

Federal Update 2004-33

December 14, 2004

TO: NCTR Members

FROM: Cindie Moore

RE: Comments on Proposed Rules on Section 403(b) Plans

IRS undertook in 2003 a complete revision of the various regulatory provisions that govern 403(b) plans. NCTR members that administer 403(b) plans submitted comments to IRS in conjunction with Lou Mazawey, the Groom Law Group, about the need for the IRS to address concerns of governmental 403(b)s.

As you no doubt heard, IRS recently released a set of proposed rules. The proposal includes favorable resolution of a number of issues submitted by the NCTR members, such as fully preserving the grandfather for self-insured programs, allowing plan terminations, and reflecting the various basic rules for loans and transfers.

On the other hand, the proposed rules would affect 403(b) programs in many significant ways that are legally subject to question, for example, many ERISA concepts would be imposed on governmental 403(b)s with no statutory basis.

Lou Mazawey and David Powell with the Groom Law Group discussed these and other issues in the article set out below. The article includes some private sector provisions, such as the nondiscrimination rules, to which governmental plans are not subject.

## **Proposed IRS Regulations Would Make Major Changes in the 403(b) World**

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For many years, IRS guidance on Internal Revenue Code section 403(b) plans ("403(b) plans") has been a hodge-podge of regulations, exam guidelines, revenue rulings and notices dating back to the 60's. Several years ago, the Service began to tackle the process of updating and consolidating most of this guidance into one unified set of regulations reflecting current law. Though delayed for a while, those regulations have now been issued in proposed form (69 Fed. Reg. 67075 (Nov. 16, 2005)), together with a proposed regulation under the controlled group rules of Code section 414(c), and a temporary regulation under Code section 3121 regarding the definition of salary reduction arrangement for purposes of including amounts in FICA wages.

The restatement of the 403(b) rules follows in the footsteps of similar IRS/Treasury efforts – some complete, some still under way – to update and consolidate other major pension regulations, including those under section 457(b) (eligible deferred compensation plans), section 401(k) and the section 415 limits.

The general thrust of the proposed 403(b) regulations is to follow 401(k)-like rules to the extent possible, and to borrow occasionally from the recently finalized 457(b) rules. While this is partly a result of convenience, it also furthers the goal of key tax policymakers to consolidate all tax-favored retirement plans under the largest umbrella –

the one covering 401(k) plans – and to help smooth the path for Administration-backed proposed legislation that would effect such a change.

Major changes that would be made by the proposed rules would –

- impose broad written plan document and operational compliance requirements,
- repeal the nondiscrimination safe harbor of IRS Notice 89-23 and impose a set of "controlled group" rules,
- prohibit the use of life insurance (and certain other incidental benefits) in 403(b) arrangements, and
- allow plan terminations (and concurrent distributions) under rules similar to those for 401(k) plans.

The following summary highlights the principal changes being proposed.

Comments are requested by February 14, with a public hearing already scheduled for the next day.

**A. Plan and Contract Terms**

**Written Plan Requirement** – While a few 403(b) requirements are required by statute to be in the underlying 403(b) contract (a term which in this context includes custodial account agreements and church retirement income accounts) – and ERISA has always imposed a written plan document requirement on 403(b) plans subject to that law – these regulations impose for the first time a requirement under the Code that there be a written plan document that contains all material terms and conditions for eligibility, benefits, limitations and time and form of distribution. In addition, optional provisions

(such as for loans and hardship distributions) must be set forth in the plan. There need not be a single plan document, however; for example, a "wrap document" could supplement an annuity contract that contained certain terms. Of course, the requirement can also be satisfied by complying with plan document rules applicable to qualified plans.

It is not clear that the Service seeks to impose by this requirement a rule similar to the qualified plan (section 401(a)) rule that a failure merely to follow the terms of the plan document, even if the action taken would not be inconsistent with statutory requirements, would cause the plan to fail to be a 403(b) plan. In addition, the preamble to the proposed regulations indicates that, although creating a plan document does not per se convert a salary-reduction-only plan relying on the ERISA exemption of DOL Reg. §2510.3-2(f) into a plan subject to ERISA, there remains the possibility that the employer may undertake responsibilities pursuant to the plan document that may cause loss of the ERISA exemption. The IRS solicits comments on these issues which it promises to share with the DOL.

This new rule (and other aspects of the proposed regulations) may cause non-ERISA 403(b) plan sponsors relying on that regulatory exemption to look at it more closely to determine whether their plans continue to be exempt from ERISA.

**Defined Benefit 403(b) Plans Not Permitted** – The proposed regulations would require that a 403(b) plan be a defined contribution plan, except in the case of a church 403(b)(9) plan in existence on September 3, 1982. With respect to other plans, the preamble provides that a defined benefit plan in existence on the effective date of the regulations that has taken the position, based on a reasonable interpretation of the statute,

that it satisfies section 403(b), would not be subject to the defined contribution requirement, but only with respect to pre-effective date accruals (though IRS notes that the plan may alternatively seek to take the position it is a 401(a) plan, if it also meets the 401(a) rules). In addition, the proposed regulation does not appear to provide that State plans grandfathered from the annuity contract requirement for certain plans in existence on May 17, 1982, would also be grandfathered from this defined contribution rule.

**What Has to be in a 403(b) Contract** – The proposed regulations indicate that certain 403(b) provisions must be in the contract, as opposed to the plan document, including:

- nonforfeitability (which the proposed rules would define by reference to the section 411 vesting rules for qualified plans, though, during the initial period the contract is unvested, the contract must at all times satisfy the 403(b) requirements)
- nontransferability (sec. 401(g))
- limit on elective deferrals (sec. 402(g))
- minimum required distribution rules (including the incidental death benefit rule) (sec. 401(a)(9))
- direct rollover rules (sec. 401(a)(31)).

**What Has to be in The Plan** – The proposed regulations indicate that certain other 403(b) provisions must be in the plan document, including:

- nondiscrimination rules

- 415 limits on annual additions.

**Annuity Contracts Treated as Single Contract** – As under current law, all annuity contracts purchased for an individual are treated as a single contract, but contributions in excess of the 415 limits are treated as made to a separate, non-403(b) contract so long as they are separately accounted for. (If not, the entire contract fails to meet 403(b).)

**Exclusive Benefit Requirement** – Although the Code does not refer to an exclusive benefit requirement for 403(b) plans, the proposed regulations add an exclusive benefit requirement for all assets held in 403(b) custodial accounts and retirement income accounts, whether covered by ERISA or not. The proposed regulations do not appear to impose the exclusive benefit rule on annuity contracts.

**Incidental Benefits Restricted** – The proposed regulation permits distributions that satisfy the incidental death benefits rules for 401(a) plans. However, they take a very restrictive approach on the provision of any benefits other than retirement benefits. In particular –

- They would absolutely prohibit the use of term and permanent life insurance and endowment contracts to fund 403(b) programs, even if the premiums are limited under the longstanding 25%/50% tests (subject to a grandfather rule for contracts issued before February 14, 2005). We suspect this reflects a concern with noncompliance with the incidental tests, as well as a strict interpretation of what funding vehicles or investments

Code section 403(b) permits. This is likely to cause an uproar in the life insurance community.

- Similarly, the proposed rules would not allow (subject to the same grandfather rule) the provision of health or accident insurance benefits – a practice that was much less frequently used, but nevertheless permitted.

**B. Eligible Employers**

**Clarification of Dual Governmental And 501(c)(3) Status** – The regulations would clarify that an organization that is both a governmental entity and a 501(c)(3) tax-exempt organization cannot maintain a 401(k) plan, though it can maintain a 403(b) plan. Such dual status governmental (but non-public school) 403(b) plans are typically seen in the case of governmental hospitals which are separately incorporated and have obtained 501(c)(3) approval by the IRS. The preamble notes that the treatment of "tax-exempt charter schools," another potential "dual status" situation, is not addressed.

**Public School Employees** – To participate in a 403(b) program as performing services for a public school, the employee's compensation must be paid by the State (or political subdivision), and a person occupying an elective or appointed public office must have received training in, or be experienced in, the field of education.

**Indian Tribal School Employees** – For purposes of determining whether an individual is an employee performing services for a public school, an Indian tribal government is treated as a State.

### C. **Funding 403(b) Arrangements**

**Timeliness of Contributions** – Similar to the final 457(b) regulations, the proposed 403(b) regulations impose an ERISA-type rule that contributions should be transferred to the insurance company or entity holding the custodial or retirement income account within a period that is no longer than reasonable for the proper administration of the plan, using the example of transferring elective deferrals within 15 business days following the month in which the amounts would otherwise be paid to the participant. It is not clear whether the use of that example signifies that it is a safe harbor for contributing salary reduction amounts (which is not the view of the DOL under ERISA).

**Grandfather For Certain Self-Insured State and Local Plans** – Rev. Rul. 82-102 clarified that 403(b) plans had to be invested in commercial annuity contracts, but permanently grandfathered certain self-insured state and local government annuity plans in existence on or before May 17, 1982, including for new participants. The proposed regulations continue this grandfather, where (as under prior IRS guidance) (1) benefits under the contract are provided from a separately funded retirement reserve subject to supervision by the State insurance department, or (2) benefits are provided from a fund separate from the fund used to provide statutory benefits under a State retirement system that is part of a State teachers retirement system to purchase benefits that are unrelated to the basic benefits provided under the State retirement system, and the death benefit provided under the contract at no time exceeds the larger of the reserve or the employee's contributions.

**Church Retirement Income Account Plans** – The proposed regulations incorporate a number of provisions for church retirement income account plans under Code section 403(b)(9) previously found only in the legislative history to TEFRA, the 1982 law which created them. Perhaps the most important of these is an "exclusive benefit" rule. The preamble to the regulations provides that this means, for example, that employers may not borrow assets from a church retirement income account. The proposed regulation also clarifies that a church retirement income account will be subject to the 403(b)(1) annuity rules (for example, for distribution restrictions) rather than the 403(b)(7) rules, even though invested in mutual funds.

The proposed regulations also allow a life annuity to be provided from a church retirement income account without purchase of a commercial annuity contract if the distribution has an actuarial present value at the annuity starting date equal to the participant's accumulated benefit, and the plan sponsor guarantees the annuity. Such self-annuitization is common among older church 403(b)(9) plans.

**Commingling of Assets** – The proposed regulations provide that, to the extent permitted by IRS guidance, assets held in 403(b) custodial accounts and retirement income accounts may be invested in a group trust with trust assets held under a qualified plan or IRA. This follows several private letter rulings issued in the past, and hints at a future solution to the omission of 403(b) in Rev. Rul. 2004-67, the recent update of the IRS' "group trust" ruling.

The proposed regulations also reflect the rule under the legislative history to TEFRA that church retirement income account assets are permitted to be commingled in

a common trust fund with amounts devoted exclusively to church purposes (giving as an example a fund from which pension payments can be made), but provides that no assets of the plan sponsor other than retirement income account assets can be combined with custodial account, qualified plan or individual retirement plan assets. It is not clear whether this is intended to restrict practices among church plans, based upon the TEFRA legislative history, of commingling retirement account plan assets with church endowment funds and church 401(a) plans, provided that the amounts belonging to each can be separately accounted for and the plans are subject to the exclusive benefit rule.

**Tax-Exempt Status of Church Retirement Income Account Trust** – The proposed regulations also clarify that a trust holding church retirement income account assets is tax-exempt.

**D. Contribution Limits**

**What is an Elective Deferral** – The regulations clarify that, for purposes of applying the limit on elective deferrals (sec. 402(g)), an elective deferral does not include a contribution pursuant to a one-time irrevocable election made on or before an employee's first becoming eligible to participate, or a contribution made as a condition of employment. Under a temporary rule that reflects the Service's longstanding position, FICA taxes, however, apply to all salary reduction contributions, whether elective or nonelective. 69 Fed. Reg. 67054 (Nov. 16, 2004).

**Excess Contributions And Deferrals** – Excess elective deferrals will not result in a 403(b) failure if distributed, with allocable net income, by April 15 of the following

year, or another correction method available under the same rules as apply to 401(k) excess deferrals.

**Coordination of Age 50 Catch-Up Contributions And Special 15-Year Catch-**

**Up** – The proposed regulations clarify that if an employee is eligible for both the age 50 catch-up and the special 403(b) catch-up for certain employees with 15 years of service, any catch-up contribution is first counted against the latter catch-up, and to the extent that is exceeded, is treated as age 50 catch-up.

**Years of Service For "Includible Compensation" And 15-Year Catch-Up**

**Rules** – The proposed regulations continue the prior guidance on determining "includible compensation" for the 415 limit of 100% of includible compensation and for determining if an employee has 15 years of service with a qualifying employer for the special 403(b) catch-up rule. This guidance includes aggregating part-time and seasonal service into full years, using the employer's annual work period (e.g., an academic year) and not necessarily the calendar year, and determining a year of service based on common-law employment, not a controlled group basis (except in the case of church plans, which have a special aggregation rule).

**Definition of "Includible Compensation"** – The proposed regulations also follow prior rules on defining includible compensation. The preamble requests comments on whether plan sponsors should be allowed to use a simpler taxable-year based definition such as that under Code section 415(c)(3) (e.g., W-2 compensation), which is usually easier to determine and administer.

**Post-Employment Contributions** – The proposed regulations incorporate the special, favorable rule added by EGTRRA that deems a former employee to have includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and for the next 5 taxable years. The regulation applies this rule to section 415 as well, but only permits nonelective employer contributions. The preamble indicates that post-employment elective contributions are to be addressed in separate guidance, which is also expected to cover 401(k) plans, governmental 457(b) plans and the section 415(c) limits.

**E. Nondiscrimination Rules**

**Repeal of Notice 89-23 Safe Harbor** – The proposed regulations would repeal the nondiscrimination safe harbors of IRS Notice 89-23, and would generally impose the qualified plan nondiscrimination rules on all employer contributions (other than elective deferrals) to 403(b) plans. The Notice 89-23 safe harbors permitted, in some cases, a nonelective contribution for HCEs at a rate of up to 180% of the rate for non-HCEs. (For example, senior staff might receive a 9% contribution while other staff receives 5%.) Many nonprofits, particularly small ones with high turnover, have relied on that guidance, and may have to make changes to their contribution formulas by 2006. In some cases, nonprofit organizations may wish to explore age and service-weighted contribution formulas, but nondiscrimination testing for such tiered formulas can be complex and difficult to pass.

**New "Universal Availability" Testing Rules** – A "universal availability" rule has long applied to all 403(b) plans with elective deferrals, excluding some church plans,

but including plans of governmental employers. The "universal availability" rule requires that, with certain exceptions, all employees normally working more than 20 hours a week must be able to make salary reduction contributions of at least \$200. Lack of guidance on this test, and the dire consequences of error, have tended to cause employers to interpret the test fairly conservatively in the past.

The proposed regulations introduce several new concepts to the "universal availability" rule, many of which are helpful to employers, including:

- an employee will be treated as normally working fewer than 20 hours per week if –
  - for the 12-month period beginning on the date the employee's employment commenced, the employer "reasonably expects" the employee to work fewer than 1000 hours of service, and
  - for each plan year ending after the close of that first 12-month period beginning on the date the employee's employment commenced, the employee worked fewer than 1000 hours of service in the preceding 12-month period.

Thus, the regulation appears to provide that seasonal and part-time workers can be excluded, if they aren't expected to work at least 1000 hours of service in the year of hire and don't actually work more than 1000 hours of service in any year (based on anniversaries from date of employment).

(The IRS notes that plans subject to ERISA's 1000-hour rules for participation purposes may be subject to additional requirements.)

- The test is performed on a common-law employer basis, not on a controlled group basis. In the case of a State entity, including a political subdivision, this rule is applied on a "common payroll" basis.
- In addition, the proposed rules allow an employer that has historically treated one or more of its various 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 day-to-day basis.

On the negative side, some of the safe-harbor exclusions of Notice 89-23 have been removed from the universal availability rule, including for –

- employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan.
- Employees covered by a collective bargaining agreement.
- Visiting professors for up to one year under certain circumstances.
- Employees affiliated with a religious order who have taken a vow of poverty.

Comments are requested on whether the universal availability rule should be applied separately to employees covered by a collective bargaining agreement, and whether any of the Notice 89-23 exceptions not carried over in the proposed regulations should be.

**Anti-Conditioning Rule** – The proposed regulations impose a rule similar to the statutory 401(k) rule that rights or benefits under other plans cannot be conditioned directly or indirectly on an employee's participation (or non-participation) in the 403(b)

plan. This seems to be overreaching since Code section 403(b) itself does not contain such a rule, and 403(b) elective deferrals themselves are not subject to discrimination testing.

**Controlled Group Rules** – The proposed regulations include new controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a), such as 501(c)(3) organizations. This change represents a major departure from the current IRS position, which is a "reasonable, good faith" interpretation pursuant to IRS Notice 96-64.

The controlled group rules reiterate a standard found in earlier, pre-Notice 96-64 guidance (including Notice 89-23) that common control exists where 80% or more of the directors of one entity are either representatives of or directly or indirectly controlled by the other organization. However, the proposed regulations would also allow permissive aggregation of tax-exempt organizations if they maintain a single plan and the organizations regularly coordinate their day-to-day activities. The proposed regulations include an "anti-abuse" rule.

These controlled group rules will apply for purposes of nondiscrimination testing, section 415, the 15 years of service catch-up election, and the minimum distribution rules. The preamble also asks for comments on whether these rules should be applied to church entities. The proposed controlled group rules do not address governmental entities (though see above for application of a "common payroll" rule for applying the universal availability rule to governmental plans).

**F. Distributions, Transfers And Exchanges**

**401(a)(9) Grandfather For Pre-'87 Monies** – As under prior guidance, pre-'87 monies may be grandfathered from the statutory minimum distribution rules, but only if the amount is separately accounted for. The proposed regulations also indicate that the pre-'87 account balance will cease to be treated as such if it is distributed and rolled over to another 403(b) contract, though it will be preserved if it is directly transferred to another 403(b) contract and separately account for. There is no mention of an age 75 beginning date for the pre-'87 portion (which is reflected in certain private letter rulings).

The regulation preserves the current rule that the required minimum distribution rules must be separately determined for each separate contract, but that distribution required under one 403(b) contract can be satisfied by a distribution from another 403(b) contract.

**Qualified Plan Profit Sharing Distribution Restrictions Imposed on 403(b)(1) Annuities** – Elective deferrals to 403(b) annuity contracts and all contributions, elective and non-elective, to 403(b)(7) custodial accounts are generally subject to distribution restrictions prior to age 59 1/2 , death, disability, financial hardship or severance from employment (subject to certain grandfathers), which are generally reflected in the proposed regulations. However, nonelective employer contributions to 403(b) annuity contracts have not been subject to restrictions on distribution under the statute, though, of course, the 10% excise tax on early distributions can be a disadvantage to taking such distributions. The proposed regulations, nevertheless, would impose the qualified profit sharing plan distribution rules (contained in various longstanding regulations and rulings

under section 401(a)) on 403(b) plans, which generally means that the plan must provide a predetermined formula for distributing the funds in the plan after a fixed number of years, the attainment of a stated age, or after the occurrence of an event such as a layoff, illness, disability, retirement, death or severance from employment.

**Severance From Employment** – The proposed regulations generally follow the 401(k) rules for determining whether there is severance from employment. They also provide that a severance occurs when an employee ceases to be employed by an eligible employer that maintains the 403(b) plan. Thus, an employee transferring from a tax-exempt parent to a for-profit subsidiary, an employee of a public school transferring to another agency of the State, or a minister employed by a non-501(c)(3) entity ceasing to perform services as a minister but continuing to be employed by the same entity, will all be considered to have severed employment. This rule does not necessarily require distributions, though it will require that 403(b) contributions for the employee stop.

**Plan Termination Permissible** – The proposed regulations announce for the first time that 403(b) plans can be terminated, and that benefits can be distributed upon plan termination. However, this does not apply if another entity in the same controlled group makes contributions to another 403(b) plan under which 2% or more of the employees in the terminated 403(b) plan participate within 12 months before and after the date of plan termination. (This "successor plan" concept is adopted from the 401(k) rules.) To be considered terminated, all accumulated benefits must be distributed as soon as administratively practicable; this can be satisfied by delivery to participants and beneficiaries of fully paid individual annuity contracts.

**Employer Ceasing to be an Eligible Employer** – The proposed regulations provide that, if an employer ceases to be eligible to maintain a 403(b) contract, the plan can either be frozen (i.e., no further contributions made) or terminated.

**Transfers Between Contracts And Plans** – The proposed regulations permit transfers between 403(b) contracts within a plan (and between plans), provided that both plans permit it, and generally reflecting the rules of Rev. Rul. 90-24 that the benefit is not reduced and the transferee contract impose restrictions on distributions no less stringent than those imposed on the transferor. In a significant change (or perhaps clarification) of the prior guidance, transfers by employees and beneficiaries may only be made to 403(b) contracts of the individual's employer. The regulation is vague as to whether the distribution restrictions can be applied only to the amounts transferred (for example, if an amount is transferred from a custodial account to an annuity contract). If a transfer does not constitute a complete transfer of the participant or beneficiary's interest in the 403(b) plan, the transfer must be treated as including a pro-rata portion of the participant's or beneficiary's after-tax contributions. The preamble also notes that additional rules may apply to a transfer to or from a 403(b) arrangement subject to ERISA under Section 208 of ERISA (the counterpart to Code section 414(l)).

**Exchanges** – Contract exchanges under the same plan may be made if conditions similar to the conditions for transfers are met.

**Mergers and Transfers With Non-403(b) Plans Prohibited** – The proposed regulations confirm the IRS position that 403(b) assets may not be merged with, or

transferred to or from, other types of tax-favored retirement arrangements (e.g., 401(k) plans, 457 plans, etc.).

**EGTRRA Transfers** – The proposed rules include a "barebones" statement of the EGTRRA rule that permits 403(b) plan transfers to purchase permissive service credit under a governmental defined benefit plan (or to repay a prior cashout under such a plan). The preamble confirms that such a transfer will not violate the general in-service distribution prohibition for elective deferrals and earnings.

**G. Effective Dates of Proposed Regulations**

The effective date of the proposed regulations is proposed to be taxable years beginning after December 31, 2005. The proposed regulations cannot be relied upon until published in final form.

Plans maintained pursuant to a collective bargaining agreement that is ratified and in effect when the final regulations are issued are not subject to the regulations until the bargaining agreement terminates, determined without any extensions after the date of the final regulations.

In the case of church plans, the regulations would not apply before the earlier of (1) July 1, 2007, or (2) 60 days following the earliest church convention that occurs after the date of publication of the final regulations.

**H. Observations**

The proposed 403(b) regulations are lengthy and complicated – to be expected for a collection, re-thinking and re-writing of over 40 years of accumulated guidance and changes in the law. Some provisions already seem likely to engender controversy – the

written plan document requirement, the prohibition on life insurance contracts, and the repeal of Notice 89-23 nondiscrimination safe harbors immediately present themselves.

It will undoubtedly take some time for the full implications of the proposals to be understood. But the overall theme of the proposed regulations is already clear – to make 403(b) plans more like 401(k) plans. This is the case even though many 403(b) plans themselves involve a collection of different 403(b) contracts and accounts that are difficult to oversee in a comprehensive manner and were never intended to be run like a cohesive plan.

We expect many employers and providers to comment on these regulations, and, of course, the Service asks for comments on many questions. It is likely that the regulations will further evolve before being finalized, and that affected parties will clamor for delayed effective dates.