403(b) Perspectives

Insights into the Administration of §403(b) Tax-Sheltered Arrangements

SUMMER 2007

The 403(b) FINAL Regulations

After waiting for more than two and a half years, retirement plan practitioners have received updated and comprehensive regulations that apply to 403(b) arrangements. The new regulations, which replace those issued on December 24, 1964, eliminate many of the differences in operation and administration between 403(b) plans and 401(k) and 457(b) plans.

Effective Date

In general, the regulations are effective for taxable years that begin after December 31, 2008.

Proposed regulations had been issued on November 15, 2004, and industry practitioners had the opportunity to provide comments to the IRS and Treasury on their content. The final regulations retain most of the changes required by the proposed regulations and also contain some clarifications.

Effective Date

In general, the regulations are effective for taxable years that begin after December 31, 2008. However, the new rules take effect for years after December 31, 2009 for some church-related plans. Arrangements that are subject to a collective bargaining agreement that was in effect on July 26, 2007 will not have to comply with the new regulations until the earlier of the date when such agreement terminates or July 26, 2010.

Note: Any plan may operate under the new regulations between the period of July 26, 2007 (the release date) and the regulatory effective date IF the new rules are applied on a consistent and reasonable basis.

Major Provisions

The final regulations retain many of the provisions of the proposed regulations, but make a number of changes and clarify many other issues. These items include:

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The 403(b) FINAL Regulations

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Plan document. A requirement to have a plan document which includes all material provisions for 403(b) arrangements and which includes the allocation of responsibilities between the employer, the service providers and the participants. The regulations provide that other documents (such as annuity contracts) may be incorporated into the plan document by reference.

Note: The IRS stated it will release model plan provisions that public schools may use and rely upon (the actual release date is unknown as of the time this article was written).

Plan termination. The ability to have plan termination as a distributable event if certain rules, similar to the 401(k) successor plan rules is followed. For example, the employer may not establish a replacement 403(b) plan for at least 12 months after the original 403(b) plan's termination. In addition, the terminating plan will have to distribute the benefits of all participating employees as soon as administratively possible after the termination date.

Nondiscrimination rules. The application of nondiscrimination rules to employer contributions on a basis similar to that applied to profit sharing plans. Matching contributions would be subject to the ACP test of Code §401(m). There would be no ADP testing of §403(b) deferrals as long as the universal availability requirements are satisfied.

Universal availability. Universal availability rules allow a plan to exclude resident aliens with no U.S. source income, students under a work study program, employees whose normal workweek is less than 20 hours and employees eligible to defer to a §457(b) plan of the same employer. The universal availability rules have been amended so that visiting professors, religious order employees who take a vow of poverty, collectively bargained employees and those who make the one-time election to participate in a governmental plan might no longer be excluded.

Controlled group rules. The regulations introduce a controlled group rule that applies to certain §501(a) tax-exempt entities. This rule is based on an 80% common control test, which applies to directors or trustees rather than a percentage of ownership.

In-service exchanges. In-service exchanges of contracts (formerly known as 90-24 transfers) will be allowed, but only if there is a written agreement between the vendor and employer so that employee information can be shared to ensure that eligibility and distribution rules will be applied properly.

Catch-up coordination. The coordination of the two types of catch-up contributions available to 403(b) participants is clarified. The special 15-year of service catch-up available to certain organizations, will always apply first. To the extent that amount is used up for a year, the §414(v) age 50 catch-up amount may be applied in addition.

402(f) Notice and 20% Withholding. A requirement that the §402(f) eligible rollover distribution notice be provided when a participant is to receive a distribution, and that 20% mandatory withholding will apply on amounts eligible for rollover that are not directly rolled over to another plan or IRA.

Severance exception. Severance from employment permitting distribution will include a situation where an employee is terminated by a member of a control group with a 403(b) arrangement and transferred to a member of the same control group that is not eligible to sponsor a 403(b) arrangement.

Post-severance 5-year contributions. The rule that nonelective employer contributions may be made for an employee for up to five years after their termination has been retained. These contributions would be subject to the discrimination testing that applies to nonelective contributions.

No conditions on deferrals. No benefit or right (other than matching contributions) may be conditioned on making §403(b) elective deferrals.

No new separate incidental life insurance. Separate incidental life insurance contracts will not be allowed if issued after September 24, 2007.

We will provide more in-depth coverage in future issues of ***403(b) Perspectives***. ■

Final 415 Regulations and 403(b) Arrangements

The general principal regarding the annual addition, Code §415 limit, when a taxpayer participates in both a 403(b) arrangement and a profit sharing/401(k) plan is that they have separate limits. If a hospital sponsors both a 401(k) and a 403(b), the participants would have a separate annual addition limit for each. For example, a participant would have an annual additions limit of $45,000 for the 401(k) plan and an annual additions limit of $45,000 (in 2007) for the 403(b) plan. It is important to remember that they only have one Code §402(g) deferral limit of $15,500 (in 2007), and one catch-up contribution limit, if applicable, of $5,000 (in 2007).

Example 1

A doctor is employed by the hospital and has no ownership in the hospital. The doctor defers $15,500 plus $5,000 of catch-up to the 403(b). The hospital makes a profit sharing plan contribution and the doctor's allocation for 2007 is $38,000. Thus, since there are separate 415 limits, neither amount has exceeded §415.

Example 2

A physician who is employed by a hospital also is engaged in his own private practice. Assuming that the doctor does not own a controlling interest of the practice contributing to the qualified plan (defined as more than 50% ownership interest in such practice), the doctor will be entitled to a separate §415(c) annual additions limit for the 403(b) and the profit sharing plan.

However, where there is control, there is a single limit as the individual is deemed to "own" both the 403(b) arrangement and the profit sharing plan. Specifically, if an individual owns more than 50%, then the individual is considered to be the company's owner for purposes of the 403(b) and the profit sharing plan; and, thus, the amounts of the 403(b) are added to the profit sharing plan for annual additions limitation.

Example 3

A doctor has 53% ownership in the hospital and is employed by the hospital. The doctor's deferral to the 403(b) would be combined with any amounts contributed to the profit sharing plan for §415 purposes. Thus, using the numbers above, the doctor's $20,500 deferral to the 403(b) would be combined with the profit sharing allocation of $38,000 and the §415 limit would be exceeded ($38,000 plus $15,500 for a total of $53,500). The catch-up contribution of $5,000 is not considered for purposes of calculating the §415 limit amount. Therefore, the doctor would have an excess annual addition of $8,500 for 2007.

If this doctor also has his/her own private practice, the doctor would have a combined §415 limit of $45,000 between the 403(b) plan of the hospital, the profit sharing plan of the hospital and the defined contribution plan of the doctor's own practice.

As an aside, the IRS has been conducting examinations on this issue and has found many cases where a doctor contributing to a hospital 403(b) arrangement has also inappropriately contributed excess amounts to their own private practice plan. This is separate and distinct from the fact that many of these doctors were prohibited from having an outside practice in their contract with the hospital. ■

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