BALLARD SPAHR ANDREWS & INGERSOLL, LLP

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Final 403(B) Regulations Released, Finally

Employee Benefits and Executive Compensation

by Jean C. Hemphill, Michele Berman Golkow, Virginia Escobar Neiswender and Jacquelyn M. Gray

Three and a half years after the publication of the proposed rules, the Treasury Department released final, comprehensive regulations governing retirement plans offered by nonprofit, governmental and church organizations under Internal Revenue Code Section 403(b). While maintaining most of the requirements set forth in the proposed regulations, the final rules allow for more flexibility in some compliance measures, responding to comments from industry representatives. The regulations also explain the penalties for failing to satisfy the regulatory requirements. Given the significance of the regulations, most organizations will be pleased to note that, for the most part, the effective date for the final regulations is the taxable year beginning after December 31, 2008.

This summary outlines major points addressed in the regulations. Stay tuned for further educational sessions on implementation issues from Ballard's Employee Benefits and Executive Compensation practice group. In the meantime, if you have any questions, please do not hesitate to contact us.

Employer Obligations in Offering a Plan

Written Plan Document Required. Unlike qualified plans, 403(b) programs have not been required to have an official plan document, and many employers have been reluctant to adopt a plan document for fear of subjecting the program to ERISA's requirements. The final regulations require a written plan document for every 403(b) plan. In recognition of the fact that most 403(b) plans are administered through outside vendors, the regulations permit a plan document to incorporate by reference other materials, such as annuity contracts, custodial accounts or summary descriptions. Nonetheless, an employer must adopt a single plan document stating the eligibility requirements and coordinating the administration of the plan(s) among multiple 403(b) vendors.

The Department of Labor concurrently issued Field Assistance Bulletin (FAB) 2007-02, which explains that having a written plan document will not by itself create a plan covered by ERISA. Most significantly, the existing safe harbor still applies: plans that are solely salary deferral plans will not be covered by ERISA, even if the employer adopts a plan document.

***Follow-Up Item**: Employers who do not currently have a plan document should seek legal counsel on whether they or their service provider should prepare such documentation.*

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).

***Follow-Up Item**: The addition of the treatment of custodial accounts as 401(a) qualified plans for purposes of the Code will result in the need to file information returns with the IRS.*

Anti-Conditioning. The final regulations impose a new rule that generally prohibits plans from conditioning benefits on a participant's contributions to the plan. However, the regulations provide exceptions that will allow most 403(b) plans to continue their current plan contribution design. These exceptions include matching contributions, benefits that require withholding from pay (*e.g.*, to repay a loan), and benefits provided under a cafeteria plan. Therefore, plan sponsors that provide an employer matching contribution, in either a 403(b) plan or in a separate 401(a) plan, will not be required to modify their arrangements.

Nondiscrimination Rules. The final regulations provide that employer contributions other than elective deferrals and after tax employee contributions must satisfy nondiscrimination requirements affecting matters such as contributions, benefits and coverage.

***Follow-Up Item**: The nondiscrimination rules will not apply to State and local public schools. However, for all other eligible entities, plans should be designed to avoid violating the nondiscrimination rules.*

Universal Availability. Elective deferrals are subject to a universal availability rule. Subject to certain exceptions, an employer that offers one employee the opportunity to contribute to a 403(b) plan (including the opportunity to make designated Roth contributions) must make the same opportunity to contribute elective deferrals available to all employees. The individuals excepted are narrower than the excluded persons under Notice 89-23. While individuals working under a vow of poverty continue to be excepted, union employees are not.

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.

In line with the proposed rules, 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. This definition is somewhat narrower than the one provided in previous IRS guidance (Notice 89-23). 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.

***Note**: Only churches and qualified church controlled organizations ("QCCOs") can rely on the old controlled group rules in Notice 89-23. See the section on Retirement Income Accounts below for more details.*

Other Provisions. The regulations adopt the proposed rule provisions relating to loans, qualified domestic relations orders (QDROs), hardship distributions and minimum distribution requirements.

Plan Contributions —Employer and Elective

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. The rules also require an employer to transfer contributions to the plan within a reasonable period, for example, within 15 business days of the month the amount would have otherwise been paid to the participant.

Catch-up Contributions. The final regulations generally adopt the proposed rules regarding the coordination of the special 403(b) catch-up contributions available to certain qualified organizations with more generally applicable catch-up rules for employees who are at least 50 years old. The final regulations provide that qualified organizations include not only educational institutions, churches, and hospitals, but an expanded list of health and welfare agencies such as adoption agencies, section 501(c)(3) organizations focused on the prevention of animal cruelty, and agencies providing services to the needy such as home health service agencies.

***Note**: With the expansion of the definition of health and welfare agencies, organizations that did not fit within the definition of qualified organization under the proposed regulations may reexamine their status to see whether they would now qualify.*

Post-Termination Contributions. Uniquely, Section 403(b) permits certain post-employment contributions that are not subject to the new 409A rules. The final regulations adopt the provisions of the proposed regulations addressing post-termination employer contribution rules. Employers are permitted to make nonelective contributions to a 403(b) plan on behalf of a former employee through the end of the taxable year in which employment terminates and for the next five taxable years. Contributions are not permitted after the employee's death. Employers may take advantage of this provision to provide severance payments through a 403(b) plan (thereby avoiding the FICA taxes that would otherwise apply to severance payments made in cash). However, employers must consider whether nonelective contributions made pursuant to this provision discriminate in favor of highly compensated former employees. The final regulations also permit a former employee to make an elective contribution to a 403(b) plan of accrued regular, bonus, sick or vacation pay paid within a limited time after termination of employment.

FICA Taxation of Employee Contributions. Temporary FICA regulations currently provide that FICA tax applies to all employeeinitiated 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

Severance from Employment. The final regulations generally follow the proposed rules in providing that an employee has a "severance from employment" when he or she ceases to be an employee of an eligible employer. A severance from employment does not occur if an employee transfers from one 501(c) organization to another that is treated as a single employer under the controlled group regulations, but a severance from employment does occur when an employee of a 501(c) organization transfers to a for-profit subsidiary; when an employee ceases working for a public school, but continues to work for the State; and when a minister ceases to perform services as a minister but continues to be employed by a governmental or for-profit entity.

Distributions Upon the Occurrence of a Stated Event. The regulations also 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 years of service or the occurrence of certain financial needs, such as the purchase of a home. In addition, the final regulations provide that certain distribution restrictions do not apply to after-tax employee contributions. The final regulations also confirm the treatment of distributions of designated ROTH contributions under 403(b) plans.

Annuity Contract Exchanges, Plan Transfers and Terminations

Plan to Plan Transfers. The final regulations permit three forms of non-taxable exchanges or transfers (other than a rollover and certain distribution events): an investment option exchange within the same plan (subject to certain distribution restriction requirements), certain plan to plan transfers involving different employers, and permissive service credit purchases with governmental defined benefit plans.

Transfers to and from qualified plans, 457(b) and other types of non-403(b) plans are still not permitted.

Plan Terminations. Consistent with the proposed rules, 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. However, a distribution of assets from a terminating 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 on the date of plan termination and ends 12 months after all assets have been distributed from the terminated plan.

Follow-up Item*: Employers should consider amending their 403(b) plan document to allow for plan termination and a resulting distribution of benefits.*

Special Rules for Church Retirement Income Accounts

Commingling of Assets for Investment Purposes. The final regulations expressly provide that a church may commingle retirement account assets in a common fund for investment purposes with amounts devoted exclusively to church purposes provided that separate accountings are maintained for the participants and the assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of the plan participants or their beneficiaries.

Church Plans May Provide an Annuity Form of Benefit. The regulations confirm a church plan may provide an annuity form of benefit if: the actuarial present value of the distribution at the annuity starting date equals the participant's accumulated benefit, based on reasonable actuarial assumptions, and the plan sponsor guarantees benefits in the event a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

Follow-Up Item*: The guarantee of benefits is a new requirement for church plans. Care must be taken in drafting the plan document when identifying the plan sponsor.*

Nondiscrimination Rules. Churches and church-related entities (now a defined term in the regulations) remain subject to the "good faith reasonable" standards for nondiscrimination described in Notice 89-23. Non-qualified church controlled organizations (*e.g.*, certain church affiliated but independent institutions such as colleges, hospitals and nursing homes that are eligible to offer a church plan but are not a church or qualified church controlled organization as defined in section 3121(w)(3)(A) and (B) of the Internal Revenue Code) are subject to the nondiscrimination rules discussed above.

Penalties for Failure to Satisfy and Effective Dates

Failure to Satisfy. The penalties for failing to satisfy the requirements of the regulations vary depending on the type of failure. If there is a failure that relates to the contract of an individual (*e.g.*, an excess contribution), any other contract purchased for that individual by that employer will also be deemed to fail. No other individuals will be affected. If there is an operational failure in one account, the failure will be deemed to extend only to the affected employees. On the other hand, if the plan fails the nondiscrimination rules, none of the contracts issued under the plan would constitute 403(b) contracts and all of the contributions and earnings would be taxable. Most plan compliance issues may be addressed through the EPCRS program (Rev. Proc. 2006-27).

Effective Date and Transition Rules. The final regulations are generally applicable for taxable years beginning after December 31, 2008. With respect to plans maintained pursuant to collective bargaining agreements in effect on July 26, 2007, the regulations are effective on the last date of the collective bargaining agreement or, if earlier, July 26, 2010. With respect to plans maintained by churches and church-related organizations whose authority to amend the plan rests with the church convention, the regulations apply the first plan year beginning after December 31, 2009.

There are special transition dates for plan provisions related to:

PROVISION	EFFECTIVE DATE
Excluded Employees	Taxable years beginning after December 31, 2009
In-Service Distributions	January 1, 2009
Life Insurance	September 24, 2007
Contract Exchange	September 24, 2007
415 Coordination	Taxable years beginning on and after July 1, 2007
Roth Coordination	Taxable years beginning on and after January 1, 2007

Follow-Up Item*: Employers with plans that provide features with early effective dates should seek legal counsel on whether immediate modifications should be made.*

The regulations were published in the July 26, 2007 Federal Register beginning at page 41127.

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