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Client Alert

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IRS Issues Proposed 403(b) Regulations

On November 15, 2004, the IRS issued proposed regulations under Section 403(b) of the Internal Revenue Code (the "Proposed Regulations"). The Proposed Regulations update regulations which are over 40 years old and incorporate various IRS written positions and proposals, as well as certain oral positions and proposals that have not been previously reflected in IRS guidance.

Internal Revenue Code Section 403(b) tax sheltered annuity plans ("403(b) Plans") are only available to employees of public schools and Internal Revenue Code Section 501(c)(3)[1] tax-exempt organizations. The Proposed Regulations reflect statutory changes from the Employee Retirement Income Security Act of 1974 ("ERISA") through the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and IRS rulings and guidance issued over the past 40 years, as well as new guidance. The Proposed Regulations are generally effective for taxable years beginning after December 31, 2005. Certain transition rules apply with respect to 403(b) Plans maintained pursuant to collective bargaining agreements and to church plans.

The changes under the Proposed Regulations are significant and will necessitate changes in documentation and practice with respect to almost all 403(b) Plans. In many cases, the changes will make 403(b) Plans look even more like Section 401(k) plans. The following is a brief summary of the Proposed Regulations.

Written Document Requirement

The Proposed Regulations require, for the first time, that a 403(b) Plan must be maintained pursuant to a written plan document. The written plan document must contain the material terms and conditions for eligibility, benefits, applicable limitations, contracts available under the 403(b) Plan and distributions. Previously, a 403(b) Plan only needed to be set forth in a written document if it were subject to Title I of ERISA. Accordingly, a "deferral only" 403(b) Plan, which had minimal employer involvement and, therefore, was not subject to ERISA did not need to be in writing. It is possible that the new written document requirement may now subject "deferral only" 403(b) Plans to the requirements of Title I of ERISA. This may, however, depend upon whether the employer or the vendor is ultimately responsible for drafting the written document. This is an issue that the Department of Labor is likely to address and which hopefully will be clarified in the final regulations. The written plan document requirement may provide employers with the ability to maintain better control of the programs offered to their employees and to clarify the role of the plan sponsor and the applicable vendors.

Nondiscrimination Rules

The Proposed Regulations do not adopt the good faith reasonable standard and the safe harbor of IRS Notice 89-23 for purposes of satisfying the nondiscrimination requirements of Section 403(b). Instead, employer contributions and after-tax employee contributions to a 403(b) Plan must satisfy the nondiscrimination requirements applicable to qualified plans under Section 401(a). These nondiscrimination requirements, which are applied on a controlled group basis (see discussion below), include rules relating to nondiscrimination in contributions, benefits and coverage (Sections 401(a)(4) and 410(b)), a limitation on the amount of compensation that can be taken into account (Section 401(a)(17)), and the average contribution percentage rules of Section 401(m). The only nondiscrimination requirement that is applicable to governmental plans is the limitation on compensation under Section 401(a)(17). Although the Proposed Regulations will not be effective until January 1, 2006, Employers who currently rely on IRS Notice 89-23 need to begin to assess whether their 403(b) Plans will need to be redesigned in order to satisfy the nondiscrimination requirements and should start to consider the changes

1 All Section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise provided.

required. The Proposed Regulations also take the position that Section 403(b)(12), which permits the exclusion for nondiscrimination purposes of employees who normally work less than 20 hours per week, is overridden for ERISA plans by the provision of ERISA (interpreted under the corresponding Section 410(a)) that prohibits the exclusion from a plan of part time employees who have worked 1,000 hours or more. This interpretation will also require redesign of many 403(b) Plans.

Universal Availability

The nondiscrimination rules described above do not apply to elective deferrals under 403(b) Plans. Instead, a universal availability requirement applies to each Section 501(c)(3) organization with respect to elective deferrals, pursuant to which all employees must be permitted to elect to have elective deferrals contributed on their behalf to a 403(b) Plan if any employee is permitted to elect such deferrals. The Proposed Regulations include a special rule allowing an employer that historically has treated one or more of its geographically distinct units as separate for employee benefit purposes to treat each unit as a separate organization if the unit is operated independently on a daily basis.

The Proposed Regulations include the statutory categories that are exceptions to the universal availability rule. These exceptions are: (1) employees eligible to participate in a Section 401(k) plan or a governmental plan under Section 457(b); (2) non-resident aliens; (3) students performing certain specified services; and (4) employees who normally work fewer than 20 hours per week. While the Proposed Regulations do include the fewer than 20 hour exception, as noted above, Employers who maintain 403(b) Plans subject to ERISA will no longer be able to rely on the fewer than 20 hour exception.

The Proposed Regulations do not adopt the transition rules for certain other exclusions included in IRS Notice 89-23. These exclusions are: (1) employees who make a one-time election to participate in a governmental plan instead of a 403(b) Plan; (2) employees covered by a collective bargaining agreement; (3) visiting professors; and (4) employees affiliated with a religious order who have taken a vow of poverty. The IRS has requested comments on whether these types of exclusions should continue to be permitted.

Special Rule for Former Employees

A 403(b) Plan may provide that nonelective employer contributions under the plan may be continued for up to five years for a former employee, up to certain generally applicable limitations. The Proposed Regulations provide guidance on determining includible compensation and years of service for purposes of this special rule. Since nonelective employer contributions will now be subject to the general nondiscrimination requirements, the special rules for former employees must be applied on a nondiscriminatory basis.

Catch-Up Contributions

All 403(b) Plans may provide additional catch-up contributions for participants who are age 50 or over. In addition, 403(b) Plans maintained by certain qualified organizations (schools, hospitals, health and welfare service agencies and church-related organizations) may also provide for special catch-up contributions for participants with at least 15 years of service. The Proposed Regulations apply an ordering rule, specifying that catch-up contributions will first be applied under the special rule and then as amounts contributed pursuant to the age 50 catch-up rule. Participants eligible for both types of catch-up contributions will need to review their circumstances carefully so that they may maximize the potential of both types of catch-up contributions. In connection with special catch-up contributions, the IRS for the first time defines a "health and welfare service agency" as either an organization whose primary activity is to provide services that constitute medical care or a Section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals, or which provides substantial personal services to the needy as part of its primary activity. The Proposed Regulations also provide that the 15 or more years of service required for the special catch-up contribution only include employment with the qualified organization.

Transfers and Exchanges

Under certain conditions, the Proposed Regulations permit the exchange of Section 403(b) contracts under a 403(b) Plan and also permit the transfer of a Section 403(b) contract to another 403(b) Plan. The Proposed Regulations generally incorporate the rules and conditions previously set forth in Revenue Ruling 90-24. The Proposed Regulations clarify that employee consent is not required in connection with an exchange or transfer. Because an employee consent requirement for transfers is often included in vendor contracts, this clarification may have a significant impact on future and existing contractual agreements between employers and vendors.

403(b) Plan Terminations

In the past, the IRS took the position that 403(b) Plans could not be terminated under the Code because they were just annuity contracts. Accordingly, many employers who wished to cease making contributions to their 403(b) Plans were forced to freeze their 403(b) Plans and continue updating them and preparing annual filings for them. Other employers, especially those going out of business, "terminated" their 403(b) Plans and left the annuities in place with no real guidance. The Proposed Regulations, for the first time, address terminations of 403(b) Plans. Under the Proposed Regulations, a 403(b) Plan may be terminated

with a resulting distribution of accumulated benefits to all participants, as long as the employer does not make contributions to another 403(b) Plan for a period of 12 months before or after the termination.

Anti-Conditioning Rule

The Proposed Regulations include a rule comparable to the "anti-conditioning" rule applicable to Section 401(k) plans. Thus, no other benefit (other than matching contributions) can be conditioned on the making of elective contributions to a 403(b) Plan.

"Controlled Group" Defined

Historically, not-for-profit entities have relied on informal and unofficial guidance in determining their controlled groups for nondiscrimination testing purposes. The Proposed Regulations incorporate this unofficial guidance and include rules that may be applied in performing a controlled group analysis. Under these rules, two or more organizations will be considered a controlled group if 80% or more of the directors or trustees of the organizations overlap, or if 80% or more of the directors or trustees of one organization are representatives of, or are directly or indirectly controlled by, another organization. In addition, the Proposed Regulations allow tax-exempt organizations to choose to be aggregated for purposes of applying the nondiscrimination requirements, Section 415 limitations, the special catch-up rules and the minimum distribution rules, if they maintain a single plan covering one or more employees from each organization and the organizations regularly coordinate their day to day exempt activities. The controlled group rules do not apply to churches or governments.

Timing of Distributions

The Proposed Regulations reflect the statutory rules regarding when distributions may be made from a 403(b) Plan and define the term severance from employment in accordance with the Section 401(k) regulations. Amounts attributable to employer contributions to a 403(b) Plan under a custodial contract may not be paid to a participant before the participant has a severance from employment, becomes disabled or attains age 59-1/2. The Proposed Regulations also set forth new rules with respect to amounts attributable to employer contributions to a 403(b) Plan which are not under a custodial contract providing that such amounts may not be paid to a participant before the participant's severance from employment or upon the prior occurrence of some event, such as a fixed number of years, the attainment of a stated age, or disability. Amounts attributable to elective deferrals to a 403(b) Plan may not be paid to a participant earlier than when the participant has a severance from employment, has a hardship, becomes disabled or attains age 59-1/2.

Additional Provisions

The Proposed Regulations incorporate the required minimum distribution rules, rules regarding loans and rules relating to qualified domestic relations orders. The Proposed Regulations also include a number of special rules for church plans and retirement income accounts for employees of church-related organizations.

Payroll Tax Temporary Regulation

At the same time the Proposed Regulations were issued, the IRS issued temporary regulations that define the term "salary reduction agreement" for purposes of payroll tax withholding under the Federal Insurance Contributions Act ("FICA"). Pursuant to the temporary regulations, FICA taxes are applicable to contributions made under the following types of Section 403(b) salary reduction agreements: (1) employee elective deferrals; (2) one-time irrevocable elections made by an employee at or before the time of initial eligibility; and (3) deferrals required as a condition of employment. These temporary regulations became effective on November 16, 2004.

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