

## **HIGHLIGHTS OF THE FINAL 403(b) REGULATIONS** **AND WHAT THE CHANGES MEAN TO PLAN SPONSORS**

### ***What's All the Fuss About?***

- Extensive regulations governing 403(b) plans were issued by the IRS in July 2007—the first comprehensive guidance in 40 years. The guiding policy behind the regulations is to try and align the 403(b) plans historically offered by schools and non-profit organizations with 401(k) plans maintained by for-profit employers.
- Many 403(b) plans will now be more actively managed and will become subject to ERISA, so sponsors will need to implement plan governance procedures and fiduciary "best practices" in order to satisfy these rules.
- The regulations generally take effect **January 1, 2009**, with limited exceptions:
  - Church plans generally need to comply with the new regulations as of the first plan year beginning after December 31, 2009.
  - Collectively-bargained plans generally need to comply with the new regulations on the earlier of the date on which the CBA ends or July 26, 2010.

## ***A Plan Document Is Now Required***

| <b>Current Rules</b>   | <b>New Rules Under Final Regulations</b>  | <b>What The Changes Mean to Plan Sponsors</b>  |
|--|---|--|
| Only 403(b) plans that are currently subject to ERISA need to have a written plan.       | <i>All</i> 403(b) plans need to have a written plan document, whether they are subject to ERISA or not—or else the entire 403(b) plan will be disqualified.   | Review plan documents in 2008 and determine what changes need to be made by 12/31/08. (The IRS has issued a model plan document for use by public school districts.)   |
| 403(b) plans that are not currently subject to ERISA do not need to have a written plan. | The "plan" does not need to be one plan document. It is permissible to have a plan, insurance policies, annuity contracts, and custodial agreements.  | For plans with multiple service providers, the plan document will need to cross-reference the custodial agreements or annuity contracts.   |
|  | <p>The plan must reflect the material terms regarding:</p> <ul style="list-style-type: none"> <li>• Eligibility &amp; contributions</li> <li>• Applicable limits</li> <li>• Contracts available under the plan</li> <li>• Time and form of distributions</li> <li>• Optional provisions such as loans, hardships, transfers, and rollovers</li> <li>• Party responsible for the administration of the plan</li> </ul> | Implementation of a formal plan document is likely to signal a move toward active sponsorship of a plan, potential coverage under ERISA (discussed below), and the sponsor's consideration of a single vendor solution to 403(b) retirement planning needs, because of the need to coordinate information and limits from all contracts in order to appropriately administer contribution limits and optional features such as loans and hardship distributions. |

## ***New Rules About Regular Elective Contributions to 403(b) Plans***

| <b>Current Rules</b>  | <b>New Rules Under Final Regulations</b>   | <b>What The Changes Mean</b>   |
|---|--|--|
| <b><i>Amount</i></b>  |  |  |
| Elective contributions by employees are permitted on a pre-tax basis, up to the annual limit for such contributions—which is \$15,500 for 2008. | <p>Elective contributions by employees continue to be permitted on a pre-tax basis, as before.</p> <p>Employees must be able to start, stop or modify deferral elections at least once per year—what is now referred to as "effective opportunity".</p> <p>It is not permissible to condition any other benefit on whether the employee contributes to the 403(b) plan, other than matching contributions.</p> <p>Employees can designate elective deferrals as Roth contributions</p> | <p>Evaluate educational programs available to employees regarding the long-term value of participating in the 403(b) plan and saving for retirement on a tax-deferred basis.</p> <p>Provide annual notices to employees about their opportunity to make elective contributions to the plan and any restrictions on the period of time during which an election may be made.</p> <p>Work with vendors to ensure that their systems will permit elective contributions to be modified at least annually.</p> <p>Work with vendors to evaluate whether recordkeeping systems are in place in order to separately account for designated Roth contributions.</p> |

## New Rules About Regular Elective Contributions to 403(b) Plans (cont'd)

| Current Rules   | New Rules Under Final Regulations  | What The Changes Mean  |
|---|--|--|
| <b>Timing</b>   |  |  |
| Only 403(b) plans subject to ERISA are subject to DOL rules about the timely handling of participant contributions, which generally require that elective contributions be transferred to the plan by the earliest date on which they can be segregated from general business assets, but <i>no later</i> than 15 business days following the month in which the deferrals were withheld from employee paychecks. | <p><i>All</i> 403(b) plans have to remit pre-tax elective contributions by employees within a period of time that is "reasonable" for the proper administration of the plan.</p> <p>403(b) plans subject to ERISA must continue to meet the DOL rules, which may require remittance earlier.</p> | Evaluate payroll systems and work with payroll vendors (ADP, Paychex, etc.) in order to make sure that they can transfer employee elective contributions to the 403(b) plan custodian within these new timing rules. |

***New Rules About Regular Elective Contributions to 403(b) Plans (cont'd)***

| Current Rules  | New Rules Under Final Regulations   | What The Changes Mean  |
|--|---|--|
| <i>Universal availability</i>  |   |  |
| <p>No ADP testing rules apply because of the universal availability requirement:</p> <p>All employees who normally work at least 20 hours per week must be able to make elective deferral contributions to the plan, except (i) employees eligible to participate in certain governmental plans; (ii) non-resident aliens; (iii) students performing certain services; (iv) union employees covered by a CBA; (v) visiting professors; and (vi) certain employees subject to religious vows.</p> | <p>No ADP testing rules apply because of the universal availability requirement.</p> <p>The exceptions to the universal availability rule have been tightened up, and a bright-line test of 1,000 hours of service has been established. Now, an employee who normally works less than 20 hours per week can only be excluded if the employer expects the employee to work less than 1,000 hours in a 12-month period and the employee actually does work less than 1,000 hours during this period.</p> | <p>Evaluate the eligibility criteria imposed under the plan, and consider deleting exclusion of those who normally work less than 20 hours per week (for administrative simplicity).</p> <p>If 20 hour per week minimum is retained, review record-keeping systems to ensure that any excluded part-time employee who actually works more than 1,000 hours during a 12-month period becomes eligible to participate in the plan.</p> |

## New Rules About "Catch-Up" Contributions to 403(b) Plans

| Current Rules  | New Rules Under Final Regulations  | What The Changes Mean  |
|--|--|--|
| <i>"Regular" catch-ups</i>   |  |  |
| "Regular" age 50 catch-up contributions can be made by employees who are age 50 or older, on a pre-tax basis, up to annual limit (\$5,000 in 2008).  | "Regular" age 50 catch-up contributions and "special" catch-up contributions continue to be available.   | Provide educational information to catch-up eligible employees, so that they can maximize their retirement savings.  |
| <i>"Special" catch-ups</i>   |  |  |
| "Special" catch-up contributions can be made by employees of qualified organizations (educational organizations, hospitals, church-related organizations and health and welfare agencies) who have at least 15 years of full-time service. | <p>The "special" catch-up contributions for qualified employees are now available to more qualified organizations.</p> <p>"Special" catch up limit continues to equal the lesser of (i) \$3,000; (ii) \$15,000, reduced by the cumulative amount of "special" catch-up contributions made in prior years; or (iii) the excess of (\$5,000 x years of service) over the cumulative amount of elective deferrals made in prior years.</p> <p>Ordering rules are now clarified.</p> | Work with plan vendors to ensure that their recordkeeping systems have been updated in order to appropriately track contributions to reflect the new ordering rules: (i) regular elective deferral contributions; (ii) "special" 403(b) catch-up contributions; and (iii) "regular" age 50 catch-up contributions. |

## ***New Rules About Employer Contributions to 403(b) Plans***

| <b>Current Rules</b>  | <b>New Rules Under Final Regulations</b>  | <b>What The Changes Mean</b>  |
|---|---|---|
| <i>Non-Elective Contributions for Former Employees</i>  |   |   |
| An employer can contribute a non-elective employer contribution to a former employee through the end of the taxable year in which the employee terminates AND for the next 5 years. | Non-elective contributions for former employees based on imputed compensation are now limited to the lesser of the IRC Section 415 limit (\$46,000 in 2008) or 100% of the former employee's pay during his last year of service.   | Consider utilizing these non-elective contributions as a feature of executive pay, incentive or severance packages.   |
| <i>Nondiscrimination testing</i>  |   |   |
| Non-elective contributions are subject to testing, but 3 safe harbors exist.  | <p>Non-elective contributions are subject to the same nondiscrimination testing rules that apply to 401(k) plans (unless a governmental or church plan):</p> <ul style="list-style-type: none"> <li>• IRC 401(a)(4) nondiscrimination in amounts, benefits, rights, features</li> <li>• IRC 410(b) minimum coverage</li> <li>• IRC 401(a)(17) limit on includible compensation</li> </ul> | <p>Work with vendors and negotiate service agreements to ensure that they will obtain the necessary data and perform testing in a timely manner (including controlled group information necessary for testing).</p> <p>NOTE: Matching contributions continue to be permitted subject to ACP nondiscrimination testing under IRC 401(m).</p> |

## ***New Rules About Funding of 403(b) Plans***

| <b>Current Rules</b>  | <b>New Rules Under Final Regulations</b>  | <b>What The Changes Mean</b>   |
|---|---|--|
| <p>403(b) plans may have annuity contracts issued by insurance companies; custodial accounts invested in mutual funds; life, health or accident insurance policies; or property, casualty or liability insurance policies.</p> <p>Church plans can have retirement income accounts.</p> | <p>Funding limited to annuity contracts or custodial accounts, and contracts must provide for compliance with certain requirements, such as deferral limits, availability of direct rollovers, and minimum distributions.</p> <p>Any death benefit must be part of an annuity contract, and the incidental death benefit rules must be satisfied.</p> | <p>Confirm that any insurance policies issued prior to 9/24/07 can remain in force, but no new insurance policies can be issued after that date.</p> <p>For 403(b) plans that are actively sponsored and subject to ERISA, there is likely to be a movement toward developing investment policy statements and standards under which investment options are selected, monitored, evaluated, and ultimately terminated or replaced, depending on performance.</p> |



## New Rules About Distributions From 403(b) Plans

| Current Rules  | New Rules Under Final Regulations   | What The Changes Mean  |
|--|---|--|
| <i>Distributions of Elective Deferrals</i>   |   |  |
| <p>Elective deferrals (including catch-up contributions) can be distributed upon:</p> <ul style="list-style-type: none"> <li>• Severance of employment</li> <li>• Death, disability</li> <li>• Age 59-1/2</li> <li>• Financial hardship</li> </ul> | <p>No change, although "severance of employment" is defined to be when an employee terminates his employment with an "eligible employer" = an employer eligible to sponsor a 403(b) plan (even if he is employed by another employer that is part of the controlled group).</p> | <p>Ensure payroll and HR records are maintained appropriately in order to track "severance of employment", especially if there is a controlled group of employers, some of whom are eligible to sponsor a 403(b) plan, and other for-profit members who are not.</p>   |
| <i>Distributions of After-Tax Contributions and Rollovers</i>  |   |  |
| <p>After-tax contributions and rollovers can be distributed at any time.</p>   | <p>No change.</p>   | <p>Work with vendors to ensure appropriate distribution elections and consents are utilized, as final regulations confirm that all distributions must now comply with the direct rollover requirements, 20% income tax withholding rules, minimum distribution requirements, and related reporting requirements.</p> |

## New Rules About Distributions From 403(b) Plans (cont'd)

| Current Rules  | New Rules Under Final Regulations   | What The Changes Mean  |
|--|---|--|
| <i>Distributions of employer contributions</i>   |   |  |
| <p>Employer contributions from <i>custodial accounts</i> can be distributed upon:</p> <ul style="list-style-type: none"> <li>• Severance of employment</li> <li>• Death, disability</li> <li>• Age 59-1/2</li> </ul> | <p>No change, although "severance of employment" is defined to be when an employee terminates his employment with an "eligible employer" = an employer eligible to sponsor a 403(b) plan (even if he is employed by another employer that is part of the controlled group).</p>                                     | <p>Ensure payroll and HR records are maintained appropriately in order to track "severance of employment", especially if there is a controlled group of employers, some of whom are eligible to sponsor a 403(b) plan, and other for-profit members who are not.</p> |
| <p>Employer contributions from <i>annuity contracts</i> are allowed at any time.</p>   | <p>Employer contributions from annuity contracts issued on or after 1/1/09 can be distributed only upon:</p> <ul style="list-style-type: none"> <li>• Severance of employment</li> <li>• Death, disability</li> <li>• Attainment of stated age</li> <li>• Completion of fixed number of years of service</li> </ul> | <p>Adjust plan documents, and notify participants, about the how distributions of employer contributions from annuity contracts will now be restricted.</p>  |

## ***New Rules About Distributions From 403(b) Plans (cont'd)***

| <b>Current Rules</b>   | <b>New Rules Under Final Regulations</b>   | <b>What The Changes Mean</b>  |
|--|--|---|
| <b>QDROs</b>   |  |   |
| Application of QDRO rules was unclear.   | QDRO rules now apply—thereby permitting an immediate distribution to an alternate payee.   | Revise plan documentation to permit QDROs and develop written QDRO procedures.  |
| <b>Loans, Hardships</b>  |  |   |
| Permissible.   | Loans (subject to limits) and hardships will be available, but information sharing among multiple vendors will be required in order to ensure that these limits are administered on a coordinated basis.   | Evaluate whether these features should be included in the new 403(b) plan. If so, negotiate terms of information-sharing agreements among multiple vendors, and appoint responsible party for administering these limits and features on a coordinated basis. |
| <b>Plan Termination</b>  |  |   |
| Accumulated benefits could not be distributed until a participant had a "distributable event", which did NOT include plan termination. | 403(b) plans may now provide for termination of the plan AND distribution of accumulated benefits, provided that all contributions become 100% vested and the employer (including all controlled group members) does not make contributions to another 403(b) plan from date of plan termination to 12 months after distribution of all plan assets (subject to some limited special rules if more than 2% of the employees from the terminated plan participate in another plan). | Work with vendors to ensure that distributions of individual annuity contracts can be implemented so that all accumulated benefits can be distributed as soon as administratively practicable after plan termination.   |

## ***New Rules About Tax-Free Transfers and Exchanges of Contracts***

| <b>Current Rules</b>   | <b>New Rules Under Final Regulations</b>   | <b>What The Changes Mean</b>  |
|--|--|---|
| <p>Tax-free transfers and exchanges were allowed from one 403(b) to another in a "90-24" transfer.</p> | <p>In order to be tax-free, transfers can only be made within the same plan (an "exchange"), or to another 403(b) plan; transfers cannot be made to or from a 403(b) plan to any different type of plan, such as a 401(a) or 457 plan.</p> <p>Transfers must (i) be permitted by the terms of the plans; (ii) ensure no reduction in the participant's accumulated benefit; and (iii) ensure all distribution restrictions are carried over from transferred plan.</p> <p>For transfers within the same 403(b) plan, information-sharing will be required between the employer and contract issuers in order to ensure compliance with certain limits (i.e., contribution limits, loan limits) that must be administered on a coordinated basis.</p> | <p>Review all plan terms for rules regarding contract transfers.</p> <p>Undertake educational campaign to encourage employees to transfer their individual annuity contracts to the new plan in order to avoid risk of taxation that the contracts may no longer meet the 403(b) rules.</p> <p>Negotiate information sharing agreements with service providers so that all appropriate information on distribution limits can be shared. This requirement applies to all transfers after 9/24/07, although the information-sharing agreement does not need to be in writing until 12/31/08.</p> <p>Negotiate with TPA to have coordinated administration and to monitor overall limits on loans, hardship distributions, etc.</p> |

## ***Fiduciary Obligations of 403(b) Plan Sponsors***

| <b>Current Rules</b>  | <b>New Rules Under Final Regulations</b>   | <b>What The Changes Mean</b>   |
|---|--|--|
| <p>403(b) plans, except governmental or church plans, are subject to ERISA and its fiduciary duties if they are actively sponsored.</p> <p>However, 403(b) plan sponsors who took a "hands-off" approach have claimed exemption from ERISA if the plan was strictly a voluntary plan, providing only for employee deferral contributions, limited employer involvement, and no direct or indirect compensation to the employer.</p> | <p>More 403(b) plans (except church or governmental plans) are likely to be subject to ERISA because of the need for a plan document; involvement in transfers and exchanges; and administrative decision-making on distributions, loans, hardships, etc. Thus, it will be more difficult to sustain the position that the plan is strictly a voluntary plan with no employer involvement.</p> | <p>Evaluate whether the 403(b) plan will be subject to ERISA.</p> <p>In the likely event that it is, implement:</p> <ul style="list-style-type: none"> <li>• Plan documents and related administrative services, nondiscrimination testing, and recordkeeping agreements</li> <li>• Notices to employees advising about deferral opportunities</li> <li>• Investment policy statement (including guidelines for selecting, monitoring, and evaluating plan investment options and related fees on a systematic basis)</li> <li>• Compliance with IRS plan limits on loans, hardships, distributions, etc.</li> <li>• Written plan procedures for administration of 403(b) plan</li> <li>• Systematic procedures for evaluating and monitoring service providers</li> <li>• Adequate fiduciary liability insurance coverage, ERISA bonding, and indemnification provisions</li> </ul> |

## A Quick Snapshot Comparing 403(b) vs. 401(k) Plans

| Feature  |   |
|--|---|
| <i>Contributions</i>   | <p>Elective, pre-tax deferral contribution opportunities are the same in both plans (although 401(k) plans are subject to ADP nondiscrimination testing, which creates the potential situation that some pre-tax deferrals may be returned to highly-compensated employees if the tests are not satisfied).</p> <p>403(b) plans offer the opportunity for more retirement savings, through (i) special catch-up contributions for qualified employees of qualified organizations, and (ii) the ability to impute compensation and make nonelective contributions for former employees, for up to 5 years after termination of employment.</p> |
| <i>Nondiscrimination testing of coverage and contributions</i> | <p>403(b) plans do not have to run ADP testing because of "universal availability" requirement</p> <p>Same ACP testing for matching contributions and, under final regulations, generally same nondiscrimination testing requirements will be imposed for other benefits, rights, features, and coverage.</p>   |
| <i>Investment/funding vehicles</i>                             | <p>401(k) plans have largely migrated to participant-direction of investments under ERISA Section 404(c), offering employers some fiduciary protection.</p> <p>403(b) plans are perceived to be more complex because of individual nature of annuity contracts and question of whether plans are subject to ERISA. With final regulations, these differences may dissipate.</p>   |
| <i>Formalities</i>   | <p>401(k) plans are subject to ERISA; must obtain IRS determination letters; must file 5500s; and must undergo independent audits if more than 100 participants.</p> <p>403(b) plans have simplified reporting and do not need to determination letters or audits at this time, and many are exempt from ERISA (although this may change in the future).</p>  |