Shipman & Goodwin LLP

Employee Benefits Alert

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New IRS Regulations for 403(b) Plans
Raise Tax-Sheltered Annuity Compliance to New Heights

On July 26, 2007, the IRS issued new final 403(b) regulations that govern all aspects of tax-sheltered annuity plans, also known as 403(b) or TSA plans. These new regulations overhaul, in large part, existing IRS rules, many of which have applied to TSA/403(b) contracts for more than forty years.

The IRS's stated goal for these regulations is to reduce the differences between the 403(b)/TSA rules and the rules for other pre-tax plans such as 401k and 457 plans. As explained in more detail in the Q & A's below, one way the regulations go about doing this is to require that starting January 1, 2009, a 403(b) program, in order to provide employees with tax-deferred benefits, MUST be maintained pursuant to a written plan document. Although many of the new IRS requirements set forth in the regulations will not apply until January 1, 2009, one important rule change regarding Contract Exchanges became applicable on September 24, 2007. (See Section II below.)

Because failing to comply with these regulations will generally mean income tax consequences for employees participating in the Employer's 403(b) Plan, every Employer offering a 403(b) Plan must understand what the regulations now require. This alert, written in a question & answer style, is intended to serve as a useful guide that will help Employers answer frequently asked questions from their employees about how these new regulations may affect them.

- **Section I** explains some of the important changes applicable more generally to 403(b) Plans that must be in place before 2009.

- **Section II** explains the new Contract Exchange rules and what an Employer needs to do right now to remain in compliance.

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Section I

1. What does the Employer need to do before 2009 to satisfy the written plan document requirement?

To be in compliance with the 403(b) Regulations, 403(b) contracts must be issued pursuant to a written plan. The written Plan, in both form and operation, must satisfy the requirements of section 403(b) and the regulations thereunder. This written plan requirement is one of the ways the IRS hopes to bring order and better compliance with the legal requirements. As with 401(k) plans and other pension plans that have always had a written plan document, 403(b) contracts now will need the same type of document that will set forth the basic rules involving eligibility, benefit amounts, applicable limitations, the investment products and vendors authorized under the plan, the time and form of distributions, and if the plan contains optional features such as plan loans, hardship withdrawals or 90-24 contract exchanges, then the terms and conditions pertaining to those optional features. One important function of the plan document will be to allocate the various responsibilities for performing the plan's administrative functions, including who is in charge for ensuring that the IRS limitations regarding plan loan amounts, elective deferral amounts, hardship withdrawal restrictions are met on an aggregated contract basis for a participant who has multiple 403(b) contracts with different vendors. The IRS regulations allow the allocation of responsibilities to be to a third party administrator, but the responsibilities cannot be placed on each Employee.

The plan document requirement, in fact, does not require there to be a single plan document with all of the terms set forth therein. The IRS allows for the plan document to be met by incorporation by reference, meaning that some of the terms and conditions could be set forth in the insurance contract or custodial account as long as the plan document contains a provision that incorporates those documents into itself. If an Employer uses this approach, then there be no inconsistencies or conflicts between the different documents. If conflicts or inconsistencies do exist, the plan document will generally govern in the absence of some other provision in the plan document.

[NOTE: Shipman & Goodwin LLP has drafted 403(b) plan documents for many years and can assist any Employer with preparing a plan document that complies with Section 403(b) and the regulations.]

2. Can the Plan document requirement be satisfied if the vendor's investment contract contains the 403(b) requirements?

No, the investment contracts provided by the vendor are no longer sufficient by themselves to satisfy the plan document requirement. The investment contracts will likely contain some but not all of the requirements needed for the plan document to be in compliance with Section 403(b) and the regulations.

3. Do the 403(b) Regulations now mean that a 403(b) Plan will automatically be subject to ERISA?

No, 403(b) plans maintained by Boards of Education continue to be governmental plans that are exempt from ERISA. For these types of governmental plans, the new IRS Regulations only apply to the tax consequences of 403(b) plans under the Internal Revenue Code. 403(b) plans maintained by private tax-exempt employers (e.g., charities, colleges, museums, hospitals) will be subject to ERISA, unless they qualify for the exemption from the definition of "employee benefit pension plan" set forth in Department of Labor Regulation 2510.3-2(f).

4. Do the Regulations allow for severance pay to be deferred by a former employee?

No, elective deferrals from severance pay will not be allowed after 2008. The Regulations now resolve what had been a grey area in the past. Starting with the 2009 taxable year of the employer, former employees who are paid severance pay may NOT elect to make voluntary contributions into the 403(b) plan coming out of the severance pay. In contrast to their severance pay, former employees who receive payments of other types of pay after they terminate employment (e.g., bonus payments, accrued sick days or accrued vacation pay), can elect to contribute those amounts subject to the IRS limit in effect for the year (for 2008, the limit is $15,500, or $20,500 for persons age 50 or older), provided they do so no later than the later of 2-1/2 months after their severance from employment or the end of the plan year that includes the date of their severance from employment.

5. May an Employer make post-employment Employer-paid contributions for retired employees?

Yes, the 403(b) Regulations permit the Employer to make ***post-employment non-elective*** contributions up to the applicable IRS limits (e.g., the upper limit in 2008 is $46,000) on behalf of a retired employee that resemble a limited "golden parachute" benefit. The Employer can contribute these post-employment contributions for up to 5 years after the year the employee retires.

[NOTE: Early Retirement Incentive/Window programs can be designed to fit within these rules. By doing so, the Employer contributions are not taxable to the retiring employees until they withdraw the amounts from their 403(b) account. However, no payments can be made into the account for years after the retired employee's death. (This may be a concern where the retiring employees have agreed through collective bargaining to convert a cash payment accrued sick days into multiple year retirement contributions.) The Plan should address whether any additional contribution will be made in the year of death.]

6. How involved must the Employer be when an Employee requests a Distribution from his or her 403(b) Account?

Under the new plan administration rules that are a necessary by-product of the new requirement that a 403(b) contract be maintained pursuant to a written plan document, employers will need to "sign-off" on a participant's distribution request before the distribution is made by the vendor. The Employer will need to be involved in the sign-off process involving every distribution request involving the 403(b) plan.

Because a plan that fails (either in form or operation) to satisfy the distribution restrictions will cause the 403(b) contract to be taxable to the participant, the Employer will need to be involved in the distribution request process. For example, distributions from a 403(b)(7) custodial account that holds employee voluntary contributions may not permit a distribution before the earliest of the date of the participant's severance from employment, death, financial hardship, disability, or attainment of age 59-1/2. ***[NOTE: Special exceptions apply for balances in the account as of December 31, 1988.]***

7. When does an employee have a "severance from employment" that would entitle him or her to a distribution from his or her TSA/403(b) Account?

Taking a cue from the 401(k) rules, the IRS defines a "severance from employment" for 403(b) purposes as the date the employee ceases to be employed by the eligible employer (e.g., a public school district or a 501(c)(3) tax-exempt entity) maintaining the 403(b) Plan. Examples of "severance from employment" that might not be immediately obvious are (1) an employee transfers form a 501(c)(3) organization to a for-profit subsidiary of the 501(c)(3) organization, (2) an employee stops working for a public school, and transfers

to a job with the State of Connecticut Department of Education; or (3) an employee retires as an employee of the Employer but returns to work as a self-employed freelance consultant who is correctly classified as an independent contractor.

8. What are the rules that apply if an employee requests a hardship withdrawal from his or her 403(b)/TSA Account?

The 403(b) Regulations incorporate all of the same hardship distribution rules that apply to 401(k) Plans. What this will mean for Employers is deciding whether the Plan should limit hardship distributions to the safe harbor reasons allowed under the regulations (e.g., medical expenses; payment toward the purchase of a principal residence for the employee; college tuition and other related expenses such as room and board for the employee and family members, payments to prevent an eviction or foreclosure on the employee's primary residence; funeral or burial expenses for the employee's family members; or repair expenses for damage to the employee's principal residence caused by storms, etc, constituting a casualty loss.) In addition, the Employer will need to include in the plan document the process for reviewing hardship distribution requests and who will be responsible for granting or denying such requests. (*e.g.* the Employer, the third party administrator, or the investment vendor).

9. What groups of employees may be excluded from the voluntary TSA Plan without violating the Universal Availability Requirement?

As the words Universal Availability suggest, all employees should be offered the opportunity to enroll in the Plan. But four categories of employees may be excluded from the voluntary 403(b) plan if the Employer chooses to make one or more of these exclusions part of its 403(b) Plan:

a. Employees who are eligible to make voluntary pre-tax contributions under a 457(b) or a 401(k) plan maintained by the same government employer. ***[NOTE: Only governmental employers maintaining 401(k) plans prior to May 6, 1986 are allowed to have 401(k) Plans.]***

b. Non-resident aliens, generally defined as non-U.S. citizens who either (1) do not have their "green cards" according them lawful permanent residence in the U.S., or (2) do not meet the "substantial presence" test, which has several components but generally means someone who is not present in the U.S. at least 183 days during the current year.

c. Student workers who are regularly attending classes at the School; and

d. Employees normally working fewer than 20 hours per week. ***[NOTE: Under the final regulations, this exclusion is only for an employee if on his or her date of hire, the Employer reasonably expects the employee to work less than 1,000 hours during the upcoming 12 months, and thereafter, for each subsequent plan year or 12-month period, the employee actually worked less than 1,000 hours in the prior 12-month period.]***

[NOTE: The 403(b) Regulations do not allow a Plan to exclude employees who are covered by a collective bargaining agreement from the voluntary salary reduction plan. Plans that currently have this exclusion will have until the later of (i) January 1, 2009 or (ii) the earlier of the date the collective bargaining agreement expires or July 26, 2010, to be brought into compliance. Also, professors who are on a paid sabbatical (including if they are teaching in a visiting capacity on a temporary basis for up to one year at another public school) must still remain eligible to contribute to their home school's plan. Plans that currently have this exclusion for professors will have until the first day of the first taxable year beginning in 2010 to be brought into compliance.]

10. How many days does the employer have to transfer the employee contributions to the 403(b) vendors?

Employers are required to transfer the funds to the insurance company or the entity serving as the 403(b)(7) custodian within a time period that is not longer than what is reasonable for the proper administration of the plan. As an example, the IRS Regulations allow the Employer to provide in the Plan that employee contributions will be transferred into the plan within 15 business days following the end of the month in which the elective amounts would have been paid to the employee in his or her paycheck.

[NOTE: The Employer, if possible, should set up systems that allow it to transfer employee contributions to the 403(b) plan as quickly as possible. If an employer can establish multiple deposits within a month that coincide with how often employees are paid (e.g., bi-weekly), so much the better.]

11. Can an employee continue to buy life insurance coverage within his or her 403(b) Plan?

No, the 403(b) Regulations now make it clear that no life insurance contracts can be purchased by a participant within his or her 403(b) account on or after September 24, 2007. Life insurance contracts issued before that date are grandfathered and can continue to be held and premiums paid within the 403(b) account. But compared to the participant's total 403(b) account, including the annuity investment contract, the value of the life insurance must be an incidental benefit. ***[NOTE: The rules restricting life insurance inside a 403(b) account do not prohibit the payment of death benefits in the form of a survivor annuity (e.g., a 50% joint and survivor annuity) as part of the investment contract so long as the portion of the survivor benefit is incidental to the main purpose of the plan to provide retirement benefits to the employee participant.]***

Section II

1. What is a Contract Exchange?

Designed to be an investment switch to a different investment vendor, a Contract Exchange, occurs when a participant replaces an existing 403(b) contract he or she has at one vendor with a new 403(b) contract with a different vendor. As part of the Contract Exchange, the account value in the first contract is transferred into the second contract. In the past, Contract Exchanges would often occur if a participant wanted to establish an investment contract with a company for his or her 403(b)/TSA account that was not one of the approved vendors through the Employer. Each Employer needs to review its current 403(b) vendor list and determine whether all of the vendors will remain eligible to receive contract exchanges.

If done correctly (as first outlined by the IRS in 1990 in guidance known as Revenue Ruling 90-24), a Contract Exchange did not produce a taxable distribution for the participant.

Example: A participant has a $50,000 account value in a TSA with MetLife, and the Participant wants to establish a new TSA contract with a different vendor--for example, Prudential--and have the $50,000 transferred into the new Prudential contract. If the Contract Exchange occurred in the correct manner and the new contract was set up with the same 403(b) restrictions in place for the first contract, then the Contract Exchange would not produce any taxable income to the participant at the time of the transfer, whether or not Prudential was on the Employer's list of approved or grandfathered vendors.

2. After so many years, why is the IRS changing these Contract Exchange rules now?

For many years, the IRS has been concerned that the TSA and 403(b) vendors have not been properly enforcing key features of 403(b) programs, such as the hardship withdrawal rules and the restrictions on plan loans from 403(b)/TSA contracts. Part of the IRS's solution to this problem is to require that all 403(b) contracts be issued pursuant to a written 403(b) plan document maintained by the employer. Under that plan document, all responsibilities regarding the administration of the plan must be properly allocated to a responsible party, whether that be the employer, the vendor, or a third party administrator. The plan document will also provide for the allowable investments, and identify which companies are allowed to issue investments pursuant to the plan. Only listed companies in the plan document are approved for investing the employees' 403(b) contributions. Under the plan document, the Employer and the listed vendors must agree to share information regarding the employees' contributions and other information about his or her TSA contracts.

The IRS believes its new regulations will strengthen enforcement and administration of the TSA/403(b) contracts in accordance with the requirements of the Internal Revenue Code set forth in Section 403(b).

3. How are Contract Exchanges being changed by the new rules?

The new IRS regulations will continue to allow these Contract Exchanges on a non-taxable basis if they occurred on or before September 24, 2007. After September 24, 2007, unless the Employer enters into an Information Sharing Agreement with a vendor, then a contract exchange by a participant with that vendor will be a taxable event.

[NOTE: The Employer needs to decide now whether it wants to continue to allow participants in the 403(b) plan to make contract exchanges under its 403(b) plan between different vendors. Also, the Employer needs to decide whether it will allow Contract Exchanges with non-approved vendors—e.g., companies that are not on its approved list.]

4. Are there any exceptions to these new Contract Exchange rules?

Yes, the IRS continues to permit a transfer from a 403(b)/TSA contract to a defined benefit governmental pension plan in order to purchase permissive service credit in that pension plan. This type of transfer, common in Connecticut for teachers who have out-of-state service that can be purchased under TRB, is not treated as a taxable Contract Exchange under the new rules. The permissive service credit transfer, because it is not treated as a distribution under 403(b), may be made as an in-service transfer during the Employee's employment with the Employer.

The new rules also continue to allow plan-to-plan transfers or rollovers that occur following an employee's retirement, termination of employment or other distributable event, such as disability or the attainment of age 59½. So, to the extent the terms of the Employee's 403(b) contract so allow, upon his or her retirement or separation from service from the Employer, the Employee would be eligible to complete a non-taxable rollover distribution into an IRA or 403(b) retirement account at the Employee's new employer, so long as the distribution is an eligible rollover distribution.

5. What is the deadline for Employers to enter into Information Sharing Agreements with their approved 403(b) Vendors?

There are actually 2 different deadlines:

- For Contract Exchanges that occur on or after September 25, 2007 and before January 1, 2009, the Employer and Vendor must have in place an Information Sharing Agreement that covers the contract exchange no later than January 1, 2009.

- For Contract Exchanges that occur on or after January 1, 2009, with new Vendors that are added to the Employer's approved vendor list after that date, the District and new Vendor must have an Information Sharing Agreement in place that covers the contract exchange no later than the date the first Contract Exchange with that new vendor is completed.

6. What will happen to Contract Exchanges that occurred before September 25, 2007?

Under the new 403(b) regulations, these pre-September 25th Contract Exchanges are grandfathered and are not affected by the new regulations. Accordingly, they will continue to remain non-taxable transfers, and only when distributions are taken from those contracts will the employee have taxable income.

7. What options will the Employee have if the Employer decides not to enter into an Information Sharing Agreement covering the Employee's Contract Exchange with the Employee's non-approved vendor that occurred after September 24, 2007?

Employers may face pressures from employees who have entered into contract exchanges with non-approved vendors on or after September 25, 2007, that will now be treated as taxable income to the employee unless the Employer decides to take measures to grandfather said exchanges. Separate and apart from the Employer decision, the Employee can qualify for one of the three IRS transition rules announced by the IRS in Section 8 of IRS Revenue Procedure 2007-71, that will allow the Employee to not have to include the Contract Exchange as taxable income:

- **Frozen or discontinued vendor contracts issued from 2005 to 2008** – Under this transition rule, if the vendor, before making any distribution or loan to the Employee from the contract, make a reasonable good faith effort to contact the Human Resources or Benefits Department of the Employer and exchanges with the appropriate HR or Benefits Manager any information that is needed in order to satisfy Section 403(b) of the Internal Revenue Code, then the vendor can treat the contract it holds as part of the Employer's 403(b) Plan (and thus non-taxable) prior to processing the Employee's distribution or loan.

- **Contracts issued before 2009 to participants who on January 1, 2009 are either former employees or beneficiaries** – Under this transition rule, former employees, as of January 1, 2009, of the Employer (or in the event of their death, their beneficiaries) will be treated as having a contract that is part of the Employer's 403(b) plan (and thus, non-taxable). However, this transition rule will not apply in the event a former employee or beneficiary receives a loan from the contract unless the vendor has first conducted a reasonable good faith inquiry of the participant's or beneficiary's recent plan loan activity in order to comply with the tax treatment for said loan under Section 72(p) of the Internal Revenue Code.

- Contracts with non-approved vendors issued after September 24, 2007 and before January 1, 2009 that are exchanged back to a contract with an approved vendor before July 1, 2009 – Under this transition rule, the Employee is able to reverse the contract exchange the Employee made between September 25, 2007 and December 31, 2008, without having to treat the contract exchange to the non-approved vendor as a taxable distribution, so long as, before July 1, 2009, the Employee exchanges the contract back into a contract with a company on the Employer's approved list.

QUESTIONS?

If you have any further questions regarding this article, please contact Richard Cohen of the Employee Benefits Practice Group in our Hartford Office at 860-251-5803 or rcohen@goodwin.com.

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SHIPMAN & GOODWIN LLP℠

COUNSELORS AT LAW

One Constitution Plaza
Hartford, CT 06103-1919
(860) 251-5000

300 Atlantic Street
Stamford, CT 06901-3522
(860) 324-8100

289 Greenwich Avenue
Greenwich, CT 06830
(203) 869-5600

12 Porter Street
Lakeville, CT 06039-1809
(860) 435-2539

SHIPMAN & GOODWIN LLP℠

COUNSELORS AT LAW