

ALERT

THE FINAL 403(b) REGULATIONS

October 2007

WHAT ARE THE NEW 403(b) REGULATIONS AND WHAT DO THEY MEAN FOR YOU?

Final regulations recently released by the IRS provide the first comprehensive guidance on 403(b) tax-sheltered retirement arrangements in 43 years. Employers that sponsor 403(b) tax-sheltered retirement arrangements will have to address a number of compliance issues as the result of these comprehensive new regulations.

403(b) tax-sheltered arrangements are defined contribution plans for employees of nonprofit organizations that are exempt from tax under Code Section 501(c)(3) and public schools. Like 401(k) plans and 457(b) deferred compensation plans, 403(b) plans offer participating employees important tax benefits. The new regulations eliminate many of the operational differences between 403(b) plans and these other plans, although some differences remain.

The final regulations are generally effective for plan years beginning on or after January 1, 2009. The intended effect of these regulations is to make the rules governing 403(b) similar to the rules governing other arrangements that include salary reduction contributions, such as 401(k) plans and 457(b) plans.

In this *Alert*, we highlight key items covered in the final regulations and commentary on what those changes mean to 403(b) plan sponsors.

WRITTEN PLAN DOCUMENT REQUIREMENT

A big change is the requirement that all 403(b) plans have a written plan document. If your plan doesn't currently have a written plan document, you'll need to adopt one. The document must outline all material plan provisions (regarding eligibility, benefits, contribution limits, distributions, etc.) and allocate the responsibilities of the employer, the annuity contract issuer(s), any other service providers, and participating employees.



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The employer must maintain documentation that includes all of the material provisions regarding:

- ◆ Eligibility
- ◆ Benefits
- ◆ Applicable contribution limits
- ◆ Available contract descriptions
- ◆ Loan procedures
- ◆ Hardship withdrawals
- ◆ The time and form under which benefit distributions may be made.

Generally, this will require something very similar to a plan document of the type required for other deferral plans.

FUNDING

The plan document must describe how the plan is funded. 403(b) plans can be funded through annuity contracts issued by an insurance company, custodial accounts invested solely in mutual funds, or retirement income accounts for church employees and certain ministers. Documents such as contracts related to the funding vehicle can be incorporated in the plan document by reference but, in the event of a conflict, the central plan document will almost always control.

ADDED FIDUCIARY RESPONSIBILITY

The pension law (ERISA) imposes a number of fiduciary responsibilities on employers that maintain retirement plans. The final regulations impose greater fiduciary responsibilities with respect to 403(b) programs covered by ERISA.

In practical terms, this will mean monitoring the plan's funding arrangements, their underlying investments, and all plan service providers. You also may need to develop an investment policy statement with guidelines for selecting and monitoring investment options, an employee education program, and a process for regularly reviewing investment performance, plan expenses, and your education program. Plan fiduciaries can be held personally liable for failure to meet their ERISA responsibilities.

NONDISCRIMINATION RULES AND UNIVERSAL AVAILABILITY

The final regulations replace the safe harbor nondiscrimination guidance provided in a 1989 Internal Revenue Service Notice. Under the new regulations, plans must satisfy specific requirements that prohibit discrimination in favor of highly compensated employees with respect to employer contributions and after-tax employee contributions. These nondiscrimination rules generally do not apply to plans offered by state and local public schools or to 403(b) contracts purchased by a church.

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For employee elective deferrals, a 403(b) “universal availability” rule provides that, with some exceptions, if you offer one employee the opportunity to make elective deferrals to your plan, you have to make that opportunity available to all employees. A new rule states that plan benefits or rights (except for matching contributions) may not be conditional on a participant’s making elective deferrals.

Under the exceptions to the universal availability rule, plans can exclude employees whose normal work week is fewer than 20 hours, nonresident aliens with no U.S. source income, students working under a work study program, and employees who are eligible to defer to your 401(k) or 457(b) plan. However, once an employee works 1,000 hours during a one year period they must be included. Plans can *no longer* exclude visiting professors, certain employees affiliated with a religious order who have taken a vow of poverty, employees covered by a collective bargaining agreement, and employees who make a one-time election to participate in a governmental plan.

The employer must:

- ◆ Ensure that new hires are aware of the plan and the right to make deferrals, and
- ◆ Monitor who is participating and determine if those who are not have been given proper notice of the right to participate.

CONTRIBUTIONS

The new regulations address the application of the tax law’s contribution limits. For example, if your organization offers more than one 403(b) plan, you must ensure that an employee’s elective deferrals to all of the plans in the aggregate do not exceed the tax law’s annual limit on elective deferrals (\$15,500 in 2007). If your plan allows employees to make designated Roth contributions, be aware that these Roth contributions are included in the definition of elective deferrals.

Some 403(b) plans can offer employees two kinds of catch-up contributions — one for employees age 50 or older (\$5,000 in 2007) and an additional special catch-up contribution for employees who have at least 15 years of service. The new regulations coordinate the two options and confirm that, if an employee is eligible for both, the 15-years-of-service catch-up applies first.

The employer must:

- ◆ Monitor excess deferrals and contributions,
- ◆ Return excess deferrals on a timely basis, and
- ◆ Establish the proper separate accounting and complete the appropriate tax reporting on any excess contributions.

TRANSFERS

The 403(b) regulations provide stricter transfer rules. A transfer to an outside-of-plan vendor (formerly called a “90-24” transfer) is permitted, but only if there is a written agreement between the vendor and the employer that ensures eligibility and distribution rules will be applied properly.

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A nontaxable transfer of assets is permitted provided that the transfer is:

- ◆ A change of investment within the same plan, or
- ◆ To the plan of another employer.

Transfers previously permitted pursuant to Revenue Ruling 90-24 are no longer allowed as of September 24, 2007.

The employer must:

- ◆ Establish a procedure of the proper sharing of information regarding a participant's employment.
- ◆ Establish a procedure to determine if transfers should be permitted.
- ◆ Ensure that the benefit cannot be reduced by the transfer.
- ◆ Ensure that the same distribution restrictions are applicable to the new plan or investment.

SEVERANCE FROM EMPLOYMENT AND HARDSHIP DISTRIBUTIONS

The new rules for 403(b) distributions are similar to the 401(k) distribution rules. Amounts attributable to deferrals can be distributed only when the employee has a "severance from employment" (i.e., ceases to be an employee of an eligible employer), has a hardship, becomes disabled, or reaches age 59½. The 403(b) regulations also require 20% federal income-tax withholding on any eligible rollover distribution that is not directly rolled over to another 403(b) plan or to a rollover IRA. In addition, 403(b) plans must provide any employee receiving a distribution with a notice explaining the tax options for the distribution. And, the rule requiring that involuntary cashouts of plan accounts valued at more than \$1,000 but not more than \$5,000 be automatically rolled over to an IRA applies to 403(b) plans.

In the event of severance from employment, **the employer must:**

- ◆ Monitor termination to determine if an employee is eligible for a distribution that he or she may not have been previously eligible to receive.

In the event of hardship, **the employer must determine:**

- ◆ If a financial need exists for a hardship distribution,
- ◆ The amount of the financial need, and
- ◆ That the distribution does not exceed the amount of the hardship.

Finally, the employer must restrict deferrals by a participant for a period of six months following the hardship distribution.

CONTROLLED GROUP/AGGREGATION RULES

In the case of tax-exempt entities maintaining a 403(b) arrangement, the employer includes not only the organization whose employees participate in the plan, but also any other exempt organization that is under common control (80% or more board control) with such organization. In addition, if two or more exempt organizations regularly coordinate their day-to-day exempt activities, they may elect to treat themselves as being under common control.

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Tax-exempt employers must:

- ◆ Determine if they are part of a group or organizations under common control.
- ◆ Ensure that the employees of all members of the group are offered the opportunity to participate in the 403(b) plan.

LOANS

Loans may be treated as taxable distributions based on certain “facts and circumstances”, which include whether or not:

- ◆ The loan has a fixed repayment schedule.
- ◆ The loan bears a reasonable interest rate.
- ◆ There are “repayment safeguards to which a prudent lender would adhere.”

The employer must:

- ◆ Ensure that the loans meet the “facts and circumstances” tests to avoid being taxable.
- ◆ Properly report the employee’s taxable income if the loan fails to meet the requirements.

PLAN TERMINATION

Under the new regulations, an employer can terminate a 403(b) plan. However, after termination, the employer cannot make contributions to any 403(b) contract that is not part of the original plan for 12 months after all the assets from the terminated plan have been distributed. The terminated plan must distribute the benefits of all participating employees as soon as administratively possible after the termination date.

The employer must ensure that:

- ◆ All accumulated benefits are distributed to participants as soon as administratively feasible following termination of the plan.
- ◆ No contributions are made to another 403(b) contract beginning on the date of plan termination and ending 12 months after the distribution of all assets from the terminated plan, subject to exceptions.

EFFECTIVE DATE

The final regulations generally are effective for tax years beginning after December 31, 2008, with delayed effective dates for plans offered under certain collective bargaining agreements and plans sponsored by certain church organizations. There are also transition rules for some of the new requirements. However, you may operate your 403(b) plan under the new regulations before the effective date as long as you apply the rules on a consistent and reasonable basis.

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TAKE ACTION

Here are some steps you can take to help ensure that your 403(b) plan is in full compliance by 2009:

- ◆ Adopt a plan document if you do not currently have one. If you do, review the document for compliance and amend it if necessary.
- ◆ Check excluded employees to make sure they meet the new exclusion rules.
- ◆ Create a list of existing service providers. Review them and set a uniform standard for services.
- ◆ If your plan is subject to ERISA, develop an investment policy statement that sets guidelines for selecting investments and investment managers and for regularly monitoring investments and service providers, and
- ◆ Form a plan or investment committee to oversee and manage your plan and make sure that you are meeting all of your fiduciary duties.

IN SUMMARY

Going forward, you should carefully consider how the new regulations will affect the administration of your 403(b) plan. A different plan might better suit your organization's needs. Our firm is available to help. Please contact your LBA professional soon. You may call us at 904.396.4015, or email us at LBA@TheLBAGroup.com.

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