

The 403(b) Final Regulations Are Finally Here!

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On July 23, 2007, the IRS released in the final form the first new regulations in over 40 years governing 403(b) plans. The regulations have been long anticipated (proposed regulations were issued November 16, 2004) and will likely transform the future of 403(b) programs.

It should be noted that the effective date for most of the provisions of the final regulations is no earlier than January 1, 2009 (with later effective dates for collectively bargained and certain church plans). In addition, there are select provisions that are not effective until 2010 and beyond (see below). Plan sponsors and others who work with 403 (b) arrangements should welcome the delayed effective date.

This Compliance Alert is intended to provide you with an initial overview of the key provisions of the final regulations, in approximate order of importance. Cammack LaRhette will also be releasing additional information to keep you informed of any new guidance or rulings to help ensure that your plan stays in compliance.

The key provisions of the final regulations are as follows:

- 1) **Written Plan Requirement:** The final regulations maintained the written plan requirement of the proposed regulations. However, the final regulations permit the plan to allocate to “the employer or another person (but, significantly, NOT an employee)” the additional administrative functions that a plan document would create, including enforcement of maximum loan amounts and suspension of contributions in relation to hardship distributions. Though the written plan requirement does not REQUIRE a single plan document -- the plan may incorporate other documents by reference (e.g., insurance policies or custodial agreements) -- it is anticipated that an employer will adopt a single plan document if multiple vendors are used, rather than having a separate document from each vendor. Model plan language will also be provided.

Our Take: The requirement for a written plan will clearly increase employer involvement

in 403(b) arrangements, since 403(b) compliance responsibilities cannot be allocated to an employee (though they can be allocated to a third party). Whether such additional involvement will subject elective deferral-only plans of non church/governmental tax-exempts to ERISA must be analyzed on a “case-by-case” basis, according to the final regs. The DOL has issued [Field Assistance Bulletin No. 2007-02](#) to assist employers in determining whether their plans will remain exempt from ERISA by detailing the interaction between the DOL safe harbor and the final regs. Though, in theory, a written plan could merely be an accumulation of several vendor documents stapled together, since the regs. require that the employer ensure that there is no conflict between any vendor documents if incorporated by reference, it may be necessary to adopt a single written plan document in multiple vendor situations.

Required Action: None for ERISA plan sponsors and other plan sponsors who already maintain a written plan document. For non-ERISA plan sponsors that do not currently maintain a plan document, benefits counsel should be consulted as to whether existing documentation would satisfy the written plan requirement or whether a single written plan document (utilizing the IRS’ model language) should be drafted. Non-ERISA plan sponsors should also review the DOL Field Assistance Bulletin and work with benefits counsel as necessary to determine whether or not their arrangements may be subject to ERISA.

2) **Notice 89-23 Bites the Dust:** As was the case with the proposed regulations, the final regulations wipe out all rulings and notices issued in the last 40 years, chief among which was IRS Notice 89-23. Notice 89-23, among other provisions, permitted employers to provide select employees with additional base (discretionary) contributions up to 80% greater than that of other employees with limited testing. As of the 2009 plan year, 403 (b) plans will be treated like 401(a)/(k) plans for purposes of testing base contributions. This means that all entities currently test base contributions under 89-23 will need to test under the general test of 401(a)(4), and, if they fail, adjust contribution formulas as appropriate. In addition, Notice 89-23 permitted several exclusions of employee groups from the right to make elective deferrals, the most significant of which was for collectively bargained employees. Collectively bargained employees may no longer be excluded from the right to make elective deferrals to a 403(b) program, but the good news is that there is a **delayed effective date** that permits the continued exclusion of such employees, if the right to a 403(b) deferral is addressed in the collective bargaining agreement, until the first day of the **first taxable year that commences after the earlier of a) the date of expiration of the CBA or b) July 26, 2010.**

Our Take: Though the elimination of Notice 89-23 will change the method of testing for many plans with employer base (discretionary) contributions, it is unlikely that many plans that passed testing under Notice 89-23 will fail testing under the new requirements. The elimination of exclusion of unions from the right to make elective deferrals will mean that the right to make 403(b) deferrals will no longer be subject to collective bargaining (since it is now a statutory right). Note that ALL employees, with limited exceptions, must be provided with the right to make elective deferrals to a 403(b) plan.

Required Action: Plans with employer base (discretionary) contributions should confirm that they will pass nondiscrimination testing in 2007 under the new

rules, so that they have sufficient time to amend their plans prior to the 1/1/2009 effective date of the new rules. ALL plans should confirm that they provide meaningful notice (e.g., new employee package, e-mail, newsletter, etc.) to ALL employees of the right to make 403(b) elective deferrals.

3) **Transfer Restrictions:** The proposed regulations were quite controversial in that employees would no longer be permitted to transfer assets in non-ERISA plans to vendors that did not have a relationship with the employer (e.g., were not on the list of approved vendors to which an employer remitted contributions). Such rules already apply to ERISA plans, but ERISA plans generally provide for a better selection of investment providers. Non-ERISA programs, by contrast, often contain a selection of providers that can be improved upon by “going outside” the plan’s list of investment providers. The final regulations, though still restrictive, provide for the possibility of transfers to so-called “non-approved” vendors. However, the employer must enter into an agreement with such vendors under which the vendor will exchange compliance information that will ensure that the transferred assets will continue to satisfy 403(b) (e.g., severance from employment information, loan information, hardship distributions, etc.). The final regs. also maintained two provisions of the proposed regs. that would permit two other types of plan transfers that are less common: 1) transfers from one 403(b) plan to another (the final regs. expanded the rules to permit assets to be transferred to plans of former employees, but both plans must be maintained by an employer); and 2) transfers to a qualified plan to purchase permissive service credit under a governmental defined benefit plan. Finally, the IRS reserved the right to issue future guidance that would permit additional transfers to vendors with whom an employer has NOT entered into an agreement to exchange compliance information, provided that the vendor has procedures that are “reasonably designed” to ensure 403(b) compliance. **Note that the new transfer rules have an effective date that is earlier than the effective dates of most provisions of the regs.; the new rules apply to transfers that occur on or after September 25, 2007.**

Our Take: Although the limitation on transfers in the final regulations appears to be less restrictive on its face than the severe restrictions imposed by the proposed regulations, it remains to be seen whether, as a practical matter, vendors and employers will enter into the agreements required to facilitate transfers to vendors with which the employer does not have a relationship. At a minimum, it appears that the process of transferring assets will be more difficult than was the case under prior guidance. The feasibility of such transfers may have been the reason why the IRS has left the door open to provide future guidance that would permit transfers that do not satisfy these rules.

Required Action: None for ERISA plan sponsors (such plans already restrict transfers). For non-ERISA plan sponsors, requests for transfers to vendors that are not on the list of vendors to which an employer remits contributions, should NOT be honored after September 24, 2007, unless the sponsor enters into an agreement with the vendor to share information necessary for compliance with 403(b) provisions.

4) **403(b) Plans May Terminate!:** For the first time in history, 403(b) plans may be terminated, with all assets required to be distributed, as long as no successor 403(b)

arrangement is implemented for 12 months. Note that a distribution for plan termination purposes includes the delivery of a fully paid individual insurance annuity contract, which may be helpful in the case of some 403(b) vendor contracts that do not provide for actual asset distribution upon plan termination.

Our Take: It will finally be possible for employers for whom a 401(k) or other qualified plan is a more favorable design solution to establish such a plan without having to maintain two plans. Thus the regs. may result in an increase in the establishment of 401(k) or other qualified plans by nongovernmental tax-exempts (note that public schools cannot maintain a 401(k) plan unless they participate in a grandfathered plan).

Required Action: None, but plan sponsors may wish to reevaluate 401(k) plans as an alternative model now that 403(b) plans may be terminated. Sponsors with inactive 403(b) plans may wish to consider termination of those plans as well.

5) **New Timing Requirement for Elective Deferrals to Non-ERISA plans:** Up until the present, only ERISA 403(b) plans were required to deposit voluntary salary deferrals within a specific timeframe (generally, as soon as such deferrals could be reasonably segregated from payroll, but no later than the 15th business day of the month following the month of withholding), though it could be argued that certain state laws could apply to non-ERISA arrangements. The final regulations require that elective deferrals be transferred to providers within a period no longer than is reasonable for proper plan administration. The regs. use the 15th business day of the month following month of withholding as a safe harbor.

Our Take: Since the safe harbor is less restrictive than ERISA, it is presumed that non-ERISA plan sponsors will not have difficulty depositing elective deferrals within the proper timeframe.

Required Action: ERISA 403(b) plan sponsors should confirm that they are depositing elective deferrals as soon as such deferrals can reasonably be segregated from payroll, and non-ERISA plan sponsors should confirm that all elective deferrals for a month are deposited no later than the 15th business day of the following month.

6) **New 80% Controlled Group Rule for Tax-Exempts:** In the past, it was unclear as to the extent of the application of controlled group rules to nonprofit entities; in fact, it could be argued that the rules did not apply to tax-exempts at all! Those days have officially ended with the passage of the final regulations. If entity A has at least 80% director/trustee commonality with entity B, or can name/remove at least 80% of the board members of entity B, Entity A and B are members of the same controlled group for testing and other purposes, whether they like it or not! Even if there is no board commonality, entities can elect to be part of the same controlled group if a) they participate in the same plan, and b) the organizations regularly coordinate their day-to-day activities. A change in the final regs. also permits the IRS to issue future guidance that would permit other types of entities to elect to be part of the same controlled group. Note that, as was the case with the proposed regs. the final regs. exclude “steeple”

churches and public schools from these new rules, instead permitting such groups to continue to rely on the provisions of Notice 89-23 (where a similar 80% rule applies, but no elective rule exists, and no controlled group rules apply at all in the case of elective deferrals).

Our Take: The final regulations are a welcome change from the ambiguity of prior law in this regard, though it is odd that the controlled group rules of Notice 89-23, which were otherwise superseded by the final regulations, will continue to apply to “steeple” churches and public schools.

Required Action: *ALL plan sponsors should determine which entities constitute members of their controlled group under the regs., working with benefits counsel as necessary.*

7) **Possible Problems for Plans with Vesting Schedules?:** As was the case with the proposed regulations, the final regulations appear to make it more difficult to administer a 403(b) plan with a vesting schedule by requiring that such nonvested amounts be placed in a separate account and treated as nonqualified annuities under 403(c) until vested, when such amounts would resume being treated as a 403(b) contract.

Our Take: It remains to be seen as to whether, as a practical matter, the new regulations will significantly impact the ability of vendors to recordkeep 403(b) plans with vesting schedules.

Required Action: *Plan sponsors who maintain vesting schedules for employer contributions should confirm with their provider that such schedules can continue to be administered by the provider in light of the new regs.*

8) **15-Year Catch-Up Election Changes:** The final regulations expand on the proposed regulations by increasing the number of groups eligible for the 15-year catch-up election as a “health and welfare service agency.” In addition to hospices, organizations that prevent cruelty to animals, and organizations that provide personal services to the needy, the definition now includes adoption agencies, home health service agencies, organizations that provide substance abuse treatment and prevention services, and organizations that assist the disabled. In addition, the regs. confirm prior guidance indicating that, for individuals eligible for both age-50 and 15-year catch-up, additional deferrals will be treated first as 15-year catch-up. Finally, the regs. address the discrepancy in prior legislation whereby ALL 403(b) Roth contributions counted against the \$15,000 in lifetime excess that could be deferred under the 15-year catch up election, effectively eliminating the use of the 15-year catch-up for those who elected Roth contributions. Treasury has recommended that the language be changed so that only Roth contributions in excess of the basic 402(g) (\$15,500) limitation count against the lifetime limit, so that Roth contributions are treated the same as elective deferrals.

Our Take: The 15-year catch-up election will now apply to a much larger group of tax-exempt organizations than was previously the case (though some organizations, such as

museums and other cultural or arts organizations, remain ineligible), and the 403(b) Roth clarification was welcome news to those who wish to contribute the maximum amount to a Roth under the 15-year catch-up election.

Required Action: Plan sponsors who continue to permit usage of the 15-year catch-up election should evaluate such a decision in light of the new complexities surrounding the interaction of this limit with the age-50 catch-up election, especially since the 15-year catch-up election remains the only election that requires data collection for the entire employment career of a participant.

9) **New Withdrawal Restriction for Employer Contributions:** For plans that do not already limit distribution of employer contributions to severance from employment, the final regulations will require an employer to apply rules similar to those of profit-sharing plans, where an employee must incur an event such as completion of a fixed number of years or attainment of a certain age. However, the new rules will not apply to contracts issued prior to January 1, 2009, creating a grandfathering possibility for such account balances. In a difference from the proposed regs. the final regs. clarify that after-tax contributions are not subject to ANY in-service distribution restrictions.

Our Take: It is our experience that there exist relatively few plans that permit distribution of employer contributions for any reason, especially in light of the fact that in-service distributions of amounts invested in mutual funds are generally prohibited.

Required Action: None for most plans. The few plan sponsors that permit in-service distributions of employer contributions will be required to amend their plans to comply with the new rules.

10) **Severance from Employment Definition Expanded:** As with the proposed regulations, the final regulations expand the definition of severance from employment to include situations where the employee transferred between entities of the same controlled group, but no longer works for an employer that can sponsor a 403(b) plan. Examples include an employee who transfers from a 501(c)(3) tax-exempt to its for-profit subsidiary, and an employee who ceases to work for a public school, but remains employed by the same state.

Our Take: The expansion of the definition will mean that more employees will be eligible for plan distributions in situations where they remain employed within the controlled group.

Required Action: For plan sponsors with 403(b) ineligible affiliates (e.g., for-profit subsidiaries) confirm that employees who transfer to ineligible affiliates have the right to receive distributions from the 403(b) plan based on severance from employment.

Note that the final regs. contain several other provisions, including the following:

- a) Life, health and property/casualty insurance no longer permitted as part of 403(b) contract, though incidental death and disability benefits remain permissible (effective September 24, 2007)
- b) Post-severance employer contributions permitted up to five tax years following employment termination (unchanged from prior guidance)
- c) Requirement that right to defer to 403(b) may not be conditioned on participating in another benefit (e.g., I may only defer to 403(b) if I participate in health insurance program)
- d) Treatment of section 415 excesses as nonqualified annuities under 403(c), with a requirement that such excesses be placed in a separate account
- e) The inapplicability of the §4973 excise tax on 403(b)(7) mutual fund contribution excesses to church retirement income accounts
- f) Clarification that certain employee classes, such as individuals working under a vow of poverty and certain visiting professors, may continue to be excluded from the right to make elective deferrals, since they are not employees of the sponsoring employer
- g) The elimination of the exclusion of employees who make a one-time election to participate in a governmental plan described in section 414(d) from the right to make elective deferrals (effective January 1, 2010)
- h) Rules relating to timing of distributions and benefits, including special rules for contributions that are continued in the event of disability and Roth contributions
 - i) Rules relating to taxation of distributions and benefits
 - j) Minimum distribution requirements for 403(b) plans (same as the prior minimum distribution guidance under 401(a)(9), excluding the rules for 5 percent owners)
- k) Rules relating to hardship distributions (mirror 401(k) regulations)
- l) Rules relating to loans (unchanged from prior guidance)
- m) Rules relating to QDROs
- n) Rules relating to funding agents (unchanged from prior guidance)
- o) Rules relating to church retirement income accounts (unchanged from prior guidance)
- p) Rules relating to the effect of the failure to satisfy 403(b) (unchanged from prior guidance, except for the fact that the failure to maintain a written plan causes all contracts under the plan to fail to satisfy 403(b))
- q) Rules relating to designated Roth accounts (unchanged from prior guidance)
- r) Clarification that two separate 415 limits apply to 401(a) and 403(b) plans of the same employer (unchanged from prior guidance)

If you would like to learn more about the impact of the final 403(b) regulations on your plan, please contact Mike Webb by phone at 212-227-7770 ext. 232 or by email: mwebb@clcinc.com.

You may also review the IRS regulations by clicking [here](#).

This Compliance Alert reflects our current interpretation of the final IRS regulations. Future

guidance may change our understanding of certain provisions, and we will provide you with updates as necessary. On an ongoing basis, we will continue to provide you with insights, ideas and relevant education regarding your retirement plan through our 403(b) Learning Series. New articles in the series will be published every two weeks.

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