Big Changes Coming to Your 403(b) Plan

by John Cheek, CPA

Final regulations under IRC 403(b) were published last year (7/26/07), implementing and expanding proposed regulations first issued in 2004. These final regs are the first major change to 403(b) regulations since 1964. Since much of the new regs. are effective for tax years beginning after 12/31/08, CPAs and advisors should begin now to brief their clients on the changes and get compliance efforts underway.

First, some background: IRC 403(b) allows an exclusion from income of certain employer nonelective contributions and employee elective salary-reduction contributions, for public school and 501(c)(3) employers. Funding is limited to the purchase of annuity contracts, custodial accounts invested solely in mutual funds, and retirement accounts for church employees or ministers. There are numerous differences between 403(b) plans and other defined contribution plans, such as 401(k) plans, but the Pension Protection Act of 2006 and the new regs. under 403(b) are a big step in narrowing those differences.

Written Plan Requirement

Most notable in the new regs is the requirement that the 403(b) contracts be issued under a written plan that, in both form and operation, complies with IRC 403(b) and the new regulations. The written plan can incorporate numerous other documents by reference, but there must be a central document that facilitates the allocation of responsibilities among the employer, the issuer(s) of the contracts, and any other parties involved in implementing the plan. If a plan incorporates other documents by reference, it is important to ensure that there are no conflicts between the central document and the incorporated documents.

The written plan must contain all of the material terms and conditions for eligibility, benefits, limitations, contracts available under the plan, and the time and form under which benefit distributions will be made. The plan can contain certain optional features such as hardship withdrawals, participant loans, plan-to-plan or contract-to-contract transfers, or acceptance of rollovers to the plan.

ERISA Impact

Governmental plans, and nonelecting church plans, are not subject to to Title I of ERISA. Other 403(b) plans are also not subject to Title I if they are not “established or maintained” by an employer. Many have worried that the extra step of creating a written plan document that complies with the new regs is enough to cause the plan to be “established or maintained” by the employer, and thus subject to Title I. The DOL has issued guidance, FAB 2007-02, that describes some of the functions an employer can perform that do not automatically cause the plan to be established or maintained by an employer. These generally include clerical functions, collecting and remitting employee contributions, verifying certain data needed by 403(b) vendors, and monitoring compliance with the law. Other functions, such as making discretionary determinations, negotiating contract terms, or setting conditions for hardship withdrawals, would likely be too much employee involvement and probably cause the plan to be an ERISA plan.

Exchanges

The regs allow three types of nontaxable transfers of 403(b) funds, including a) a contract exchange– switching investments within the same plan, b) a plan-to-plan exchange to another employer's 403(b) plan, and c) a transfer to purchase permissive service credits or repay a governmental defined benefit plan. Transfers that do not fit one of these three categories are taxable distributions, if a distributable event has occurred, or a taxable conversions to a nonqualified annuity, if no distributable event has occurred.

Universal Availability and Nondescrimination

If any employees of an eligible employer can make elective deferrals to a 403(b) plan, all employees of that employer must be permitted that same election. If the plan allows any employee to designate elective deferrals as Roth contributions, all employees must also have that option. All employees must have an *effective opportunity* to participate. This means that, at least once a year, employees can make, or change, a cash or deferral election. And the employer can not offer certain other benefits that depend on whether a participant does, or does not, make an elective deferral.

Certain classes of employees can be excluded:

> Employees eligible under other deferral plans, including 403(b), 457(b), or 401(k) plans,
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> non-resident aliens,
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> students, and
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> those who normally work less than 20 hours per week.

In determining if an employee normally works less than 20 hours per week, at the hiring date the employer must reasonably expect employee to work less than 1000 hours for ensuing 12-month period, and for every subsequent 12 month period the employee must have worked less than 1000 hours in the preceding 12-month period.

Also, individuals under a vow of poverty and certain visiting professors, who are technically not considered employees of the 403(b) employer, can be excluded.

If a nongovernmental plan provides for nonelective contributions, those nonelective contributions are now subject to discrimination testing under 401(a)(4) and 401(m) testing as in a qualified plan.

Failure to Satisfy 403(b)

The effects of failing to satisfy 403(b) depend on the nature of the failure. Since contracts are aggregated, a failure of an individual contract to satisfy 403(b) requirements would affect all contracts purchased by that employer for that individual. A failure to operate in accordance with the terms of the plan adversely affects all contracts purchased by the employer for the individual or individuals with respect to whom the operational failure occurred, but would not necessarily affect contracts for other individuals. However, a failure

that is not operational is not limited to specific employees, so it would affect all contracts issued under the plan. These would include a failure to have a written plan that satisfies 403(b) in form, a nondiscrimination failure, or an employer eligibility failure.

Contribution Limits

The written plan must provide that contributions are limited under IRC §402(g) and IRC §415. For 2008, §415 limits all amounts contributed by an employer to purchase annuity contracts for a participant to $46,000. For 2008, §402(g) limits elective deferrals to $15,500, applied on an aggregated basis to all 403(b) contracts of an employer for a participant. The plan may provide that contributions in excess of the 402(g) limits will be distributed to participants, including earned income, no later than April 15. If the §415 limit is exceeded, the excess may be treated as a nonqualified annuity, if the contract issuer holds the excess in separate accounts.

A 403(b) plan may provide for "catch-up" contributions for participants who are age 50 by year end. For 2008, §415(v) limits catch-up contributions to $5,000.

For employees with at least 15 years of service with a qualified employer, there is also a special 403(b) catch-up limit. This special provision increases the annual deferral limit under 402(g) by the lowest of i) $3,000, ii) $15,000 minus prior year "special" contributions and designated Roth contributions, or iii) $5,000 times years of service, minus total prior year elective contributions. Qualified employers, for this provision, are schools, hospitals, health and welfare agencies, or church related organizations.

Effective Dates

The final regs are generally effective for taxable years beginning after December 31, 2008, with some exceptions. For a plan maintained pursuant to collective bargaining agreements in effect on July 27, 2008, the regs do not apply until the last such CBA expires, or July 26, 2010 if earlier. For a plan maintained by a church related organizations, the regs do not apply until after December 31, 2009.

Certain provisions have delayed effective dates. Plans that previously excluded certain classes of employee, as allowed under the 2004 proposed regs, but not allowed under the 2008 final regs, have until tax years beginning January 1, 2010 to include those groups.

Start Now

There is not much time to draft that written plan document, so employers should get the process started as soon as possible. Model plan provisions published at Revenue Procedure 2007-71 may help, and some 403(b) annuity issuers may provide model language, also.