

# Pension ANALYST

Important Information

Plan Administration and Operation

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## A New World for 403(b) Arrangements

**WHO'S AFFECTED** These developments affect sponsors of and participants in ERISA and non-ERISA 403(b) arrangements.

**BACKGROUND AND SUMMARY** In July 2007, the IRS published the long-awaited final 403(b) regulations, which were summarized in an [August 2007 Compliance Bulletin](#). In November 2007, the IRS provided additional guidance in [Revenue Procedure 2007-71](#).

The regulations provide guidance regarding:

- A written plan requirement;
- Required contractual provisions;
- The application of certain qualified plan nondiscrimination rules;
- The application of the universal availability rule;
- The interaction of various catch-up provisions;
- Required timing for remitting contributions;
- New distribution restrictions;
- New rules for nontaxable exchanges and transfers; and
- The termination of 403(b) arrangements.

The Revenue Procedure provides model plan language that may be used by a public school employer to satisfy the new written plan requirement. It also provides additional guidance regarding contract exchanges and transfers.

**ACTION AND NEXT STEPS** In general, the final 403(b) rules are effective January 1, 2009. During 2008, plan sponsors must review their programs and identify changes needed to comply with the new rules.

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The final 403(b) regulations contain a number of provisions that will significantly affect the administration and operation of both ERISA 403(b) plans and non-ERISA 403(b) programs, beginning in 2009. To a large extent, the new rules bring 403(b) arrangements closer to the world of qualified plans. These changes may be especially noteworthy for sponsors of non-ERISA programs.

## Written Plan Requirement

Historically, only ERISA 403(b) plans were required to have written plan documents. Non-ERISA 403(b) programs were typically governed by the terms of the underlying contracts. Effective January 1, 2009, all 403(b) arrangements must have written defined contribution plans, which specify:

- Terms and conditions for eligibility, contributions and applicable limitations;
- Times and forms of distribution;
- Optional provisions, such as hardship withdrawals, loans, plan-to-plan transfers or contract exchanges, service credit purchase transfers and acceptance of rollover contributions; and
- The party or parties responsible for plan administration and operation.

In addition, the plan may incorporate by reference other documents, such as contracts, which then become part of the plan.

## Impact on Non-ERISA Programs

In connection with this new requirement, the Department of Labor (DOL) provided guidance to enable certain employers to continue to make non-ERISA 403(b) programs available to their employees. In [Field Assistance Bulletin 2007-02](#), the DOL states that the written plan could consist of:

- The separate contracts and related documents supplied by the annuity providers, account trustees and custodians; and
- A separate document that coordinates administration among the different issuers and addresses applicable tax matters, such as the universal availability requirement.

The DOL expects that these documents will:

- Identify the parties that are responsible for various administrative functions;
- Correctly describe the employer's limited role; and
- Allocate discretionary activities to the annuity providers or other selected third parties.

In addition, the employer may periodically review these documents to ensure there are no conflicting provisions and that they comply with the applicable tax laws and regulations.

## Model Plan Language

To help public school employers comply with the written plan requirement, the IRS has published [model plan language](#). This language is suitable for use when a plan permits only pre-tax elective deferral

contributions. If employees are able to make Roth deferrals or receive employer contributions of any kind, the language will have to be modified. If a public school plan sponsor adopts the entire model language as its written plan, it will have assurance that the written plan satisfies the 403(b) form requirements, without having to request a formal private letter ruling from the IRS.

Employers that are not public schools may use the model plan language as sample language to comply with some of the written plan requirements. However, they would need to request private letter rulings to obtain assurance that the written plan satisfies the 403(b) form requirements. Currently, the IRS does not have a determination letter program for 403(b) plans, but they are considering implementing such a process.

## **Required Contractual Provisions**

Under the final rules, 403(b) contracts must contain specific provisions. A contract must:

- Provide that the employee's rights under the contract are nonforfeitable;
- Be nontransferable;
- Limit the employee's deferrals to the standard deferral limit (\$15,500, for 2008), plus applicable catch-up amounts;
- Limit the employee's contributions and other annual additions;
- Limit incidental benefits provided under the contract;
- Contain minimum required distribution provisions; and
- Permit rollover distributions.

In addition, contracts generally must be held under a plan that meets nondiscrimination rules, including the long-standing universal availability requirement.

## **Revised Nondiscrimination Rules**

Until January 1, 2009, 403(b) plans that accept contributions other than elective deferral contributions must make a "good faith" effort to comply with the qualified plan nondiscrimination rules that apply to those contributions. Employer matching and employee after-tax contributions must satisfy the actual contribution percentage (ACP) test rules. Other employer contributions may be tested under the qualified plan rules or may meet the safe harbor rules described in IRS Notice 89-23. Elective deferral contributions are subject to a universal availability requirement.

After December 31, 2008, more stringent nondiscrimination rules apply to most employer and employee after-tax contributions. The universal availability requirement continues to apply to elective deferral contributions, but with significant changes made to the classes of employees that may be excluded, and with additional notification requirements.

Only church plans are completely exempt from these nondiscrimination rules.

## **Qualified Plan Rules**

In general, employer nonelective contributions are subject to the following nondiscrimination rules, beginning in 2009:

- Minimum coverage;
- Nondiscrimination in amount;
- Nondiscriminatory availability; and
- The section 401(a)(17) compensation limit.

Likewise, employer matching contributions must satisfy the following rules:

- Minimum coverage;
- ACP test;
- Nondiscriminatory availability; and
- The compensation limit.

However, both nonelective and matching contributions made to governmental plans are only subject to the compensation limit.

### **Universal Availability Requirement**

The “universal availability” rule continues to apply to elective deferrals, including Roth deferrals. This rule applies to all 403(b) arrangements, other than church plans.

Under prior IRS guidance, the following classes of employees could be disregarded when applying the universal availability rule:

- Employees covered by a collective-bargaining agreement;
- Non-resident aliens with no U.S.-source earned income;
- Employees who normally work less than 20 hours per week;
- Students who are providing services to a school, college, or university;
- Professors who are providing services on a temporary basis to another public school for up to one year;
- Certain temporary governmental employees;
- Employees who made a one-time election to be participate in another governmental plan;
- Employees who participate in a section 457(b) plan;
- Employees who are eligible to make deferral contributions to a 401(k) plan or another 403(b) arrangement sponsored by the employer; and
- Employees affiliated with a religious order who have taken a vow of poverty.

Under the final rules, only the following classes of employees may be excluded when applying this rule:

- Non-resident aliens with no U.S.-source earned income;
- Employees who normally work fewer than 20 hours per week (or a lower number of hours that is stated in the plan);
- Students who are providing services to a school, college, or university; and
- Employees who are eligible to make deferral contributions to another 403(b) plan, governmental 457(b) plan, or 401(k) plan sponsored by the employer.

The final rules contain special transition provisions that allow plans that excluded classes of employees based on the prior IRS guidance to come into compliance with the new rules.

- Plans that as of July 26, 2007, excluded employees covered by a collective bargaining agreement may have until the first day of the first tax year beginning after July 26, 2010, to remove this exclusion.
- Plans that as of July 26, 2007, excluded professors providing services to another school, employees who made a one-time election to participate in a governmental plan, or employees who have taken a vow of poverty, generally have until the first day of the first tax year beginning after December 31, 2009, to remove these exclusions. Certain governmental plans have until January 1, 2011, to remove these exclusions.

Employees must be given an effective opportunity to make elective deferrals. “Effective opportunity” is determined based on the specific circumstances, and includes a notice to employees of the right to make such an election, the time period for making the election, and any other conditions imposed on elections. Also, the employees must be given the opportunity, at least once each plan year, to make (or change) an election to defer contributions into the 403(b) arrangement.

The final rules also clarify that this universal availability requirement applies separately to each tax-exempt organization covered by a 403(b) plan and to each governmental entity that is not part of a common payroll.

## **Contribution Rules**

### **Deferral Contributions**

Each employee’s elective deferral contributions to 403(b) arrangements are subject to a basic annual limit (\$15,500, for 2008). However, employees who have reached age 50 are eligible to make catch-up contributions (\$5,000, for 2008). In addition, employees of certain organizations may make special 15-year catch-up contributions. The final rules clarify several aspects of these deferral contribution limits.

First, the rules confirm that the deferral limits apply to both pre-tax contributions and designated Roth contributions.

The final rules also clarify which organizations’ employees are eligible to make the 15-year catch-up contributions. In general, individuals may make these contributions if they are employed by a school, hospital, health and welfare service agency (including home health service agency), or church-related organization. Under the final rules, the definition of “health and welfare service agency” is expanded to include:

- Hospice organizations;
- Tax-exempt organizations whose primary activity is to prevent cruelty to individuals or animals;
- Tax-exempt organizations that provide substantial personal services to the needy as part of its primary activity;
- Adoption agencies;
- Agencies that provide home health services;
- Agencies that provide assistance to individuals with substance abuse problems; and
- Agencies that provide help to the disabled.

The IRS also confirms that if an individual is eligible to make both age 50 catch-up contributions and 15-year catch-up contributions, his catch-up contributions will first be treated as 15-year catch-ups, until that limit is reached. Any remaining deferrals will be treated as age 50 catch-ups.

### **Contribution Timing Rules**

ERISA 403(b) plans are subject to the DOL’s contribution timing requirements. Under these rules, employers must deposit employee contributions and payroll-deduction plan loan repayments to the plan as soon as they can reasonably be segregated from the employer’s general assets.

Effective January 1, 2009, the IRS imposes a similar contribution deposit timing rule on all 403(b) arrangements. Under the IRS rules, an employer must transfer elective deferrals to the insurance company or entity holding a custodial account within a period that is no longer than reasonable for proper plan administration. For example, a plan may require the employer to contribute elective deferrals within 15 business days following the month in which the amounts would otherwise have been paid to the employees. However, if the plan is subject to ERISA, such a requirement does not override the DOL rules.

## Post-Employment Contributions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) revised the definition of “includible compensation” to provide that a former employee is deemed to have includible compensation through the end of his fifth tax year following the tax year in which he ceases to be an employee. The final rules reflect this provision, but only apply it for purposes of determining employer nonelective contributions and applying the annual additions limit. Any nonelective contributions made for former employee must satisfy applicable nondiscrimination requirements. Former employees may not make deferral contributions based on this imputed income

## Contribution Limits and Excesses

Contributions to a 403(b) arrangement are subject to both the basic annual limit on deferrals and the annual additions limit. The final rules provide mechanisms for correcting both excess deferrals and excess annual additions.

Excess deferrals must be distributed to the participant, along with allocable income, no later than April 15 of the calendar year following the year in which the excess occurred. The excess deferral amounts are included in the participant’s taxable income in the year they were contributed to the plan. Allocable income distributed to the participant is taxable in the year distributed.

Excess annual additions must be set aside in separate accounts and included in the participant's income for the tax year in which the limitation year ends. These excess amounts must be identified and set aside as the contributions are being made. Plan sponsors or administrators cannot wait until year-end to make these determinations, or the arrangement will lose its 403(b) status with respect to the affected participant. The excesses may be distributed to participants at any time. Additional information about the application of the section 415 limit to 403(b) arrangements can be found in an [August 2007 Pension Analyst](#).

## Distribution Rules

The final rules clarify the distribution restrictions that apply to elective deferral contributions and impose new restrictions on the distribution of employer contributions. They also permit the distribution of account balances due to plan termination. Finally, the rules describe transfer situations that are not subject to the general distribution restrictions.

### Distribution of Deferral Contributions

In general, elective deferral contributions may not be distributed before the earliest of a participant’s:

- Severance from employment date;
- Date of death;
- Hardship;
- Disability date; or
- Attainment of age 59½.

For purposes of these rules, a “severance from employment” is the date an employee ceases employment with the employer maintaining the 403(b) arrangement. While the employer is generally determined according to the controlled group rules, some special rules do apply. If an employee transfers employment from an entity that maintains a 403(b) arrangement to a [related entity](#) that cannot maintain such an arrangement (e.g., from a tax-exempt organization to a for-profit subsidiary, or from a public school to another State agency), the employee is treated as having a severance from employment. However, if an

employee transfers employment from one tax-exempt organization to a related tax-exempt organization or from one public school to another public school in the same State, no severance has occurred.

The final rules also confirm that the 401(k) hardship distribution rules apply to 403(b) arrangements. This includes the limitation on amounts that may be withdrawn.

### **Distribution of Employer Contributions**

Under the final rules, employer nonelective and matching contributions may only be distributed upon the occurrence of some stated event. Acceptable events include:

- A fixed number of years (generally, two);
- The participant's attainment of a stated age;
- The participant's death, disability, retirement, or severance from employment (as defined above).

These restrictions do not apply to assets in section 403(b)(7) custodial arrangements or contracts issued before January 1, 2009. In addition, if the sponsor of an ERISA 403(b) plan adopts a plan amendment before January 1, 2009, to comply with these rules, the plan will not violate the ERISA prohibition on eliminating in-service distribution options.

### **Distribution at Plan Termination**

For the first time, IRS rules allow plan sponsors to terminate 403(b) arrangements and distribute all plan assets. In order for a 403(b) arrangement to be considered terminated, all assets must be distributed as soon as administratively practicable following the plan termination date. This requirement can be satisfied by the distribution of fully paid individual annuity contracts. However, plan termination distributions cannot be made if they are prohibited under the underlying contracts.

In addition, assets generally cannot be distributed if the employer or any member of its controlled group makes contributions to a 403(b) contract for the benefit of a participant in the terminating plan for 12 months following the plan termination date.

### **Contract Exchanges and Transfers**

The final rules permit three types of nontaxable exchanges or transfers within and between 403(b) arrangements:

- A change of investment within the same plan (a "contract exchange");
- A plan-to-plan transfer, where a 403(b) arrangement sponsored by another employer receives the assets; and
- A transfer to purchase permissive service credits or to repay a qualified defined benefit governmental plan.

According to these rules, contract exchanges may be made after September 24, 2007 only if they are expressly permitted under the plan, and the contract issuer and employer agree to share sufficient information to ensure compliance with 403(b) distribution rules, loan limits and hardship provisions, to the extent applicable. In addition, the new contract must contain distribution restrictions at least as stringent as the old contract, and the participant's benefit cannot be reduced as a result of the exchange. Plan documentation and information sharing agreements must be in place before January 1, 2009.

Following the publication of the final rules, IRS representatives informally attempted to clarify the contract exchange concept. Additional formal guidance was provided in [Revenue Procedure 2007-71](#). According to this additional guidance:

- In general, old-style [90-24 exchanges](#) may be made until January 1, 2009, as long as an information sharing agreement is in place between the contract issuer and employer before January 1, 2009. If such an exchange is made after September 24, 2007, and that contract (the “interim contract”) is then exchanged before July 1, 2009, for a contract issued by either an issuer that is receiving ongoing contributions under the plan or one that has an information sharing agreement in place, the information sharing requirement does not apply to the interim contract.
- If a contract is issued after December 31, 2004, and before January 1, 2009, by an issuer that does not receive ongoing contributions under the 403(b) arrangement after January 1, 2009, that contract will continue to be treated as a 403(b) contract if the employer makes a “reasonable, good faith effort” to include the contract in the employer’s plan.
- A contract issued to a former employee or beneficiary, which does not receive contributions after January 1, 2009, will continue to be subject to the 403(b) rules, even if the plan does not contain provisions relating to that contract.

## Expanded Form 5500 Reporting Requirements

On November 16, 2007, the Department of Labor (DOL), IRS, and Pension Benefit Guaranty Corporation (PBGC) published final annual reporting regulations. For 2007 and 2008 plan years, the traditional limited Form 5500 filing requirements continue to apply to ERISA 403(b) plans. However, effective for plan years beginning on and after January 1, 2009, ERISA 403(b) plans will be subject to standard Form 5500 filing requirements. As a result, sponsors of these plans will need to complete the entire Form 5500 and applicable Schedules. In addition, sponsors of plans with more than 100 eligible participants will need to have their plans’ financial statements audited. While the first expanded Form 5500 filings generally will not be due until July 2010, plan sponsors should begin to familiarize themselves with the new requirements.

Non-ERISA 403(b) programs will continue to be exempt from Form 5500 filing requirements on and after January 1, 2009.

## Compliance Activities Underway

Sponsors of both ERISA and non-ERISA 403(b) arrangements should be reviewing their plans and programs to identify the changes needed to both documents and plan operation to comply with the new rules as of January 1, 2009. A number of industry groups are actively working with the IRS to obtain additional guidance, especially with respect to information sharing agreements. Prudential Retirement is participating in these efforts. If you have questions about how the new rules affect your plan or program, please contact your Prudential Retirement representative for assistance.

### Pension Analyst by Prudential Retirement

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