# Tax-Sheltered Annuities Under Code Section 403(b)

## New Regulations and New Obligations

by Allen T. Steinberg

Sponsors of 403(b) plans will have to become more active and hands-on in managing their 403(b) programs and providers for two reasons. First, the new 403(b) regulations published in July 2007 will impact plan sponsors' oversight of plan administration and legal compliance. Second, some of the "environmental" factors that have given rise to recent 401(k) trends apply to 403(b) sponsors and should be considered when assessing employers' relationship with their 403(b) program. In fact, for many sponsors, these trends will represent a shift in emphasis and resources far beyond the legal effort needed to comply with the new regulations.

### INTRODUCTION

The benefits community and the media focus significant and frequent attention on matters affecting 401(k) plans. On the other hand, 403(b) programs—providing pretax employee contributions and employer contributions for employees of not-for-profit entities and public schools—are often overlooked. However, these plans are important—they cover a group that exceeds ten million workers.

The publication of new final regulations governing 403(b) programs on July 26 (72 *FR* 41128) will require that affected employers and their service providers pay more attention to 403(b) programs. And, once the spotlight is on 403(b) plans, two key points emerge. First, the new 403(b) regulations will have a significant impact on 403(b) sponsors and will require additional efforts from these sponsors regarding oversight of plan administration and legal compliance. And, at the same time, many of the nonlegal changes occurring in the 401(k) world (e.g., changes affecting plan design and investments) will also start affecting 403(b) plans. As a consequence of these developments, 403(b) sponsors will need to start playing a more active role in plan oversight.

This article discusses these points and is intended to start the (now necessary) dialogue regarding 403(b) plans.

### NEW 403(b) REGULATIONS

The final regulations issued in July 2007 were, according to the preamble, intended to reflect the changes made to Section 403(b) of the Internal Revenue Code since the issuance of the last set of comprehensive regulations in 1964. And, if the new regulations focused solely on changes made by Congress to the Code, they would be far more limited in impact. But the regulations have also provided the Internal Revenue Service (IRS) with an opportunity to articulate additional requirements reflecting a greater role for 403(b) plan sponsors. This greater role stems, in part, from the IRS' conclusion that employer involvement in 403(b) administration and oversight is critical to compliance with the legal requirements under 403(b).

Some of the more significant requirements under the new regulations are described below. Generally, the new regulations are effective in 2009; however, the restriction on the exchange of contracts (described below) was effective September 24, 2007.

### *Plan Documentation*

A 403(b) plan must be maintained pursuant to a written plan document. The documentation requirement has several aspects and implications that must be noted.

- The plan document must contain all of the "material terms" of the plan, including plan provisions governing conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. For many employers, this will require articulation of many plan practices that, in the past, have been delegated to administrative procedures. In effect, the new regulations will require many employers to increase the amount of documentation required in their 403(b) plans.
- The requirement regarding the written plan document can be met by incorporating, by reference, other documents. Also, the plan document can allocate administrative responsibilities, including compliance with Code Section 403(b), to the employer or other persons (such as the issuers of annuity contracts). Indeed, the preamble to the regulations states the IRS' intention that the plan document will facilitate the allocation of administrative and compliance responsibility among the employer, annuity contract/custodial account provider(s) and any other parties. Thus, the plan document will serve as the vehicle for coordinating responsibilities of the employer and the annuity contract or custodial account provider(s).
- However, incorporation by reference has its limitations. The plan sponsor remains responsible for ensuring that any referenced documents are consistent with the plan document. Also, while a 403(b) contract issued to an individual can allocate some responsibilities to the issuer of the contract, the contract cannot set forth eligibility requirements for other individuals. Similarly, certain legal requirements (such as loan limitations) can only be met through coordination of multiple sources. And, a plan document generally cannot allocate administrative and compliance responsibilities, such as satisfaction of contribution limits, to participants.
- This requirement applies to all 403(b) plans, even those that are not employer-sponsored plans subject to the Employee Retirement Income Security Act (ERISA), such as plans providing only for employee deferrals or plans maintained for public school employees. Thus, employers that were not previously concerned with a written 403(b) plan will need to pay more attention to their documentation.

In summary, the documentation requirements represent the focal point of employer responsibility for the oversight of 403(b) programs. For many employers, the amount of involvement necessitated by these regulations will represent a real shift in their relationship with their 403(b) program.

### *Eligibility and Nondiscrimination Requirements*

Another key component of the regulatory framework governing 403(b) plans is the eligibility and nondiscrimination requirements.

#### Universal Availability

Under the eligibility requirements, if any employee of the employer is able to make elective deferrals under a 403(b) plan, then all employees must be granted that ability (with limited exceptions described below). This is referred to as the "universal availability" requirement. The regulations take a somewhat expansive interpretation of the universal availability requirement, requiring that plans meet several additional secondary rules in order to demonstrate satisfaction of universal availability. Specifically:

- A 403(b) plan must extend the right to make (after-tax) Roth contributions to all eligible employees (if any employee of the employer makes such contributions).
- Eligible employees (including eligible part-time employees) must have the right to make contributions up to the legal limits (including catch-up contributions). An employer can impose a lower limit, but it must apply to all eligible employees.
- Eligible employees must be given the "effective opportunity" to make or change deferral elections under a plan at least once a year. Although not specified in the regulations, this could be interpreted to require annual communication to employees about their right to make or change elections under the plan.
- Other rights or benefits cannot be conditioned on a participant making—or not making—elective deferrals. There are limited exceptions to this prohibition against conditioning of other benefits, such as employer matching contributions.

The regulations provide narrow exceptions to the groups of employees who are not covered by the universal availability requirement. For example, the final

regulations no longer allow an exception from universal availability for collectively bargaining employees. Thus, the following groups of employees are excluded from the universal availability requirement:

- Employees eligible to make elective deferrals under another defined contribution plan of the employer (including another 403(b) plan, a Section 457(b) plan (for governmental employers) or a 401(k) plan)
- Nonresident aliens with no U.S. earned income
- Employees who are students performing services described in Code Section 3121(b)(10)
- Employees who normally work fewer than 20 hours per week, or a lesser number of hours as may be set forth in the plan document. The 20-hour per week provision is applied by looking at whether an employee works 1,000 or more hours in a 12-month period (or, in his or her first 12 months of employment, whether an employee can reasonably be expected to complete at least 1,000 hours of service).

Also, if any employee in one of the last two categories of excludable employees is allowed to make contributions to a 403(b) plan, then all employees in that category must (generally) be given the opportunity to contribute, although there are additional special rules for students performing services under Code Section 3121(b)(10).

The preamble to the regulations also suggests ways of treating individuals who were previously covered by explicit exceptions to the universal availability rule. For example, the preamble suggests that universities may treat visiting professors as eligible employees of their home university.

### Nondiscrimination

Employer matching and other nonelective contributions must satisfy a range of Code provisions intended to ensure that plans do not disproportionately favor highly compensated employees. These provisions include:

- Code Section 401(a)(17), limiting the amount of compensation that can be considered by a plan ($250,000 in 2008)
- Code Section 401(m), limiting employer matching contributions based on the actual contribution percentage (ACP) test that restricts the matching contributions for highly compensated employees to a threshold tied to the matching contributions made on behalf of nonhighly compensated employees—effectively limiting matching contributions for highly compensated employees in plans with low participation rates by nonhighly compensated employees
- Code Section 401(a)(4), imposing general nondiscrimination requirements with respect to employer nonmatching contributions
- Code Section 410(b), imposing minimum coverage requirements.

### Application of Eligibility and Nondiscrimination Requirements

There are many nuances that will require careful review of each employer's circumstances. For example:

- The eligibility and nondiscrimination rules are applied by treating all entities under "common control" as a single employer. Common control is generally considered to exist if at least 80% of the directors or trustees of one organization are representatives of another organization or are directly (or indirectly) controlled by another organization. However, there are special rules if a 403(b) plan covers employees of more than one state entity; in such a case, these requirements are applied by looking at entities on a common payroll.
- The universal availability and nondiscrimination rules do not apply to church plans.
- The nondiscrimination requirements and minimum coverage requirements (Code Sections 401(a)(4), 401(m) and 410(b)) do not apply to governmental plans; however, the limit on allowable compensation (Code Section 401(a)(17)) and the universal availability rules do apply to such plans.

### Effective Date

Although the universal availability rules generally have the same 2009 effective date as the rest of the regulations, IRS provided certain delayed effective dates for (i) employers that relied on previous issued exceptions to the universal availability rules, (ii) plans that exclude employees covered by collective bargaining and (iii) governmental plans.

The cumulative effect of the plan documentation, universal availability and nondiscrimination rules is an increased likelihood that compliance problems will surface for some employers. These problems are likely to emerge as employers better identify all eligible employee groups and confront the potential need to increase employer nonmatching contributions to meet minimum coverage and nondiscrimination tests and/or expand the group eligible for a match—to meet minimum coverage tests. However, addressing these emerging compliance needs will have costs: increasing employer contributions adds to the cost of maintaining the plan, while offer-

ing a match to additional lower paid employees (with low deferral rates) risks weighing down matching contributions available to highly compensated employees.

### Effect of Failure to Satisfy 403(b)

The new regulations describe the impact of a plan failing to satisfy the Section 403(b) requirements. The preamble to the regulations describes two categories of plan failure and the consequences of each category:

1. If an entire 403(b) plan fails to comply with the IRS' requirements, then all contracts purchased by that employer are considered as not constituting 403(b) contributions. This results in immediate taxation for all contributions made by that employer. Examples of a compliance failure for an entire 403(b) plan include a failure to adopt a plan document, failure to meet the nondiscrimination requirements and failure to meet the universal availability requirements.
2. Operational failures affecting individual participants (such as a failure to properly limit contributions to the plan) result in taxable income only for the individual employees covered by the failure.

The description of penalties for failing the 403(b) requirements provides IRS with a tool—for some, a cudgel—for enforcing the 403(b) requirements. The existence of this express penalty structure will encourage greater employer activity for monitoring and overseeing compliance with 403(b); in turn, this will also encourage voluntary self-corrections under IRS' voluntary self-correction programs.

### Other Requirements

The new regulations articulate many other requirements applicable to 403(b) programs. Generally, these additional requirements reflect rules set out in the Code and should not be surprises for employers or providers. Specifically:

- **Limits on contributions and deferrals.** An employee's elective deferrals must not exceed the dollar limit expressed in Code Section 402(g) ($15,500 in 2008). This dollar limit may be increased both by (i) a special catch-up contribution for employees who attain age 50 ($5,000 in 2008) and (ii) a special catch-up contribution for certain employees (those who complete 15 or more years of service) of educational organizations, hospitals and certain other specified entities.

  Also, contributions (including matching contributions) must satisfy the limit on annual additions under Code Section 415.
- **Distributions.** Generally, elective deferrals can be distributed only upon the earliest of
  —Severance from employment
  —Death
  —Hardship
  —Disability
  —Age 59½.
  Different rules apply to employer contributions not attributable to elective deferrals.
- **Minimum distribution rules.** The requirements of Code Section 401(a)(9) apply to 403(b) plans. Under these requirements, distributions to a participant must begin by the April 1 following the later to occur of the participant's (1) attainment of age 70½ or (2) termination of employment.
- **Loans.** A participant can borrow against his or her account balance in a 403(b) plan. A loan will not be treated as a distribution if it has a fixed repayment schedule, bears a reasonable rate of interest and has repayment safeguards to which a prudent lender would adhere.
- **Rollovers and direct transfers.** Section 403(b) plans are subject to rollover rules very similar to those applicable to qualified plans. A distribution from a 403(b) program can be rolled over into an individual retirement arrangement, a qualified retirement plan or another 403(b) program within 60 days. Also, plan-to-plan transfers are allowed if certain requirements are met.

### Contract Exchanges

The final regulations restrict the ability of participants to exchange 403(b) contracts. The restrictions are based on IRS concerns that, in the absence of such restrictions, the exchanges would undermine employers' ability to monitor compliance with the requirements of Section 403(b), such as rules governing loans or distributions.


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Under the regulations, an exchange is permitted within a plan only if:

- The plan provides for the exchange.
- The participant has an accumulated benefit immediately after the exchange that is at least equal to the accumulated benefit immediately before the exchange.
- The other contract is subject to distribution restrictions with respect to the participant that are not less stringent than those imposed on the contract being exchanged.
- The employer enters into an agreement with the issuer of the other contract under which the employer and the issuer will from time to time in the future provide each other with information needed to enable the employer to ensure compliance with the requirements of Section 403(b) and other requirements of the Code.

The regulations also contain rules governing when plan-to-plan transfers can be made (generally, covering a transfer to the plan of a different employer).

The final regulations make it more difficult for employers to take a "hands-off" approach to 403(b) plans. At a minimum, IRS will require employer involvement in documenting plan provisions and overseeing vendor activities with respect to compliance. ◀

Unlike the 2009 effective date applicable to the rest of the final regulations, the new restrictions on contract exchanges are applicable to exchanges occurring after September 24, 2007.

### *Interaction With Title I of ERISA*

The issuance of the new regulations was accompanied by the release by the Department of Labor (DOL) of Field Assistance Bulletin (FAB) 2007-02. This bulletin reiterated the position previously taken in DOL regulations—that an employer is not considered as establishing or maintaining a plan under ERISA by offering 403(b) arrangements funded solely by employee contributions. In order for this exemption to apply, the FAB specifies that the plan must be voluntary; rights under the 403(b) contract are enforceable solely by the participant; employer involvement is limited to certain specified activities; and the employer receives no compensation in connection with the plan (other than reimbursement to cover expenses). The FAB further specifies that employers can comply with the requirements of the new 403(b) regulations and retain the exemption from ERISA. Thus, although the new regulations may increase employers' role in maintaining their 403(b) programs, they will not change employers' ERISA status with respect to such plans.

### *Setting the Stage for an Increased Employer Presence*

The final regulations make it more difficult for employers to take a "hands-off" approach to 403(b) plans. At a minimum, IRS will require employer involvement in documenting plan provisions and overseeing vendor activities with respect to compliance. And, as seen below, the IRS' push for greater employer involvement will take on added impact when combined with other factors.

## LESSONS FROM THE 401(k) FRONT

The last few years have seen the beginning of some significant trends within the 401(k) realm. These trends include:

- The explosive growth of features that shift the nature of employee decision making and allow the employee election process to run on autopilot. These features include automatic enrollment, automatic investment rebalancing and automatic contribution escalation. Lifecycle or "target maturity" funds can also be included in this category. Taken together, these features can provide employees with simpler decisions. These features can also reduce the impact of the human foibles that often cloud employees' judgment and give rise to behaviors that adversely affect the accumulation of retirement assets, such as procrastination and poor investment allocations.
- Employers have also begun embracing design-based "safe harbors" that can free employers from the impact of the actual deferral percentage (ADP) and ACP tests. These tests limit the contributions by—and matching contributions for—highly compensated employees; the limits are

based on the rate of contributions by (and the rate of matching contributions for) nonhighly compensated employees. These tests have proven to be a challenge for many employers, especially those with high numbers of lower paid employees and with high employee turnover—both factors associated with low employee savings rates.

- Roth features—allowing employee contributions to be made on an after-tax basis, and then providing for completely tax-free distributions—are starting to gain traction among 401(k) sponsors. The increase in Roth features gained a boost when the Roth provisions of the Code were made permanent by the Pension Protection Act of 2006.
- Employers and employees (as well as Congress, the Department of Labor and the media) are all focusing greater attention on plan fees and the internal "revenue sharing" that can occur among vendors. This awareness over fees is giving rise to a new focus on lower cost investment vehicles—such as passively managed index funds and collective investment trusts.
- Concerns about some of the inherent limitations of a defined contribution plan-centric system have also generated increased attention. Some of these limitations include the risks of declining asset values in the event of a market decline and the risk of outliving defined contribution plan assets. Both of these concerns are giving rise to the development of new investment products to guarantee asset values and create some additional protections to better assure lifetime benefits.

New trends and developments among 401(k) plans do not necessarily foretell similar changes in the 403(b) area. For example, 403(b) sponsors are not subject to the same ADP test imposed on 401(k) plans and do not feel the same pressure to increase the deferral rate of nonhighly compensated employees in order to enable highly compensated employees to maximize their own deferrals. This pressure emanating from the ADP test has provided some of the impetus for 401(k) sponsors to move to safe harbor and automatic enrollment approaches, and accounts for some of the differences between trends in 401(k) design and trends in 403(b) plans.

However, it is also important to note that some of the "environmental" factors that gave rise to these 401(k) trends do also apply to 403(b) sponsors. For example:

- Rising retiree medical costs affect 403(b) sponsors, and some of these employers are going to start reacting the same way that 401(k) sponsors have done in the years since the adoption of Financial Accounting Standard (FAS) 106—by shifting more cost to employees and retirees.

  Among nongovernmental 403(b) sponsors (such as private universities and hospitals), this trend is already underway. Similarly, governmental employers offering 403(b) plans (such as public universities and schools) are now subject to new accounting standards under Governmental Accounting Standard (GAS) 45 covering retiree medical benefits. These governmental employers are now feeling the same pressure to reduce their retiree medical obligation. Although it is not anticipated that governmental employers will shift costs to employees with the same vigor evidenced by the private sector, some movement toward shifting greater financial responsibility to employees and retirees can be expected. And, as this shift occurs, there is greater pressure on the voluntary savings vehicle—in this case, the 403(b) plan—to help employees meet this increased financial responsibility.
- There is also pressure on 403(b) sponsors with respect to pension costs and funding. As with retiree medical pressures, 403(b) sponsors are not a monolithic group. Thus, there are differences between the pressure felt by—and the likely response from—governmental and nongovernmental employers. But it is fair to conclude that some nongovernmental 403(b) sponsors are likely to reconsider and, in some cases move away from, defined benefit plans. And, although legal, political and other factors make it more likely that governmental employers will retain their defined benefit structures, they are also feeling pressure to move to a different balance between defined benefit and defined contribution—with more weight going toward defined contribution.
- Concerns regarding the efficiency of 401(k) plans and the return generated by these plans—with the attendant focus on plan fees, total plan costs, investment returns and employee investment decisions—should apply with comparable intensity to 403(b) sponsors. In the 401(k) world, these concerns have prompted widespread scrutiny of investment alternatives and employee investment decision making. This scrutiny, in turn, has generated movement toward greater transparency of 401(k) plan fees and plan investment alternatives with lower fee structures. There are some key distinctions that affect employers' legal status and obligations. After all, in the case of employee-only voluntary 403(b) plans, the employer remains outside of the ERISA definition of a fidu-

ciary and governmental employers are, generally, exempt from ERISA. However, many 403(b) sponsors are subject to the ERISA fiduciary responsibilities. And those 403(b) sponsors that are not subject to ERISA still have some level of responsibility to oversee the vendors providing this (increasingly important) retirement vehicle.

Despite these obligations, 403(b) sponsors seem to be lagging behind 401(k) sponsors in their willingness to tackle these issues. It is reasonable to expect, however, that this difference in sponsor attitudes will narrow in the coming years. After all, high fees and poor employee decisions have the same corrosive effects on the retirement income provided to 403(b) participants as they do on benefits provided to 401(k) plan participants.

## CONCLUSION

The final 403(b) regulations will require many 403(b) sponsors to undertake significant documentation and compliance efforts. Taken alone, this makes these regulations noteworthy. However, there are several other nascent trends that should also be considered when assessing employers' relationship with their 403(b) program; these trends are likely to accelerate in coming years. Taken together, one can anticipate that 403(b) sponsors will have to be more active and hands-on in managing their 403(b) programs and providers. For many 403(b) sponsors, this represents a shift in emphasis and resources far beyond the legal effort needed to comply with the new regulations. ◀


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Issues represent a mix of articles on subjects reflective of the industry. Some specialty topics, as listed on page 64, are planned for upcoming issues. Individuals interested in contributing articles to *Benefits Quarterly* should contact the editor as soon as possible. Manuscript guidelines are available upon request.

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