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A legal update from Dechert's Employee Benefits and Executive Compensation Group

Final 403(b) Regulations Issued by IRS Require Employer Action

The IRS has issued the long-awaited final regulations under Section 403(b) of the Internal Revenue Code. These regulations are welcome, because they provide guidance on many of the rules pertaining to 403(b) plans. However, the regulations introduce or explain a number of rules which create significant new responsibilities for employers, and which will require employers to amend and update their 403(b) plans and to establish or revise administrative procedures for complying with Section 403(b).

By way of background, 403(b) plans may be maintained by public schools and tax-exempt organizations for the benefit of their employees. They may be funded through annuity contracts issued by an insurance company, custodial accounts invested solely in mutual funds, and (for church employees and certain ministers) retirement income accounts. For convenience, a funding arrangement is called a "tax-sheltered annuity contract" or "TSA contract" below. A 403(b) plan may generally accept elective deferrals and after-tax contributions from employees, employer matching contributions, and employer nonelective contributions. The contributions are not taxable to the employees when made to the plan.

The final regulations are generally effective as of January 1, 2009. However, several important rules become effective currently, and therefore require immediate employer attention. The final regulations and new rules are summarized below.

The "Written Plan" Requirement

A 403(b) plan must be maintained under a written plan of the employer which, in both form and operation, satisfies the requirements of Section 403(b) and the final regulations. The plan document must contain all of the material terms and conditions for eligibility and benefits, limitations on contributions, the available funding for the plan (e.g., annuity contracts or custodial accounts), the time and form under which benefit payments are made, and any optional features such as hardship withdrawals, loans, plan-to-plan transfers or TSA contract exchanges, and acceptance of rollovers.

The plan document should also allocate responsibility for performing administrative functions, such as those needed to comply with the requirements of Section 403(b) and other tax requirements (e.g., monitoring contribution limits, determining whether a distribution or hardship withdrawal may be made, or computing the permissible amount of any loan). These responsibilities may be allocated among the employer, the issuers, and custodians of the TSA contracts funding the plan and other third parties, but, generally, not to employees.

The plan document may incorporate by reference other documents, such as the documents for the TSA contracts which fund the plan. However, the employer is responsible for determining that there is no conflict between the terms of the plan document and the other documents so incorporated.

The IRS intends to issue guidance, which includes model plan provisions, to help employers meet the written plan requirement.

Contract Exchanges and Plan-to-Plan Transfers

The final regulations contain rules governing the exchange of TSA contracts within a 403(b) plan, as well as the transfer of benefits from one 403(b)

plan to another, replacing the prior such rules under Revenue Ruling 90-24. The rules regarding the exchanges of TSA contracts are of immediate concern, because they apply after September 24, 2007. Under these rules, each of the following conditions must be met for any exchange of TSA contracts within a 403(b) plan:

- the 403(b) plan must provide for the exchange;
- immediately after the exchange, the employee has a total benefit under the 403(b) plan which is at least equal to the total benefit of that employee under the plan immediately before the exchange;
- the TSA contract received in the exchange contains restrictions on distributions which are not less stringent than those imposed under the TSA contract given up; and
- the employer enters into an agreement with the issuer or custodian of the TSA contract received, under which the employer and the issuer or custodian will from time to time in the future provide each other with information necessary for the contract received, or for any other TSA contract to which contributions have been made by the employer, to satisfy Section 403(b) and other tax rules.

As to any plan-to-plan transfer (effective as of January 1, 2009), each of the following requirements must be met:

- the plan participant whose benefits are being transferred is an employee or former employee of the employer (or the business of the employer) that maintains the receiving plan;
- the 403(b) plans involved provide for the transfers;
- immediately after the transfer, the participant has a total benefit under the 403(b) plans involved which is at least equal to the total benefit of that participant under those plans immediately before the transfer; and
- the receiving 403(b) plan imposes distribution restrictions on the benefits transferred which are not less stringent than those imposed on the benefits by the transferor 403(b) plan.

No More Life Insurance Contracts

On or after September 24, 2007, a 403(b) plan cannot acquire a life insurance contract to fund a 403(b) plan.

Controlled Groups

The final 403(b) regulations contain rules for identifying controlled groups for organizations which are tax-exempt under Section 501(a). For convenience, a tax-exempt organization is referred to below as a "TEO." These rules apply when determining whether a TEO is to be treated a single employer with another organization (whether or not the other organization is a TEO) under the employer aggregation rules of Section 414(b), (c), (m), and (o) of the Internal Revenue Code, and are *in addition to* the rules otherwise applicable under those Code provisions.

For a TEO that maintains a 403(b) plan, these rules would generally be relevant for purposes of applying the Section 403(b) nondiscrimination requirements (discussed below), the Section 415(c) contribution limit, the special Section 403(b) catch-up contribution rules, and the Section 401(a)(9) minimum distribution rules. Further, these controlled group rules have implications beyond 403(b) plans, since they apply to any situation in which Section 414 requires aggregation of entities, such as the rules pertaining to a qualified retirement plan (e.g., a 401(k) plan) maintained by a TEO.

Under these rules, the employer for a 403(b) plan includes the TEO whose employees participate in it, and any other organization which is under common control with that TEO. For this purpose, common control would exist between the TEO and another organization if at least 80% of the directors or trustees of one of those organizations are either representatives of, or directly or indirectly controlled by, the other organization.

Designated Roth Contributions

The final regulations contain rules for allowing participants to designate all or some of their (pre-tax) elective deferrals as being (after-tax) Roth contributions.

Among these rules is that the designated Roth contributions must be kept in a separate account.

Nondiscrimination Requirements

Under the final regulations, employer matching and nonelective contributions, as well as after-tax employee contributions, made to a 403(b) plan must satisfy the requirements of all of the following Sections of the Internal Revenue Code, in the same manner as a qualified retirement plan:

- Section 401(a)(4) (relating to nondiscrimination in contributions and benefits);
- Section 401(a)(17) (limiting the amount of compensation that can be taken into account);
- Section 401(m) (relating to matching and after-tax employee contributions); and
- Section 410(b) (relating to minimum coverage).

The foregoing requirements do *not* apply to elective deferrals. The above rules eliminate the "good faith" reasonable standard for satisfying non-discrimination requirements which had previously applied.

The controlled group rules discussed above apply here, and all 403(b) plans of the aggregated employers are taken into account. The requirements in (1), (3), and (4) above do not apply to a governmental plan.

Universal Availability Requirements

Under the final regulations, all employees of an employer maintaining a 403(b) plan must be permitted to make elective deferrals to the plan, if any particular employee of that employer may do so. Further, an employee's right to make elective deferrals includes the right to designate the elective deferrals as being designated Roth contributions, if any particular employee of the employer is allowed to do so. To meet the foregoing requirement, an employee with a right to make elective deferrals to a 403(b) plan must be provided with an "effective opportunity," as defined in the final regulations, to make the deferrals.

Subject to certain restrictions, the following employees may be excluded from making elective deferrals under an employer's 403(b) plan:

- employees who are eligible to make elective deferrals under another 403(b) plan, or under a 401(k) plan or Section 457(b) eligible governmental plan, of the same employer;
- employees who are non-resident aliens with no U.S. source income from the employer;
- employees who are students performing certain services; and
- employees who normally work fewer than 20 hours per week.

Distribution Restrictions

Under the final regulations, except for amounts held in custodial accounts or amounts attributable to elective deferrals and catch-up contributions, a 403(b) plan is not permitted to distribute amounts to the employee until the earlier of the employee's severance from employment or the occurrence of some event, such as the passing of a fixed number of years, the attainment of a stated age, or disability. Amounts held in custodial accounts, and amounts attributable to elective deferrals and catch-up contributions, may not be distributed to the employee until his or her severance from employment or upon the occurrence of certain other events.

A distribution of elective deferrals and catch-up contributions (but not earnings) may be made from a 403(b) plan on account of hardship, in accordance with the rules and restrictions which apply to hardship withdrawals of such contributions under 401(k) plans.

Severance from Employment

Under the final regulations, a "severance from employment," as that term is used throughout the final regulations, particularly as an event upon which a distribution may be made, occurs when an employee ceases to be employed by the employer maintaining the 403(b) plan. The severance may occur, even though the employee continues to be employed *either*:

- by another entity which is treated as being the same employer under the controlled

group rules, but is not an entity that can maintain a 403(b) plan (such as a for-profit subsidiary of a Section 501(c)(3) organization); or

- in a capacity that is not employment with an employer that can maintain a 403(b) plan (for example, ceasing to be an employee performing services for a public school but continuing to work for the same State employer).

On the other hand, a severance from employment does *not* occur if an employee transfers from one Section 501(c)(3) organization to another Section 501(c)(3) organization that is treated as the same employer under the controlled group rules, or if an employee transfers from one public school to another public school of the same State employer.

Catch-up Rules

Two types of "catch-up" contributions are permitted by 403(b) plans. One type is allowed for employees who are age 50 or older, and another type is a special 403(b) catch-up allowed for employees who have at least 15 years of service with certain types of employers. Under the final regulations, any catch-up contributions made to a 403(b) plan by an employee, who is eligible to make both types of catch ups, are treated, first, as being special 403(b) catch-ups, and then as being age 50 catch-ups.

Plan Terminations

Employers are allowed to amend their 403(b) plans to eliminate future contributions for existing participants, or to limit participation to existing participants (to the extent consistent with the nondiscrimination/universal availability rules). Also, employers may terminate their 403(b) plans and subsequently distribute the benefits, without regard to the restrictions which normally apply to distributions. To take advantage of the termination rule, the plan document must specifically allow the termination to be made. The distributions made upon the plan's termination will generally be eligible for rollover treatment.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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