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White Paper:  
*403(b) Plan*

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# 403(b) Plan

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## What is a 403(b) plan?

A 403(b) plan is a special type of employer-sponsored retirement plan for certain religious, public educational, and tax-exempt organizations. Typically, the employer either purchases annuity contracts for eligible employees, or establishes custodial accounts to be invested in mutual funds or other investments. In the case of annuity contracts, a 403(b) plan is sometimes referred to as a tax-deferred annuity or a tax-sheltered annuity plan (TSA). Depending on the specific type of 403(b) plan, plan contributions may be made by only the employee, only the employer, or both employee and employer (see below).

A 403(b) plan is not a qualified retirement plan, but it mimics such a plan in that it enjoys similar tax benefits, and is subject to many of the same requirements that apply to qualified plans. The most significant benefit is that participating employees are generally not taxed on their plan benefits (including both contributions and investment earnings) until they begin to receive distributions from the plan. Although an employer tax deduction may be possible, this is usually of little or no value, since the employer is exempt from income tax anyway.

**Caution:** On August 17, 2006, President Bush signed the Pension Protection Act of 2006 into law. The law attempts to shore up the nation's pension system by making sweeping changes to the funding rules that apply to defined benefit plans. The Act also protects workers' retirement benefits and encourages savings by making numerous changes to the rules governing defined contribution plans, including Section 403(b) plans. Finally, the Act makes permanent the IRA and retirement plan provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which had been scheduled to expire at the end of 2010. Several of the provisions of the Act are discussed in this article. For a fuller discussion, see The Pension Protection Act of 2006.

**Caution:** On July 24, 2007, the IRS issued comprehensive final regulations covering almost all aspects of 403(b) plan taxation and administration. The regulations are generally not effective until January 1, 2009 (later for certain collectively bargained plans), but taxpayers can rely on the regulations before then if the reliance is on a consistent and reasonable basis. A summary of the final regulations appears at the end of this topic discussion.

**Caution:** Special rules apply to qualified individuals impacted by Hurricanes Katrina, Rita, and Wilma and the Kansas storms and tornados that began May 4, 2007.

## What types of employers can have a 403(b) plan?

Your organization is eligible to adopt and maintain a 403(b) plan if it is an organization that is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code (IRC), or if it is a public educational organization. Section 403(b) plans may also be adopted and maintained for a duly ordained, commissioned, or licensed minister of a church who is self-employed, or by an organization (other than a Section 501(c)(3) organization) that shares common religious bonds with such a minister under its employment.

Tax-exempt Section 501(c)(3) organizations include organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or education purposes. Section 501(c)(3) organizations can also include certain qualifying organizations that sponsor amateur sports competition, or that exist for the purpose of preventing cruelty to children or animals.

Qualifying public educational organizations that can adopt and maintain a 403(b) plan are those described in Code Section 170(b)(1)(A)(ii), regardless of whether they qualify as Section 501(c)(3) organizations. Such an educational organization must normally maintain a regular faculty and curriculum, and must normally have a regular enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

**Tip:** Public employers that have the same attributes as nonpublic 501(c)(3) organizations may qualify as 501(c)(3) organizations, and may adopt a 403(b) plan. Such institutions may include government-operated hospitals, libraries, and museums.

## 403(b) plans and ERISA

The Employee Retirement Income Security Act (ERISA) is a 1974 federal law that governs many aspects of retirement plans. Title I of ERISA imposes requirements that include reporting and disclosure, participation and vesting, funding, fiduciary responsibilities, and administration and enforcement. Title I of ERISA applies to all "employee benefit plans," which generally include all retirement plans unless specifically excluded.

Section 403(b) plans established or maintained by a state, a political subdivision, or a state agency or instrumentality are specifically exempted from ERISA Title I. This would generally include 403(b) plans established or maintained by public schools and colleges. A 403(b) plan established or maintained by a church (a "church plan") for its employees is also specifically exempted from ERISA Title I unless an election is made to make the plan subject to ERISA's vesting and funding rules.

Section 403(b) plans other than government or church plans are generally subject to ERISA Title I. However, an exception applies to 403(b) plans in which the organization that sponsors or maintains the plan plays a very minimal role. Specifically, a plan will not be subject to ERISA Title I if:

- Employee participation is completely voluntary

- The 403(b) plan is funded completely through employee salary deferrals (no employer contributions)
- Rights under the plan are solely enforceable by the employee or the employee's authorized representative or beneficiary
- The employer's involvement is limited to: permitting third-party providers to publicize their products to participants, requesting information from providers, summarizing information for participants, collecting and remitting employee contributions, holding group annuity contract(s) covering employees, and providing reasonable investment choices

**Caution:** See "Final 403(b) regulations--ERISA Considerations" below for additional DOL guidance on this subject issued in connection with the IRS final section 403(b) regulations.

## Salary-reduction plans vs. employer-funded plans

Section 403(b) plans generally fall into one of two categories: a salary-reduction plan or an employer-funded plan.

### Salary-reduction plan

The salary-reduction plan is the most widely used type of 403(b) plan. This type of plan is funded solely by the employee's salary-reduction contributions. The participating employee elects to defer a certain amount of money to the plan (typically, a percentage of his or her salary), rather than receiving that amount as taxable compensation. This arrangement is called a salary-reduction plan because the amount deferred to the plan is a pretax contribution, thereby reducing the employee's taxable income. Since the amount deferred to the plan is automatically deducted from the employee's salary each pay period, the employee may find it more convenient to save with this arrangement.

**Tip:** As a result of the Economic Growth and Tax Relief Reconciliation Tax Act of 2001 (EGTRRA), an employer can (but isn't required to) let employees designate all or part of their elective deferrals as after-tax "Roth" contributions for tax years beginning after 2005. While there is no up-front tax deduction, qualified distributions of Roth contributions and related earnings are completely tax free when distributed to the employee from the plan. All of the rules and limits for pretax salary-reduction contributions also apply to after-tax Roth contributions.

**Tip:** A 403(b) plan can also let employees make non-Roth after-tax contributions. These contributions are tax-free when distributed from the plan. However, the earnings on these contributions are subject to income tax when distributed.

### Employer-funded plan

The employer-funded 403(b) plan is typically funded by both employer contributions and employees' salary-reduction contributions (although salary-reduction contributions are not necessarily required). Employer contributions may include nonelective contributions that are a fixed percentage of each

employee's compensation or may be discretionary on the part of the employer. They may also include matching contributions that are a specified percentage of each employee's salary-reduction contribution. The employer-funded plan is more common among employers that use the 403(b) plan as their primary retirement plan, while the salary-reduction plan is more common among employers that offer the 403(b) plan as a supplement to a primary retirement plan.

**Tip:** Employers can make 403(b) contributions on behalf of former employees for up to five years after the employee no longer receives compensation from the employer.

## What is the contribution limit for 403(b) plans?

The IRC contains overlapping limitations that apply when determining exactly how much can be put into a 403(b) plan.

For 2007 and 2008, an employee may defer up to \$15,500 of his or her compensation to a 403(b) plan on a pretax basis. A "catch-up" retirement savings provision is also available for employees age 50 and over. These individuals may contribute \$20,500 pretax for 2007 and 2008. If the plan permits Roth contributions, pre-tax and Roth contributions are combined for purposes of these contribution limits. These are the same contribution limits that apply to 401(k) plans.

**Tip:** In addition, there are special catch-up contribution limits that apply to the 403(b) plans of certain organizations separate from the catch-up provision described above. Consult a tax professional for more information about these special contribution limits for 403(b) plans.

**Tip:** These dollar limits apply per person across all employer boundaries. Consequently, an employee who has several jobs with different employers and participates in several plans can't contribute more than a total of \$15,500 in 2008 (plus any applicable catch-up contribution for those age 50 or older) to all plans. Deferrals to 401(k) plans, 403(b) plans, SIMPLEs, and SAR-SEPs are included in this limit, but deferrals to Section 457(b) plans are not (employees who participate in both a 403(b) plan and a 457(b) plan can defer the full dollar limit to each plan--a total of \$31,000 in 2008 (plus any catch-up contributions)). In addition, only employee pretax salary deferrals and after-tax Roth contributions amounts count. Employer contributions and employee traditional (non-Roth) after-tax contributions, if allowed, aren't subject to these dollar limits.

**Tip:** Your employee is responsible for making sure the overall limit isn't exceeded if he or she participates in plans of more than one employer during a calendar year.

**Caution:** If your employee contributes too much in any particular year, the employee must withdraw the excess by April 15 of the following year to avoid adverse tax consequences. If your employee fails to do so, the excess will be treated as taxable income both in the year contributed to the plan and again in the year the excess contributions (and earnings) are distributed from the plan. This applies to both pretax and Roth excess contributions.

Also, total annual additions for any one participant in a 403(b) plan are limited to the lesser of \$46,000 (in 2008, \$45,000 in 2007) or 100 percent of the participant's includible compensation. Total annual additions are the sum of employer contributions and employee contributions, plus any reallocated forfeitures from other employees' accounts. Age 50 catch-up contributions are not subject to this limit, but the special 403(b) catch-up contributions mentioned above are included.

**Caution:** In general, the annual additions limit for a 403(b) plan is determined separately from the annual additions limit for a qualified plan maintained by the same employer. However, special rules apply if an employee controls more than 50% of a corporation, partnership, or sole proprietorship--any contributions made on the employee's behalf to a qualified plan or SEP maintained by a controlled entity must be aggregated with the employee's 403(b) contributions when determining the annual additions limit for the employee.

## Tax advantages of 403(b) plans

### Tax advantages for employees

As with many other types of retirement plans, employees who participate in a 403(b) plan can enjoy significant tax benefits, including the following:

- Pretax contributions: Employees' salary-reduction contributions to a 403(b) plan are made on a pretax basis. The contribution is taken directly from the employee's salary and invested in the 403(b) plan before any taxes are withheld. This means that the amount each employee defers to the plan is not included in his or her gross income. The employee pays less current income tax because his or her taxable income is lower than it would otherwise be.
- Roth contributions: Qualified distributions of an employee's Roth contributions (if permitted by the plan) and earnings are tax free.
- Tax-deferred growth: Funds held in a 403(b) plan grow on a tax-deferred basis. Any earnings on plan investments are not taxable as long as they remain in the plan. Only when an employee begins to receive distributions from the plan will he or she pay income tax on the earnings. Depending on investment performance, this creates the potential for more rapid growth (and a larger retirement fund) than money invested outside a tax-deferred plan.
- Possible tax credit: Employees who participate in a 403(b) plan may qualify for a partial income tax credit for amounts deferred to the plan. The amount of the tax credit (if any) is based on the employee's annual gross income and federal income tax filing status.

**Tip:** Salary-reduction contributions (but not employer contributions) are generally subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) payroll taxes.

## No employer tax deduction

With many types of employer-sponsored retirement plans, the employer's contributions to the plan are tax deductible for federal income tax purposes.

Contributing to the plan can therefore reduce the employer's taxable income, saving money in taxes. However, any employer that is eligible to have a 403(b) plan generally does not pay any federal income tax in the first place. This means that deductibility of contributions is typically not an issue for such employers. In addition, payments to exempt governmental deferred compensation plans may be exempt from both FICA and FUTA. Consult a tax advisor for details.

## Other advantages of 403(b) plans

### You are not required to contribute to the plan

As discussed, depending on the type of 403(b) plan, you can set up the plan to be funded entirely through salary-reduction contributions by your employees. (This would be a salary-reduction plan, as opposed to an employer-funded plan--see above for details.) Consequently, it is possible to adopt a 403(b) plan without incurring any additional costs for employee compensation. In this case, the only additional costs involved would be for plan installation and administration. A 403(b) plan funded largely or solely by salary-reduction contributions may actually reap some savings to you as a result of lower state or local (but not federal) payroll taxes.

### Participants may access their benefits while still employed

Section 403(b) plans are subject to similar restrictions on "in-service" withdrawals as other types of employer-sponsored retirement plans. (An in-service withdrawal is a distribution while the plan participant is still working for the employer.) The IRC generally prevents a 403(b) plan participant from withdrawing salary-reduction contributions and related earnings until the participant reaches age 59½, retires or otherwise separates from the employer's service, dies, or becomes disabled. There is an exception, however, for financial hardship.

Under this exception, you can allow participants who demonstrate "immediate and heavy financial need" to make hardship withdrawals from the 403(b) plan. You are not required to make in-service hardship withdrawals available but, by allowing such withdrawals, you may encourage employee participation. However, like all 403(b) plan distributions, hardship withdrawals will generally be subject to federal and state income tax. Such withdrawals may also be subject to a federal 10 percent early withdrawal penalty tax if the participant is under age 59½. See Premature Distribution Rule. Finally, only salary-reduction contributions (not the earnings on those dollars) may be withdrawn in the event of hardship.

**Tip:** In general, a 403(b) plan can also permit a hardship withdrawal if the hardship is incurred by the employee's spouse or dependent. The Pension Protection Act of 2006 expands this rule,

permitting a distribution if the hardship is incurred by the employee's designated plan beneficiary.

**Tip:** The Pension Protection Act of 2006 also lets Section 403(b) plans make "qualified reservist distributions." A qualified reservist distribution is a distribution: (1) To a reservist or national guardsman ordered or called to active duty after September 11, 2001, for a period in excess of 179 days or for an indefinite period, and (2) That's made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after active duty ends (or, if later, the two year period beginning August 17, 2006) make one or more contributions to an IRA in an aggregate amount not to exceed the amount of the qualified reservist distribution. The dollar limitations otherwise applicable to contributions to IRAs don't apply to, and no deduction is allowed for, these contributions. Qualified reservist distributions are exempt from the 10% early distribution penalty tax.

Another (often better) way that you can allow a needy plan participant to access his or her money in a 403(b) plan is by allowing participant loans. Typically, a loan provision will enable plan participants to borrow a portion of their vested benefits at a reasonable interest rate. This can be an especially valuable feature to encourage employee participation in the plan because, in contrast to a hardship withdrawal, a loan will generally not be taxable or subject to the early withdrawal penalty tax (assuming that the loan is repaid on time and all other requirements are met). However, many 403(b) custodial accounts do not provide loans to participants (although the IRC allows loans from such accounts).

## Creditor protection

Funds held in a 403(b) plan are fully shielded from your employee's creditors under federal law in the event of the employee's bankruptcy. If your 403(b) plan is covered by ERISA, plan assets are also fully protected under federal law from the claims of both your employee's and your creditors, even outside of bankruptcy.

## Disadvantages of 403(b) plans

### Reporting, disclosure, and other requirements may apply to 403(b) plans

Although 403(b) plans are nonqualified plans, the reporting, disclosure, and other requirements that apply to qualified retirement plans under Title I of ERISA also apply to some 403(b) plans. See 403(b) plans and ERISA, above.

### Plan investment choices may be limited

With 403(b) plans, the investment choices available to participants are fairly limited. The IRC generally allows only annuity contracts (fixed or variable annuities) or mutual fund custodial accounts to be used as funding vehicles for 403(b) plans. Certain types of life insurance contracts are also permitted. In the

case of mutual fund custodial accounts, there may be a limited selection of funds to choose from. By contrast, IRAs and other types of employer-sponsored retirement plans can (and often do) provide a wider range of investment choices. For example, some 401(k) plans allow participants to invest a portion of their balance in the stock of the employer company.

For some employees, a lack of investment options may be a factor in their decision about whether to participate in a 403(b) plan. (Other employees, especially those who lack investment knowledge, may actually prefer a limited selection.) To encourage employee participation, some 403(b) plans in recent years have been offering more investment choices and flexibility to allocate money among the choices offered. Some plans even give participants multiple funding agents to choose from. Again, however, the investment restrictions imposed by the tax code present a challenge to employers trying to expand their employees' options.

**Tip:** Section 403(b) plans maintained by churches may offer any of the above investment options permitted by the tax code, as well as "retirement income accounts." A retirement income account is a defined contribution program established by a church or other religious organization for the purpose of holding employees' retirement benefits, and eventually distributing those benefits to employees. In addition, investment of 403(b) plan contributions in a stable value fund may be possible under certain circumstances. Seek professional advice regarding these alternate investment options.

## How to set up a 403(b) plan

### Have a written plan developed for your organization

The establishment of a 403(b) plan is generally not subject to the qualified plan rules. However, some 403(b) plans are subject to ERISA, and consequently require a written plan document. In either case, it is advisable as a matter of good policy to draft and adopt a 403(b) plan document. 403(b) plan documents similar to qualified plan prototype documents are usually available from your 403(b) vendor. To ensure compliance with the rules governing 403(b) plans (e.g., ERISA requirements, if applicable), you may want to obtain the assistance of a retirement plan specialist.

### Have participants complete salary-reduction forms

Unless your 403(b) plan will be exclusively employer funded, you need to have plan participants complete salary-reduction forms before the plan's effective date so that salary-reduction elections will be immediately effective. An employee may generally make or modify a salary-reduction election at any time before the affected compensation would otherwise become payable. The employee's salary-reduction election specifies how much he or she will contribute to the 403(b) plan from each paycheck. The contribution amount is typically expressed as a percentage of the employee's pretax compensation.

## Questions & Answers

### What employees are eligible to participate in a 403(b) plan?

Generally, all employees of an eligible employer must be allowed to participate in the salary-reduction portion of a 403(b) plan. As an employer sponsoring a 403(b) plan, however, you may generally opt to exclude certain employees, including:

- Employees who normally work fewer than 20 hours per week
- Employees who participate in another eligible deferred compensation plan, such as a 401(k) plan or a Section 457 plan
- Employees who are nonresident aliens with no U.S. source income
- Certain employees who are students and work for a university

You may establish different eligibility rules for the employer-funded portion of a 403(b) plan as long as the plan satisfies the coverage requirements of Internal Revenue Code section 410(b). In general, you can exclude the employees described above (other than those who participate in another eligible deferred compensation plan) as well as employees who haven't reached age 21 or completed a year of service (two years of service if your plan immediately vests employer contributions) and certain union employees.

In addition, independent contractors are not considered employees, and are therefore generally not eligible to participate in a 403(b) plan. The following example may help clarify the distinction between an employee and an independent contractor.

Example(s): Hal, a doctor who operates as an unincorporated sole practitioner, contracts with ABC Hospital to perform a specialized medical service. The contract provides that Hal (1) determine when and how frequently he will perform the services, (2) be entitled to all fees for medical services rendered to patients, and (3) be responsible for maintaining professional liability insurance and other expenses of the medical practice. Hal also offers similar services under similar conditions to other hospitals, and, in fact, signs up several hospitals under those conditions. The combination of these factors strongly indicates that Hal is an independent contractor and not an employee. Consequently, Hal is not eligible to participate in the 403(b) plan of ABC Hospital.

**Tip:** Notice 89-23 provides three safe harbors that a plan can use to establish compliance with the IRS nondiscrimination rules that apply to 403(b) plans, including the 410(b) coverage requirements. Consult a retirement plan specialist for more information.

### Can an employee who makes salary-reduction contributions to a 403(b) plan also make tax-deductible contributions to a traditional IRA?

Possibly. In most cases, when a traditional IRA owner is not covered by an employer-sponsored retirement plan, his or her contributions to the traditional IRA are fully tax deductible for federal income

tax purposes. However, when the traditional IRA owner (or his or her spouse) is covered by such a plan (including a 403(b) plan), his or her ability to make tax-deductible IRA contributions may be limited or even phased out entirely. The amount of the tax deduction (if any) would depend on the IRA owner's federal income tax filing status and modified adjusted gross income for the year.

### Can an employee who makes salary-reduction contributions to a 403(b) plan also contribute to a Roth IRA?

Yes, if the employee's compensation doesn't exceed certain limits. Participation in a 403(b) plan has no impact on an employee's ability to contribute to a Roth IRA.

### When do employees vest in their 403(b) plan accounts?

Vesting is the process by which participants in a 403(b) plan or other retirement plan earn the right to benefits under the plan.

A 403(b) plan participant is immediately 100 percent vested in all amounts contributed via salary reduction (i.e., the participant's own contributions) and any investment earnings on those amounts. With respect to employer contributions (either matching or nonelective contributions), participants need not be immediately vested. Those plans that provide employer contributions, however, are generally subject to minimum vesting standards under ERISA.

Those standards generally require that employer-matching contributions either vest 100 percent after three years of service ("cliff vesting"), or vest 20 percent after two years of service, increasing by 20 percent per year until 100 percent vesting is achieved after six years ("graded" or "graduate" vesting). Employer contributions other than matching contributions (i.e., nonelective contributions) generally must vest 100 percent after five years of service, or vest 20 percent after three years of service, increasing by 20 percent per year until 100 percent vesting is achieved after seven years. Of course, for either matching or nonelective contributions, an employer's vesting schedule can always be less (but not more) restrictive than ERISA's standards. Special rules apply to governmental and church plans.

**Caution:** Effective for contributions in plan years beginning after December 31, 2006, the Pension Protection Act of 2006 provides that all employer contributions to Section 403(b) plans must vest: (1) 100 percent upon the completion of three years of service, or (2) 20 percent for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service. Prior to the Pension Protection Act, this faster vesting applied only to employer matching contributions. This provision doesn't apply to an employee until he or she has an hour of service after the effective date. Further, when applying the new vesting schedule, service before the effective date is taken into account. A later effective date applies to certain collectively bargained plans.

**Tip:** Although employers with 403(b) plans are allowed to impose vesting requirements relating to employer contributions, many employers do not because they would rather avoid the

additional administration. Employers that want to have vesting requirements are typically more likely to use a 401(k) or other qualified plan.

### Do you need to have the IRS approve your 403(b) plan?

You do not need to obtain IRS approval of your 403(b) plan.

### Is a 403(b) plan subject to the required minimum distribution rules?

Yes. Participants in a 403(b) plan are generally subject to the same required minimum distribution rules that apply to IRAs and most employer-sponsored retirement plans. Required minimum distributions are amounts that a participant must withdraw annually from his or her plan account, beginning no later than April 1 of the year following the year in which age 70½ is reached (or, if later, April 1 of the year following the year of the participant's retirement from the employer maintaining the plan).

**Tip:** 403(b) account balances that existed on December 31, 1986 ("old money") are not subject to the age 70½ distribution requirement. However, any post-1986 earnings on such a balance, and any new contributions after 1986, are. Distributions from the 12/31/86 balance must start at age 75. Any distributions in excess of required distributions are deemed to reduce the 12/31/86 balance.

**Caution:** December 31, 1986, balances that are transferred to another 403(b) plan in a plan-to-plan transfer will retain their grandfathered status. However, if an employee receives a distribution and then makes a rollover (including a direct rollover) to another 403(b) plan, that grandfathered status will be lost. Refer to Treasury Regulation Section 1.403(b)-3 for further information.

### Can funds in a 403(b) plan be rolled over?

Yes. A participant in a 403(b) plan may generally roll over all or part of his or her eligible rollover distribution to a traditional IRA or to another 403(b) plan, an employer qualified plan, or a 457(b) plan that accepts rollovers. Any distribution that is (1) one of a series of substantially equal periodic payments made at least annually, (2) a required minimum distribution, or (3) a hardship distribution is not eligible for rollover.

**Caution:** Roth 403(b) dollars can only be rolled over into another Roth 403(b) account, a Roth 401(k) account, or a Roth IRA. The period of time the funds are held in the Roth 403(b) plan counts when determining whether a subsequent distribution from the Roth 401(k) or Roth 403(b) plan (but not Roth IRA) receiving the rollover is a tax-free qualified distribution.

**Tip:** Beginning in 2008, 403(b) plan distributions can be rolled over directly into a Roth IRA, subject to the same income limits that apply to rollovers from traditional IRAs to Roth IRAs (\$100,000 for both single taxpayers and married taxpayers filing a joint return). (Note: these income limits are repealed beginning in 2010.) The taxable portion of the distribution must be included in the participant's gross income in the year of the rollover. However, for rollovers in

2010, the taxable amount will be recognized pro-rata in 2011 and 2012 unless the participant elects to recognize the entire taxable amount in 2010.

A rollover can be direct or indirect. With a direct rollover, the funds are moved directly from the 403(b) plan into an IRA or other employer plan. With an indirect rollover, the participant first receives the distribution from the old 403(b) plan, and then rolls it over into an IRA or other employer plan within 60 days. In either case, as long as the rollover follows all rollover rules, it will be treated as a tax-free transfer of assets. (In the case of an indirect rollover, a mandatory 20 percent federal income tax withholding will apply. The participant will then receive a credit for tax withheld when he or she files a federal income tax return for the year.)

**Caution:** The 60 day indirect rollover rules can't be used to roll over the non-taxable portion of a 403(b) distribution to a qualified employer plan or to another 403(b) plan. The direct rollover rules must be used. In addition, the receiving plan must agree to separately account for the non-taxable dollars and earnings.

### **Can funds in a 403(b) plan be transferred to another 403(b) investment while a participant is still employed ("90-24" transfers)?**

As a result of a 1990 revenue ruling (IRS Revenue Ruling 90-24) a participant in a 403(b) plan was able to transfer funds in his or her 403(b) plan to a separate account with a different financial institution--even if that institution was not one of the funding agents offered under the employer's 403(b) plan. The main advantage of being able to do a tax-free transfer was that it provided an option for 403(b) plan participants who were dissatisfied with the investment alternatives available through their employer's plan. This could be the case, for example, if those investments had performed poorly or carried high fees. By doing a transfer, the participant was able to move his or her money into better-performing or lower-cost investments with a different institution. These so-called 90-24 transfers are no longer permitted after September 24, 2007. After September 24, 2007, plans can permit tax-free transfers of assets from one 403(b) investment vehicle to another only if the requirements of the final regulations are satisfied. In general, the regulations limit transfers to 403(b) vendors approved by the plan.

The final regulations allow employees to make tax-free transfer of funds from one Section 403(b) investment vehicle to another only if the plan permits the transfer and certain other conditions are satisfied in order to facilitate compliance with tax requirements. Specifically, the new contract must include distribution restrictions that are at least as stringent as those imposed on the contract being exchanged, and the employer must enter into an agreement with the issuer of the new contract under which the employer and the issuer will from time to time in the future provide each other with certain information. This includes information concerning the participant's employment; information that takes into account other section 403(b) contracts or qualified employer plans, such as whether a severance from employment has occurred for purposes of the distribution restrictions and whether the hardship withdrawal rules in the regulations are satisfied; and any additional information that is required to satisfy other tax requirements, such as whether a plan loan constitutes a deemed distribution under section 72(p).

**Caution:** Participants should determine whether any surrender charges apply before transferring out of a 403(b) investment.

## Final 403(b) regulations

### In general

On July 24, 2007, the IRS issued comprehensive final regulations covering almost all aspects of 403(b) plan taxation and administration. The regulations are generally not effective until January 1, 2009 (later for certain collectively bargained plans), but taxpayers can rely on the regulations before then if the reliance is on a consistent and reasonable basis.

### Written plan document requirement

The regulations require that all 403(b) plans be maintained pursuant to a written plan document (or documents) that contains all the material terms and conditions for benefits under the plan. Plans can incorporate other documents by reference, including the 403(b) insurance policy or custodial account. Any documents incorporated by reference become part of the plan. If a plan incorporates other documents by reference, then, in the event of a conflict with another document (for example, an annuity contract), except in rare and unusual cases, the plan document would govern. In the case of a plan funded through multiple 403(b) issuers, the preamble to the regulations indicates that the IRS expects the employer to adopt a single plan document to coordinate administration among the various issuers, rather than having a separate plan document for each issuer.

A plan can allocate to the employer or another person (but not employees) the responsibility for performing functions to administer the plan, including functions to comply with Section 403(b). Any allocation must identify who is responsible for compliance with IRC requirements that apply based on the aggregated contracts issued to a participant, including the requirements for obtaining plan loans and hardship withdrawals.

**Tip:** The IRS expects to issue model plan provisions that may be used by public school employers to comply with the written plan document requirement.

### Distributions and transfers

The regulations describe the rules governing the distribution and transfer of 403(b) plan assets in great detail. The following are some key provisions:

- Employer contributions to 403(b) plans funded with annuity contracts will be subject to the same distribution rules that apply to qualified profit-sharing plans (currently, these contributions are not subject to any mandatory distribution restrictions).

- The 401(k) hardship withdrawal rules (including, apparently, the six-month suspension requirement for plans that use the "deemed hardship" safe harbor) will apply to employee 403(b) salary deferrals.
- Employers will be required to provide written explanations of the rollover rules for eligible distributions, and mandatory 20 percent withholding will apply to amounts not directly rolled over to an eligible employer plan or IRA (these are the same rules that currently apply to qualified plan distributions).
- A participant who leaves an employer maintaining a 403(b) plan and goes to work for a related employer that is not eligible to maintain the plan (for example, where an employee transfers from a tax-exempt employer to a for-profit subsidiary of that employer) will be eligible to receive a distribution on account of "severance from employment."
- The regulations allow an employer to terminate a 403(b) plan and distribute benefits to plan participants if certain conditions are satisfied. This issue has been at best unclear until now.
- The regulations clarify that after-tax employee contributions are not subject to any in-service distribution restrictions.
- "90-24 transfers" are no longer permitted after September 24, 2007. The regulations provide that an employee can make an in-plan transfer of assets from one 403(b) vendor to another only if the plan permits the transfer and the new vendor is also one approved by the plan. The regulations also permit an employer to transfer 403(b) assets from one vendor to another without employee consent. Finally, assets can be transferred from one 403(b) plan to a different 403(b) plan if the participant is an employee or former employee of the employer sponsoring the receiving plan, and certain other requirements are satisfied.

## Contributions

- Employers must transmit plan contributions to the insurer or custodian within a reasonable period of time (for example, within 15 business days in the case of employee salary deferrals).
- For plans sponsored by tax-exempt employers, employer contributions and employee after-tax contributions will be subject to the same nondiscrimination rules that apply to qualified plans. The "good faith" compliance standard contained in Notice 89-23 will no longer apply. (Governmental and church plans are generally exempt from discrimination testing, as are employee salary deferrals.)
- The "universal availability" rule (which requires, with limited exceptions, that all employees be permitted to make pre-tax deferrals) will apply separately to each common law employer (even if the employers are members of the same controlled group), and in some cases can even be applied separately to geographically distinct and independent operating units of an employer. (The universal availability rule does not apply to church plans.)
- IRS Notice 89-23 had allowed, pending further IRS guidance, the exclusion of the certain classes of employees for purposes of the universal availability rule, including employees who are covered by a collective bargaining agreement and certain visiting professors. In general, these exclusions are no longer permitted under the final regulations, subject to transition rules.

- The regulations clarify how the age 50 and special 403(b) catch-up contribution rules interact with each other, and with the section 415 annual contribution limits.

## Funding

403(b) plans cannot be funded with life insurance or endowment contracts (except for retirement income contracts used by church plans). Contracts issued on or before September 24, 2007 are grandfathered.

## Miscellaneous

- Section 403(b) provides that all contracts purchased for an employee by an employer must be treated as a single contract. As a result, if a contract fails to satisfy certain Section 403(b) requirements, then generally not only that contract but also any other contract purchased for that individual by that employer would fail to be a contract that qualifies for tax-deferral under Section 403(b).
- The final regulations clarify that if an employer fails to have a written plan, any contract purchased by that employer would not be a Section 403(b) contract. Similarly, if an employer is not an eligible employer for purposes of section 403(b), none of the contracts purchased by that employer is a Section 403(b) contract. And if a plan subject to Section 403(b)'s nondiscrimination rules fails to satisfy those rules, none of the contracts issued under the plan would be Section 403(b) contracts.
- The final regulations also provide that an operational failure, other than those described above, that is solely within a specific contract generally will not adversely affect the contracts issued to other employees, if those contracts satisfy Section 403(b)'s requirements.
- The regulations formalize the IRS position that separate tax-exempt employers may be treated as members of a controlled group if they share 80 percent or more of the same directors or trustees, or if one entity controls 80 percent or more of the other entity's directors or trustees. The regulations also allow separate tax-exempt employers to voluntarily elect to be treated as a single employer in some cases. These rules are important for applying the nondiscrimination, section 415, catch-up, and minimum distribution rules. Regulations have not yet been issued covering the controlled group rules that apply to governmental plans. (The controlled group rules do not apply to church plans. The IRS intends to issue additional controlled group guidance for public schools.)
- The regulations confirm that 403(b) plans can distribute assets to an alternate beneficiary under a qualified domestic relations order (QDRO), regardless of whether the employee has severed employment or is otherwise currently eligible to receive a distribution under the plan.

## ERISA considerations

In general, Section 403(b) plans other than governmental and church plans are subject to the Employee Retirement Income Security Act of 1974 (ERISA). However, in 1979 the DOL issued a safe harbor that

allows plans funded solely by employee elective deferrals to avoid ERISA if the employer's involvement in the operation of the plan is limited.

The 403(b) regulations generated concern that an employer's actions required to comply with the regulations, including the requirement that the employer maintain a written plan document, might result in sufficient "involvement" to cause plans previously exempt from ERISA's coverage to lose their safe harbor protection.

In response, on July 24, 2007, the Department of Labor issued Field Assistance Bulletin No. 2007-02 addressing this issue. The Field Directive clarifies that the DOL safe harbor is still available, but because employers can comply with the regulations in a number of ways the facts and circumstances of each case will control. However, the Directive indicates that the following activities will not generally cause the employer's involvement to be significant enough to subject the plan to ERISA:

- maintaining a written plan document
- conducting administrative reviews of the 403(b) plans structure and operation for tax compliance defects (including discrimination testing and compliance with contribution limits); fashioning and proposing any necessary corrections; working with third parties to correct tax defects; and keeping records of its activities
- providing employment information to contract providers, such as an employee's address, compensation, hours of service, etc.
- allocating in the plan document responsibility for performing administrative functions to other parties
- periodically reviewing the documents that make up the plan for conflicting terms and compliance with the IRC and regulations
- limiting contract exchanges to providers who have adopted the employer's plan (assuming the providers offer employees a reasonable choice of contracts), or limiting the number of providers the plan will forward elective deferrals to if employees can transfer their funds to non-plan providers as provided in the final regulations
- terminating the 403(b) plan in accordance with the regulations

The DOL cautions that an employer cannot, however, consistent with the safe harbor, have responsibility for, or make, discretionary determinations in administering the 403(b) plan. Examples of such discretionary determinations are authorizing plan-to-plan transfers, processing distributions, satisfying applicable qualified joint and survivor annuity requirements, and making determinations regarding hardship distributions, qualified domestic relations orders (QDROs), and eligibility for or enforcement of loans. Further, negotiating with contract providers to change the terms of their products for other purposes, such as setting conditions for hardship withdrawals, would be a form of employer involvement outside the safe harbor.

## Effective date and transition rules

The final regulations are generally applicable for taxable years beginning after December 31, 2008. Because individuals will almost uniformly be on a calendar taxable year, the regulations will generally take effect on January 1, 2009. However, the regulations include a number of transition rules:

- For collectively bargained plans, the regulations generally don't apply until the earlier of: (1) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after July 26, 2007; or (2) July 26, 2010
- In addition, if a plan excludes employees covered by a collective bargaining agreement from eligibility to make elective deferrals on July 26, 2007, the plan is permitted to continue that exclusion until the later of (i) the first day of the first taxable year that begins after December 31, 2008, or (ii) the earlier of (I) the date that such agreement terminates (determined without regard to any extension thereof after July 26, 2007) or (II) July 26, 2010. In the case of a governmental plan (as defined in section 414(d)) for which the authority to amend the plan is held by a legislative body that meets in legislative session, the plan is permitted to continue the exclusion until the earlier of: (i) the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009; or (ii) January 1, 2011
- The rule prohibiting distributions from 403(b) annuity contracts before the earlier of the participant's severance from employment or the occurrence of some other event does not apply to contracts issued before January 1, 2009. In addition, the regulations provide that a plan amendment adopted before January 1, 2009, to comply with these rules does not violate the anti-cutback rules of section 204(g) of ERISA
- Plans that currently permit contract exchanges pursuant to Rev. Rul. 90-24 can continue to allow those transfers only through September 24, 2007. Presumably, contract exchanges after that date would need to conform to the provisions of the final regulations

Taxpayers can rely on the final regulations before the effective date if the reliance is on a consistent and reasonable basis.

## Disclosures

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