20 hours per week).

There was no bright-line test for the fewer-than-20-hours-per-week exception, which can be problematic in the instance of employees whose schedules are irregular (e.g., substitute teachers).

The new regulations establish a bright-line universal availability test of 1,000 hours of service. New employees who are hired with the expectation of working fewer than 1,000 hours in their first year of employment may be initially excluded, but would have to be included if they ever complete 1,000 hours in a year.

There is no change in the rules applying to plans that are subject to ERISA. ERISA plans may not apply the 20-hour-per-week exclusion, and may exclude "part-time" employees only under the fewer-than-1,000-hour rule.

The universal availability rules have been amended so that visiting professors, religious order employees who take a vow of poverty, collectively bargained employees and those who make the one time election to participate in a governmental plan may no longer be excluded. The elimination of these exclusions is phased in until final elimination in 2010.

Meaningful notice to plan participants

Besides being universally available, the 403(b) plan must also be effectively available. For instance, if an employee is eligible to participate in the plan, but is unaware because he has not been notified that he may participate, the plan is not considered to be available to him. Therefore, the new regulations will require an employer to provide an annual meaningful notice to all eligible employees of their rights to participate in a 403(b) plan and an effective method for making and changing their deferral elections.

Controlled group determinations for tax-exempt entities

Controlled group rules have always presented challenges to church-related and other non-profit organizations. These rules determine whether two or more entities need to be treated as a single employer for purposes of complying with certain rules, such as nondiscrimination testing, 415 employer contribution limits, catch-up rules, and minimum distribution rules.

“Board control test”

The final regulations provide that two or more tax-exempt organizations will be treated as a single employer if at least 80% of the directors or trustees of one organization are representatives of, or directly or indirectly controlled by, the other organization. The new rules generally do not apply to governments and certain churches, which may continue to rely on Notice 89-23 for determining controlled group status.

Plan contributions

Contributions

The final regulations include several rules regarding contributions. They clarify that elective deferrals include designated Roth contributions. They require an employer with more than one 403(b) plan to ensure that the elective deferral limits under Section 402(g) and employer contribution limits under Section 415 are not exceeded for all of the plans combined.

Deposit requirements

The rules also require an employer to transfer contributions to the plan within a reasonable period. For this purpose, the regulations cite an example of no later than fifteen business days after the month in which the amounts would have been paid to the employee.

403(b) plans that are subject to ERISA are already subject to similar, yet somewhat stricter, DOL rules that require the deposit of employee deferrals on the earliest date the employer can reasonably segregate and transmit them, but not later than 15 business days after the month the deferrals are made.

Catch-up contributions

There are no changes in the provisions for catch-up contributions. However, the regulations now specify how the special fifteen-year catch-up contribution based on service is to be coordinated with the over fifty catch-up contribution. The regulations clearly state that an employee may be eligible for both catch-up contributions, but any deferral in excess of the permitted annual elective contribution amount will first be counted toward the special fifteen-year catch-up contribution and secondly toward the age fifty catch-up contribution. The regulations also define how years of service will be determined for purposes of establishing eligibility for the special catch-up.

Excess contributions

Under the previous rules, excess contributions were required to be returned prior to April 15th of the calendar year, following the year the excess contribution deferral was made. As with the previous rules, excess employee deferrals may be returned to the employee prior to April 15th of the calendar year following the year that the excess contribution deferral was made. However, other contributions that exceed the 415 limit (such as employer contributions), cannot be returned to the employer. Instead, these excess contributions must be deposited in a separate contract and treated as a 403c taxable contribution and be immediately included in the gross income of the employee.

The final regulations provide that two or more tax-exempt organizations will be treated as a single employer if at least 80% of the directors or trustees of one organization are representatives of, or directly or indirectly controlled by, the other organization.

Failure on the part of the employer to establish a separate contract to comply with section 403c for purposes of accepting excess contributions would disqualify the entire contract and all amounts held in that contract become immediately taxable.

FICA taxation of employee contributions

Temporary FICA regulations currently provide that FICA tax applies to all employee-initiated contributions to a 403(b) plan, even if such contributions are considered mandatory or a condition of employment. Through a reference to these temporary regulations, the final 403(b) regulations confirm the IRS's FICA tax position.

Distributions

Distributions upon the occurrence of a stated event

The regulations permit a plan to identify certain events that will trigger the commencement of benefits attributable to elective deferrals. These events may include a participant's attainment of a particular age or number of year of service, death, disability, hardship, or severance from employment. The hardship distributions (financial need) follow the better-established guidelines applicable to 401(k) plans. Additionally, like a 401(k) plan, the amount available from an elective deferral account is limited to the employee's cumulative deferrals, excluding gains allocated. The 403(b) participant may not self-certify the financial hardship. There must be a coordination procedure in place between the employer, the fund vendor, and any other third party to ensure that the hardship withdrawal rules are satisfied.

Plan loans

Plan loans from a 403(b) must satisfy the same rules as those followed under 401(k) plans. For example, plans loans may not be made if the participant's total amount of outstanding plan loans exceeds certain limits. As with the hardship withdrawal, there must be a coordination procedure in place to ensure the plan loan rules are satisfied.

Severance from employment

Severance from employment is defined in the final rules as the date the employee terminates employment with the employer. It is only at that date that an employee would be eligible to receive a 403(b) distribution, if no other distributable event applies. A severance from employment does not occur if an employee transfers from one 501(c)(3) organization to another that is treated as a single employer under the controlled group regulations; however, a severance from employment does occur when an employee of a 501(c)(3) organization transfers to a for-profit subsidiary or when an employee ceases working for a public school, but continues to work for the same State employer.

Annuity contract exchanges, plan transfers, and terminations

Exchanges and transfers

Non-taxable transfers among different funding vehicles within the same 403(b) plan are permitted, as well as transfers to another 403(b) program of the same employer or a different employer, if offering the same vendor investment option. In-service exchanges of contracts (formerly known as 90-24 transfers) continue to be allowed, but only if (1) the plan allows for the exchange, (2) the benefit after the exchange is at least equal to the benefit before the exchange, (3) the distribution restrictions are at least as stringent as before, and (4) there is a written agreement between the vendor and employer so that employee information can be shared to ensure that eligibility and distribution rules will be applied properly.

Termination of the plan

The final regulations permit an employer to terminate a 403(b) plan. A terminated plan must distribute accumulated benefits as soon as administratively possible. Distributions may include the delivery of a fully paid annuity contract. Plans may provide for the rollover of benefits. Distributions of assets from a terminated plan is permitted only if the employer (taking into account other employers in the same controlled group) does not make more than de minimis contributions to any successor 403(b) plan during the period that begins the date of the plan termination and ends 12 months after all assets have been distributed from the terminated plan.

The employer should amend the 403(b) Plan document or include a provision in the new document that would permit the employer to terminate the plan and authorize all benefits accumulated under the plan to be distributed on account of the termination.

Employers and their vendors and providers had until the end of 2008 to prepare for the new 403(b) rules.

Additional effective dates:

<i>Provision</i>	<i>Effective date</i>
Excluded employees	Taxable years beginning after December 31, 2009
In-service distribution of annuities	January 1, 2009
Life insurance contracts	Cannot be purchased after September 24, 2007
90-24 contract exchange	Cannot be entered into after September 24, 2007
415 coordination	Taxable years beginning on or after July 1, 2007
Roth coordination	Taxable years beginning on or after January 1, 2007

How can you comply?

Employers and their vendors and providers had until the end of 2008 to prepare for the new 403(b) rules. Employers should have taken a number of steps to make plan operations and management easier and address the additional complexity resulting from the new fiduciary responsibilities and due diligence requirements.

In order to be in compliance with the new rules, please ensure you've taken the following steps:

- > Implement a written plan document or review the existing document for compliance with the new rules and amended if necessary.
- > Develop an investment policy statement that creates guidelines by which investment options will be selected, fund performance evaluated, and, if necessary, replaced. Fiduciary standards dictate regular evaluation of fund options. By limiting the number of fund options available, employers also reduce complexity and administrative oversight.
- > Create a list of all existing providers, and review them for investment performance, investment options, fees, expenses, and service standards. The rules require the written plan document include both a description of all investment options available under the plan and a list of approved investment providers for exchanges and transfers. The new regulations encourage employers to reduce the number of vendors and investment options available in their 403(b) plans, which will benefit both employees and employers.
- > Offer impartial employee education.
- > Form a plan committee and/or an investment committee to oversee and manage your 403(b) plan. Establish fiduciary criteria, create procedures to monitor your plan and vendors on an ongoing basis, and assess the need for hiring outside advisory expertise.
- > Add Roth provisions to the existing 403(b) plan.

Baker Tilly can help

You need your 403(b) plan to not only be in compliance with IRS and DOL regulations, but also to provide employees with access to quality, reasonably priced investment choices and services, with no hidden fees.

The new 403(b) regulations present you with a prime opportunity to reduce fees, improve investment performance, and improve the quality of services to your 403(b) plan, resulting in a much-improved retirement program for employees.

By partnering with Baker Tilly, we can offer you comprehensive services which will provide you with the consulting, compliance, plan administration, investment options, investment guidance, employee communications, and overall support you need to be in compliance.

For additional information about the IRS final 403(b) rules or assistance developing and implementing a compliance action plan, please connect with us at bakertilly.com or 800 362 7301, or directly with:

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We welcome the opportunity to discuss how we can help you meet your business goals.

For more information or any questions you might have on the 403(b) regulations, please connect with us at bakertilly.com or 800 362 7301.