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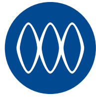

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PERiScope
Public Employee Retirement Systems

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IRS Issues Final 403(b) Regulations – The First Comprehensive 403(b) Guidance in More Than 40 Years

By: Ginny Boggs

In the words of the IRS, "On July 23, 2007, a momentous event occurred in the world of 403(b) [plans] with the issuance of the first comprehensive regulations in 43 years." The final 403(b) regulations provide updated guidance and incorporate numerous statutory changes and interpretive guidance since the original 403(b) regulations were issued in 1964.

These new rules generally take effect Jan. 1, 2009, (with a later effective date for certain church-related and collective bargaining plans) but may be relied on before the effective date if reliance is consistent and reasonable.

The new 403(b) regulations reflect the increased similarity in the rules governing 403(b), 401(k), and governmental 457(b) plans. The new regulations introduce important due diligence and compliance requirements, reflecting the IRS's point of view that employers and retirement system officials will have greater responsibility for overseeing and managing 403(b) plans. Because of this, the new 403(b) rules are expected to result in significant changes for sponsoring employers and their employees.

While the 403(b) regulations affect both tax-exempt and public organizations, this PERiScope focuses on some of the key provisions of interest to public-sector 403(b) plan sponsors including:

- *Written plan document requirement.* Previously, only 403(b) plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) were required to have a written plan document. Now, all 403(b) plans must have a central written plan document that includes all of the material provisions regarding eligibility, benefits, contribution limits, all available investment contracts and accounts, loans, hardship withdrawals, distributions, fund transfers, rollovers, and allocation of compliance responsibilities between the employer and service providers. The central document may include other documents by reference (e.g., the funding vehicle contract or agreement), together forming the overall terms of the plan, with the central plan controlling whether there are conflicting provisions.

  The new requirement for a written 403(b) plan document is likely to lead many employers to choose a single administrative service provider because the plan document must include a description of all available investment contracts and accounts and identify who is responsible for the coordination and monitoring of compliance with all IRS plan limitations. This would include the loan, distribution, and hardship withdrawal rules, on an aggregate basis, across all providers and investment options.

  The IRS is expected to publish model plan provisions that may be used by employers that do not have existing 403(b) plan documents.

  The written plan document requirement will significantly increase the potential liability of employers who sponsor 403(b) plans relative to IRS qualification failures, which could result in adverse tax consequences to plan participants.

- *Increased fiduciary responsibility.* The new regulations will impose due diligence and compliance criteria that will require employers and plan officials to assume a greater fiduciary role and the potential liability that comes with it. Consequently, employers and plan officials must act in the best interest of employees and ensure that their 403(b) programs are operated strictly in accordance with the governing plan document.

  Added fiduciary responsibility will necessitate developing guidelines for selecting, monitoring, and evaluating plan investment options, as well as forming an investment committee that meets regularly to review investment performance, plan expenses, and employee education, keeping well-documented minutes of each meeting. This required monitoring by employers and 403(b) plan officials will likely lead to a demand for better investment products, greatly benefiting employees.

  In addition, employers and plan officials will be required to coordinate compliance with all IRS plan limitations, including loan and distribution rules, among all providers, whereas in the past, the employer simply had to ensure only compliance with contribution limits.

  Although public-sector plans are not subject to many of the provisions of ERISA, including the Department of Labor's (DOL) fiduciary rules, applicable state law may impose similar rules.

- *Stricter transfer rules.* IRS Revenue Ruling 90-24 currently allows a 403(b) plan participant to exchange his 403(b) contract or account to another vendor, even one not offered through the employer, provided that distribution restrictions remain at least as strict. Consequently, many employers are unable to monitor for compliance with the various IRS limitations and distribution rules. Through Sept. 24, 2007, a 403(b) plan participant may still make a Revenue Ruling 90-24 exchange. After Sept. 24, 2007, this ruling becomes obsolete.

The new regulations have stricter rules for transfers between 403(b) plans to eliminate a 403(b) plan participant's ability to move 403(b) funds without employer involvement. Any 403(b) exchanges outside the employer's vendors will require an agreement between the employer and outside vendor to share employment and plan benefit information, to ensure compliance with plan provisions, IRS limitations, and IRS rules governing loans, distributions, and withdrawals.

A plan participant may transfer assets between 403(b) plans if (i) he is a current or former employee of the receiving plan's employer, (ii) distribtion restrictions are maintained, and (iii) both plans allow for the transfer.

- *Universal availability rule.* Under what is known as the "universal availability rule," organizations sponsoring a 403(b) plan are required to offer the plan to all employees, with limited exceptions (i.e., non-resident aliens, certain students, and employees who normally work fewer than 20 hours per week). The new regulations repeal prior allowable exclusions under IRS Notice 89-23 for collectively bargained employees, visiting professors, government employees who make one-time elections, or employees working under a vow of poverty (with certain transitional relief through 2010).

  Previously, there was no standard for the fewer-than-20-hours-per-week exception. The new rules establish a standard of 1,000 hours of service. New employees who are hired with the expectation of working fewer than 1,000 hours in their first year of employment may be initially excluded, but must be included if they ever complete 1,000 hours in a one-year measurement period (as defined in the plan).

  Besides being universally available, the 403(b) plan must also be effectively available, requiring an employee to be aware of his eligibility to participate. Therefore, the new regulations will require an annual "meaningful notice" to all eligible employees of their rights to participate in a 403(b) plan and an effective method for making and changing their deferral elections.

- *Deposit requirements.* Organizations must transmit employees' salary reduction contributions to the 403(b) plan's investment vehicle as soon as is reasonable for proper plan administration. The regulations provide an example of no later than 15 business days after the month in which the amounts would have been paid to the employee.

- *Plan termination.* The new regulations will allow 403(b) plans to be terminated, subject to certain successor 403(b) plan rules. All accumulated benefits under the plan must be distributed to participants and beneficiaries as soon as administratively possible, with the right to roll over their distributions to another eligible retirement plan (i.e., a 403(b), 401(k), 457(b) governmental plan, or IRA). It is important to note that the transfer of any 403(b) monies upon plan termination must be at the request of the employee through the rollover process.

  Employers may not transfer 403(b) plan assets to non-403(b) plans. Thus, employers that freeze or terminate a 403(b) plan cannot merge or transfer 403(b) plan assets into a 401(k) or 457(b) plan. Only an individual plan participant who receives a distribution after termination of employment or plan termination may transfer 403(b) assets to a non-403(b) plan, via the rollover process.

  An employer may terminate a 403(b) plan earlier than the effective date of the new regulations if it complies with all applicable requirements of the new regulations at that time, *with one notable exception: the requirement that there be a written plan document.*

Plan sponsors should take the following steps in order to comply in a timely manner with the new rules at the beginning of 2009, including addressing the additional complexity as a result of the new fiduciary responsibilities and due diligence requirements:

- *Implement a written plan document.* If the plan already has a written document, it should be reviewed for compliance with the new rules, and amended if necessary.

- *Review excludable employees.* The plan document and administrative practices should be reviewed to ensure that the exclusion of any groups of employees does not violate the new rules.

- *Develop an investment-policy statement that creates guidelines to evaluate fund performance and to make informed decisions regarding the selection and, if necessary, replacement of investment options.* Fiduciary standards dictate regularly evaluating fund options. Limiting the number of fund options available will reduce complexity and administrative oversight.

- *If using multiple vendors, create a list of all existing providers, and review them for investment performance, investment options, fees, expenses, and service standards.* This is very important because the new rules require that the written plan document include both a description of all investment vehicles available under the plan and a list of approved investment providers for exchanges and transfers.

  Employers should determine exactly what products and services are currently being provided from all existing vendors and exactly what fees and surrender charges are being imposed. Increased employer oversight and expanded fiduciary responsibilities will lead many employers with numerous vendors to choose a single administrative service provider.

- *Form a plan committee and/or an investment committee to oversee and manage the 403(b) plan.* Establish fiduciary criteria, create procedures to monitor the plan and vendors on an ongoing basis, and assess the need for hiring outside advisory expertise.

For additional information about the new IRS 403(b) rules, or assistance developing a compliance action plan, please contact your Milliman consultant.

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This publication is intended to provide information and analysis of a general nature. Application to specific circumstances should rely on separate professional guidance. Inquiries may be directed to: Brent Banister, Editor; 1120 South 101st Street, Suite 400, Omaha, NE 68124-1088; (402) 393-9400; periscope@milliman.com

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