Legal Alert:
Final Section 403(b) Regulations Are Announced

July 23, 2007

On July 26, 2007, final regulations under Section 403(b) – providing for retirement savings through annuity contracts and mutual fund custodial accounts for employees of public schools and tax-exempt organizations and retirement income accounts for church employees and certain ministers – will be published in the Federal Register. (Click here for a copy of the regulations.) These regulations, which were proposed in November 2004, represent the first comprehensive guidance issued under Section 403(b) since 1964. Significant changes from the proposed regulations include the following:

- The final regulations are generally effective for tax years beginning after December 31, 2008, with special rules for collectively bargained plans and certain provisions of the regulations. (The proposal originally would have taken effect in 2006.) Taxpayers generally may rely on the final regulations in advance of the applicable effective date provided they do so on a reasonable and consistent basis.

- The final regulations reflect statutory changes from ERISA (enacted in 1974) through the Pension Protection Act (enacted in 2006, after the proposed regulations were issued).

- The final regulations retain, with refinements, the "written plan" requirement announced in the proposed regulations, reflecting the government's ongoing concerns with Section 403(b) tax compliance in general and designation of responsibility for such compliance in particular. Under the final regulations, the "written plan" may incorporate other documents by reference, such as annuity contracts or custodial account agreements (which as a result of such incorporation will become part of the "plan"), although it is "expected" that a single document will be adopted for any program involving multiple investment providers. The "written plan" may allocate administrative and tax compliance responsibilities (which in some respects cut across all investment vehicles) to either the employer and/or third parties, but generally may not allocate compliance responsibility to participants. The IRS and Treasury are to publish model plan provisions for public schools to adopt, in advance of the effective date of the regulations.

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- According to the preamble, the Department of Labor continues to believe that the Section 403(b) plans of nongovernmental employers can satisfy the final regulations without necessarily becoming subject to Title I of ERISA, and will issue a field assistance bulletin elaborating those views (which is not publicly available at the time of writing of this alert).

- The final regulations somewhat liberalize the conditions under which investment products may be exchanged on a nontaxable basis, which under the proposed regulations were limited to cases where a new product was being provided under the plan. This change is positioned in the preamble as allowing exchanges having characteristics associated with Rev. Rul. 90-24 transfers, but under rules similar to those applicable to qualified plans. (Exchanges consistent with Rev. Rul. 90-24 are expressly permitted for 60 days after publication of the final regulations in the Federal Register and that ruling is to be declared obsolete in a subsequent announcement; it is not entirely clear what rules are to apply thereafter until the January 1, 2009, effective date of the final regulations.) Under the final regulations, the exchange is permitted on a tax-free basis if (i) the plan permits the exchange, (ii) the participant's accumulated benefit after the exchange is at least as great as such benefit before the exchange, (iii) the transferee product imposes distribution restrictions at least as stringent as those applicable under the transferor product and (iv) the employer and transferee issuer enter into an agreement to provide to each other certain information related to tax compliance requirements. The Service is authorized to issue revenue rulings allowing other procedures with tax compliance safeguards, although reliance on employee certifications generally will not suffice.

- The final regulations also conditionally permit plan-to-plan transfers if the participant is a current or former employee of the employer (or business of the employer) maintaining the recipient plan and if certain other conditions are met. (The proposed regulations would have limited such transfers to cases where the participant was a current employee of that employer.) Transfers among Section 403(b) programs and Section 401(a) or 457(b) plans are not permitted, except in connection with the purchase or repayment of permissive service credits in respect of governmental defined benefit plans.

- The final regulations generally adopt the proposed rules under the universal availability requirement for elective contributions and the nondiscrimination requirement for nonelective and employee after-tax contributions, including the general elimination of the Rev. Rul. 89-23 good faith reasonable standard. The special exceptions from the universal availability requirement for collectively bargained employees, visiting professors, government employees who make one-time

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elections, or employees working under a vow of poverty are also repealed, subject to (i) transition relief; (ii) treatment pursuant to pre-existing authority of certain individuals working under a vow of poverty as not "employees" subject to the universal availability requirement; and (iii) a rule permitting a "home" university conditionally to continue elective contributions by its faculty visiting at other institutions.

- The final regulations continue to prohibit the use of life insurance, endowment, health or accident, property, casualty or liability insurance policies as Section 403(b) funding vehicles, except if issued before 60 days after the publication of the final regulations in the Federal Register. (In the proposed regulations, the grandfather date was February 14, 2005.) Annuity contracts may include death benefits as part of the contract, to the extent permitted under the incidental benefit rule and otherwise in accordance with Section 403(b).

- The final regulations retain the requirement (as in a Section 401(a) profit-sharing plan) that distribution may be made only on earliest of severance from employment or the occurrence of a stated event, subject to certain exceptions including a new exception for amounts attributable to after-tax contributions. Contracts and custodial accounts issued before January 1, 2009, are grandfathered, and relief from the ERISA Title I anti-cutback rule is provided for pre-2009 amendments to comply with these rules.

- Severance from employment that permits a distribution of elective contributions includes cessation of employment by an eligible employer (even if the individual continues to work for the same controlled group) or in a capacity allowed under Section 403(b) (even if the individual continues to work in a different capacity for the same employer).

- The final regulations retain the general approach of, but modifies in a number of specific respects, the proposed rules regarding controlled groups for tax-exempt entities, which apply not only for Section 403(b) purposes but also under Code Sections 414(b), (c), (m) and (o).

- The definition of a health or welfare service agency, which is among the employers allowed to take advantage of the special 403(b) catch-up for employees with at least 15 years of service, is expanded to include adoption agencies and agencies that provide either home health services, substance abuse assistance to individuals, or help to the disabled.

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- Final regulations are provided for elective contributions that are designated Roth contributions under a Section 403(b) program.

- The final regulations provide additional guidance on the failure to satisfy Section 403(b). *All contracts or accounts under an employer's program* are disqualified if the employer is not an eligible employer, if the written plan or nondiscrimination rules are not satisfied, or if the defect is otherwise not an operational failure. *Operational failures* solely within a single contract or account will not adversely affect other participants, but (except as provided under special rules for vesting conditions and excess contributions) will disqualify *all the contracts or accounts of the affected participant provided under the employer's program*. Contributions in excess of the Section 415 limits do not disqualify the entire contract or account and are treated as made to a separate arrangement taxed under Section 403(c), provided that the issuer maintains separate bookkeeping accounts for the Section 403(b) and Section 403(c) portions.

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