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SECURE 2.0 Brings Significant Changes for 403(b) Plans

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As part of our continuing series on SECURE 2.0, signed into law December 29, 2022, this post focuses on significant changes for section 403(b) tax-sheltered annuity plans ("403(b) plans"). 403(b) plans are similar to 401(a) tax-qualified defined contribution plans but sponsored by public schools or non-profit entities and subject to unique requirements under the Internal Revenue Code (the "Code").

As discussed in more detail below, SECURE 2.0 provisions that specifically impact 403(b) plans include changes to: (1) amounts available for hardship distributions, (2) eligibility to participate in pooled and multiple employer plans, (3) treatment of long-term, part-time employees, and (4) *potentially*, investments in collective investment trusts. The statute also includes numerous required and optional changes that impact both 403(b) plans and 401(a) plans, which are addressed in our prior blog post.

Hardship Withdrawals

The Code allows 403(b) plans to provide in-service withdrawals to satisfy an immediate and heavy financial need that cannot be met through other sources reasonably available to the participant. IRS regulations have established standards for plans to approve financial hardships and a safe harbor for six types of hardships automatically considered to create an immediate and heavy need.

Historically, the Code restricted 403(b) plans more than 401(k) plans in terms of the contributions and earnings available for hardship withdrawal. Before SECURE 2.0, hardship withdrawals from a 403(b) plan could only be funded from the employee's elective deferrals exclusive of earnings. Effective for plan years beginning after December 31, 2023, 403(b) plans may also allow hardship withdrawals of non-elective and matching contributions, inclusive of earnings on such contributions, as well as earnings attributable to the employee's elective deferrals. 403(b) plan sponsors looking to implement this change should consider amending their plans to permit hardship distributions from all available sources.

SECURE 2.0 simplifies the administration of hardship withdrawals by allowing 403(b) and 401(k) plan administrators to accept a written declaration from the participant affirming that the requested withdrawal is (1) on account of a hardship of a type deemed to be an immediate and heavy financial need and, (2) not in excess of the amount required to satisfy that need. This change, effective for plan years beginning after SECURE 2.0's enactment, builds on recent IRS guidance that allows participants to self-certify that they lack alternative means reasonably available to meet a financial hardship. The flexibility to rely on a participant declaration is good news for plan administrators looking to take advantage of available e-certification processes offered by many record-keepers. Before utilizing e-certification, plan sponsors should confirm that the record-keeper's process collects and records the required participant self-certification responses.

Multiple Employer and Pooled Employer 403(b) Plans

SECURE 2.0 allows 403(b) plans (other than church plans) to participate in multiple employer plans ("MEPs") and pooled employer plans ("PEPs") in plan years starting after December 31, 2022. This change will allow 403(b) plans to aggregate plan management services, potentially resulting in simpler and more cost-effective plan administration. The statute creates an exception to the unified plan rule for 403(b) plans—similar to the exception for 401(k) MEPs and PEPs in the SECURE Act of 2019 ("SECURE 1.0")—that will prevent one participating 403(b) plan's loss of tax-qualified status from affecting the tax-qualification of other plans in the MEP or PEP.

Eligibility of Long-Term Part-Timers

SECURE 1.0 provided that, effective for plan years beginning after December 31, 2023, 401(k) plans must allow part-time employees who complete at least 500 hours of service in three consecutive 12-month periods to make elective deferrals. SECURE 2.0 modifies this long-term part-timer rule by (1) reducing the eligibility period for elective deferrals to two consecutive twelve-month periods, (2) providing that, for vesting purposes, service in 12-month periods beginning before January 1, 2023 shall not be taken into account, and (3) extending the rule to ERISA-covered 403(b) plans. These changes are effective for plan years beginning after December 31, 2024.

Because 403(b) plans are subject to the universal availability rule, the long-term part-timer rule may not significantly expand eligibility. The universal availability rule generally requires that all employees of 403(b) plan sponsors be eligible for elective deferrals; the narrow exceptions include a carve-out for employees who normally work less than 20 hours per week. To simplify administration, 403(b) plans commonly allow all employees to make elective deferrals. Sponsors of 403(b) plans should review the terms of their plans to determine whether an amendment is required to satisfy the long-term part-timer rule and consider whether to begin tracking hours of any populations of part-time employees not currently eligible to participate in the plan.

Investments in Collective Investment Trusts

The Code generally limits 403(b) plan investments to annuity contracts and 403(b)(7) custodial accounts ("mutual funds"). SECURE 2.0 amends the Code to expand 403(b) plan investment options to include collective investment trusts ("CITs"), effective for amounts invested after enactment of the statute. A CIT is a tax-exempt pooled investment vehicle that holds assets attributable to certain types of employer-sponsored retirement plans. 401(k) plans increasingly offer group trusts in their investment line-ups as cost-effective alternatives to mutual funds.

However, SECURE 2.0 only offers a partial fix for 403(b) plans looking to expand into CITs: It removes the tax-qualification rule against 403(b) plans investing in CITs without changing the securities laws that prevent CITs from holding 403(b) plan assets. CITs are generally exempt from the requirements of the Investment Company Act of 1940 (the "'40 Act"), a disclosure law that requires certain investment companies to register with the Securities and Exchange Commission. To be exempt from these requirements, CITs must exclude assets from certain kinds of retirement plans, including 403(b) plans sponsored by not-for-profit entities. Accordingly, it is unlikely that most CITs will be accepting 403(b) plan investments until the securities laws have been updated.

A provision that would have allowed CITs to hold 403(b) plan asset without triggering the '40 Act's registration and disclosure requirements was dropped from the final version of SECURE 2.0, and it remains to be seen if or when Congress will enact changes to the securities laws allowing 403(b) plans to have meaningful access to CITs.

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