Final 403(b) Regulations Released

On July 26, 2007 the Internal Revenue Service ("IRS") published final 403(b) regulations, which provide for tax exempt retirement arrangements sponsored by public schools, 501(c)(3) organizations and some churches. The new regulations reflect legislative and regulatory developments enacted over the past 40 years, including amendments made by ERISA, the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Pension Protection Act of 2006, which overall have the effect of diminishing the differences between 403(b) plans and other salary reduction arrangements, such as 401(k) and 457(b) plans.

The regulations are generally effective for plan tax years beginning after December 31, 2008, however there are some exceptions.[1] The regulations provide for differing effective dates for collectively bargained plans, certain governmental 403(b)'s, and for limited universal availability exclusions. [2]

Following are highlights of the final 403(b) regulations as generally applicable to educational employers including school districts:

Plan Document - Both in Form and Operation

An employer which allows for contributions (a "Plan Sponsor") is now required to maintain a written 403(b) plan.[3] While the plan will incorporate by reference other documents, such as an insurance policy and custodial account, a single document is expected to be adopted. This adopted plan must comply with the final 403(b) regulations both in form and operation.

While it is acceptable to incorporate material provisions into the plan document, the plan must provide for the following provisions; eligibility, benefits, applicable limits, contracts available under the plan, and the time and form under which benefit distributions will be made. The IRS plans to publish model plan provisions by October 24, 2007.

[1] IRC §1.403(b)-11(a)
[2] IRS §1.403(b)-11(b) – (d)
[3] IRS §§ 1.403(b)-3(b)(3) and 1.403(b)-3(d)(1)(i) & (ii)

Transfers

Transfers Taking Place On or Before September 24, 2007

Transfers prior to September 24, 2007 will fall under the current standard of Revenue Ruling 90-24, for a tax-free transaction. In order to receive the tax-free treatment all of the paperwork must be fully in place by September 24, 2007. While the actual tender of the check need not take place prior to the deadline, the legal obligation to transfer must be present by September 24, 2007.

Transfers Taking Place after September 24, 2007, but before January 1, 2009

There are two, new general requirements for these transfers to take place 1) the transfers must be permitted by both the transferring and receiving plans and 2) they can only be made to vendors that have entered into a written agreement to share information with the Plan Sponsor. If the Plan Sponsor establishes the agreement and plan document by December 31, 2008 then the transactions that occur between September 24, 2007 and December 31, 2008 will be tax free. Failure to establish an information sharing agreement with a vendor by December 31, 2008 will cause all transfers that occur between September 24, 2007 and December 31, 2008 with that vendor to be treated as a taxable distribution.

Transfers Taking Place after December 31, 2008

Any transfer after December 31, 2008 will either be an exchange or a transfer. An exchange occurs when an amount is moved between vendors but there is no change in plan sponsorship; the employee remains with the same plan. Each vendor will need to have a written agreement with the plan sponsor and the plan document will need to allow for exchanges. A transfer will occur when an employee changes from one Plan Sponsor's 403(b) plan to another Plan Sponsor's 403(b) plan.

Universal Availability

403(b) plans allowing employee contributions (generally referred to as elective deferrals) must satisfy the universal availability requirement. This rule provides that generally all employees of a Plan Sponsor that offers a 403(b) program must be permitted to make elective deferrals if any employee of the Plan Sponsor may make elective deferrals under the 403(b) program.

However, the IRS permits certain employees to be excluded:

-Non-resident aliens;
-Employees eligible for 457(b) deferrals;
-Students; and

-Employees who normally work fewer than 20 hours per week

At least once during each plan year, the Plan Sponsor must provide employees with an opportunity to make or change an elective deferral election by communicating the availability of this election, the period of time during which this election may be made, and any other conditions on elections. The opportunity to make deferrals would include the employee's right to contribute up to the lesser of the maximum allowable contribution.

Catch-Up Provisions

A 403(b) program can provide for (1) an additional special catch-up contribution for an employee who has at least 15 years of service with the same employer; and (2) a catch-up contribution for an employee who is age 50 or older (up to $5,000 in 2007). The final regulation confirms that if an employee is eligible for both catch-up contributions the special 15 years of service catch-up should be applied first.[4] In order for eligible employees to choose whether to participate in the catch-up provisions the Plan Sponsor will have to communicate the availability of these options.

Roth

Employees have the option of directing 403(b) contributions to either a regular 403(b) or a Roth 403(b), or some combination of the two plans that does not exceed that year's contribution limits. A Plan Sponsor that provides the option of a Roth 403(b) will need to communicate the options availability to employees.

Post-Employment Employer Contributions

Section 403(b) permits certain post-employment employer contributions that are not subject to the new 409A rules. Plan Sponsor's are permitted to make post-employment employer contributions to a 403(b) plan on behalf of a former employee through the end of the taxable year in which employment terminates and for the next five taxable years. Plan Sponsors may take advantage of this provision to provide severance payments through a 403(b) plan (thereby avoiding the FICA taxes that would otherwise apply to severance payments made in cash).

[4] §§402(g)(7) & 414(v)

Employee Contribution Timing

The final regulations include rules regarding contributions. The rules require a Plan Sponsor to transfer employee contributions to the plan within a reasonable period of time. For example, the plan could provide for elective deferrals to be contributed within 15 business days, if this time frame were deemed reasonable.[5]

Eligibility for Loans and Hardship Distributions / Verification

The final regulations clarify that employee self-certification for certain transactions are not sufficient. Third party verification of eligibility for certain transactions, such as loans and hardship distributions, will now require "employer oversight"—stressing the necessity to ensure accuracy. The plan is required to provide the oversight and the third party verification to determine eligibility for these transactions.

Distributions

The final regulations clarify that an employee has a "severance from employment," and then is eligible to receive a distribution when he or she ceases to be an employee of an eligible employer. For example, a severance from employment occurs when an employee ceases working for a public school district and goes to work for the State.

[5] §1.403(b)-8(b)