A VIEW FROM THE TOP: AN OVERVIEW OF THE FINAL 403(b) REGULATIONS

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In July 2007, the IRS and Department of Treasury issued final regulations governing retirement plans organized pursuant to Section 403(b) of the Internal Revenue Code. These plans are generally sponsored by qualified charitable organizations, public schools and state colleges and universities. The regulations are the first comprehensive 403(b) plan guidance in over 40 years and constitute major changes in the governance of these types of plans. The effect of the final regulations was a narrowing of the difference between the rules that apply to 403(b) retirement plans and the rules that apply to other tax-qualified retirement arrangements, particularly the 401(k) plan.

The final regulations went into effect January 1, 2009; however, the IRS issued guidance at the end of 2008 extending the written plan document requirement to December 31, 2009 and allowing 403(b) plan sponsors to operate their plans under a "reasonable interpretation" of the 403(b) rules, including the final regulations during 2009. Therefore, employers should make every attempt to operationally comply with the rules beginning January 1, 2009. But, certainly prior to the end of 2009, every employer should evaluate its plan(s) in light of the final regulations and have made all applicable and appropriate changes necessary for compliance.

The final regulations touch a wide variety of provisions within the statutory framework. Although there are many subtle changes and details, some of the major provisions are summarized below.

Written Plan Document Requirement

In an unprecedented move, the regulations will now require all 403(b) plans, including non-ERISA plans, to have a written plan document containing all material terms of the 403(b) arrangement. The plan document is to contain terms regarding eligibility for participation, types of contributions permitted, the form and time of distributions, applicable limitations, i.e. 415 limitations, and identification of the contracts available for investment under the plan.

Prior to the issuance of the final regulations, only ERISA-governed 403(b) plans were required to have a written plan document. There was a concern that having a plan document might cause a previously exempt, non-ERISA plan, to become subject to Title I of ERISA. In response to this concern, the Department of Labor issued a Field Assistance Bulletin in July 2008 that stated the DOL would still view tax deferred annuity plans (non-ERISA plans) as exempt from ERISA if certain new safe harbor requirements are met. The overall import of these new requirements is that the plan could become subject to ERISA if the employer becomes more than "minimally involved' with the plan. Compliance with the safe harbor requirements will be determined, though, on a case-by-case basis.

Nondiscrimination Testing, Universal Availability and Controlled Group Rules

The final regulations repeal the nondiscrimination safe harbors previously provided under a special Notice issued by the IRS in 1989 for 403(b) plans and now generally require the same nondiscrimination testing on all employer contributions made under a 403(b) plan (other than employee salary deferrals) that apply to qualified retirement plans.

Although salary-reduction-only 403(b) plans have always been exempt from statutory non-discrimination requirements that apply to 401(k) plans, participation in such plans must be made "universally available." Under the "universal availability" rule, an employer must allow all employees normally working more than 20 hours per week to make elective deferrals of at least $200 if any employee is permitted to make deferrals, with limited exceptions. The final regulations change these

limited exceptions. Specifically, the regulations remove the exception that allowed employers to exclude union employees. There is, however, a delayed effective date for the provision eliminating the exclusion for union employees.

The final regulations include controlled group rules for tax-exempt entities that will apply equally to 403(b) plans, 401(a) qualified plans and eligible 457(b) plans. For section 403(b) plans, these rules are relevant for nondiscrimination testing. Under these rules, organizations under common control are treated as a single employer for purposes of applying these nondiscrimination rules, as well as section 415 contribution limitations and the 15-year catch-up limits. Common control between two or more organizations exists when 80% or more of the directors or trustees of one organization are either representatives of, or are directly or indirectly controlled by, another organization. These rules do not apply to governmental or church employers.

Contract Exchanges and Transfers

The final regulations have made significant changes in the rules governing contract exchanges and plant-to-plan transfers. These regulations relate to how a 403(b) contract or custodial account can be exchanged for another 403(b) contract or custodial account within the same plan (contract exchanges) or plan-to-plan transfers between plans (transfers). The final regulations now only permit these exchanges and transfers if certain conditions are met for each situation. Specifically, effective after September 24, 2007, contract exchanges are only permitted if:

- The plan provides for the exchange;
- The contract or account to which the transfer is being made imposes distribution restrictions at least as strict as those imposed by the old contract or account;
- The benefit payable to the participant immediately following the transfer is at least equal to the benefit prior to the transfer; and

- The employer and the annuity contract provider must agree to provide each other with information about the participant's employment status and other information to necessary to maintain the tax-deferred status of the plan.

Similarly, the final regulations permit nontaxable plan-to-plan transfers for current and former employees if:

- Both the transferring and receiving plans provide for the transfers;
- The participant's accumulated benefit immediately after the transfer at least equals the accumulated benefit immediately before the transfer; and
- The distribution restrictions for the transferee plan are at least as stringent as those of the transferring plan.

Expansion of Distribution Restrictions

The final regulations expand the distribution restrictions to include all employer contributions to a 403(b) annuity, but only for annuity contracts issued after December 31, 2008. This means that the historical restrictions on distribution, i.e. "triggering events" such as disability, severance from employment or the participant reaching age 59-1/2, which previously only applied to elective deferrals to 403(b) annuity contract and all contributions (employee elective deferrals and employer contributions other than elective contributions) made to a 403(b) custodial account, will now apply to employer contributions to a 403(b) annuity.

Prompt Transmission of Deferrals/Contributions

The final regulations require employers to forward all elective deferrals/contributions to the plan as soon as administratively possible. The regulations suggest that transferring such deferrals/contributions within 15 business days following the months in which these amounts would have been paid to the participant will be considered reasonable.

Plan Termination

In another unprecedented move, the final regulations permit an employer for the first time to termination a 403(b) plan and distribute benefits upon plan termination. The distribution of benefits is, however, restricted, in that, they may only be distributed if an employer within the controlled group does not contribute to another 403(b) plan within one year before and one year after termination of the plan under which two percent or more of the employees in the terminated plan participate.

This article provides a broad overview of the major provisions of the final regulations. There are additional more subtle changes proscribed in the final regulations on which your legal counsel can advise you. Processing the impact of these final regulations can be a daunting task; however, if small steps are taken by the employer, a comprehensive review becomes more manageable. The starting point for any employer should be reviewing any current written plan document or beginning to prepare one. The next step might be to determine controlled group status by reviewing organizational structure. Once a controlled group has been identified, an analysis of nondiscrimination requirements would be in order. As the safe harbors are no longer available, the employer should determine whether the plan has been relying on this option and review the plan design to determine if it will satisfy statutory and regulatory requirements. A determination of whether compliance with the universal availability rule would follow. Finally, employers need to determine what they need to do to ensure operational compliance. The various administrative responsibilities must be allocated and they cannot be allocated to participants.

In summary, while the deadline to comply with the written plan requirement has been extended to the end of 2009, employers should be prepared to be operationally compliant with the final regulations issued for the governance of 403(b) plans as soon as possible. In any event, employers must be compliant by January 2010.