

# To Be or Not to 403(b): That Is the Question (and, After Years of Waiting, We Finally Have the Answers) – Part II

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The final regulations recently issued under Section 403(b) contain many new components that employers offering 403(b) programs should consider. This client memorandum discusses many of these developments, including:

- the requirement that all 403(b) programs be maintained in accordance with a written plan document;
- the ability for employers (that are not otherwise related through the current aggregation rules) to be treated as one employer (for many employee benefit purposes, including 403(b) programs) if the organizations regularly coordinate their day-to-day exempt activities;
- the new opportunity to terminate a 403(b) program and distribute benefits to participants as a result of program termination;
- clarification of the meaning of “severance from employment” for distribution purposes under 403(b) programs;
- coordination of the special 403(b) catch-up contribution and the age 50 catch-up contribution; and
- clarification of the exchange and transfer rules applicable to 403(b) programs (replacing the rules in IRS Notice 90-24).

The Internal Revenue Service (“IRS”) last issued extensive regulations under Internal Revenue Code (“Code”) Section 403(b) on December 24, 1964. In November 2004, the IRS issued proposed regulations and now, more than two years later, the IRS has published an updated set of comprehensive final regulations concerning 403(b) programs (also commonly referred to as tax-sheltered or tax-deferred annuity plans), which are available to employees of Section 501(c)(3) organizations and public schools. The primary purposes of this newest set of regulations are to organize and consolidate the Section 403(b) guidance issued since 1964 and to override prior guidance that no longer applies. The final regulations also provide additional flexibility, introduce new restrictions and attempt to make 403(b) programs operate more like 401(k) plans, although key differences remain. Qualified 401(k) plans became available to Section 501(c) organizations in 1996, but 403(b) programs remain common among the organizations that are eligible to sponsor them.

**EFFECTIVE DATE.** The final regulations are generally effective for taxable years beginning after December 31, 2008. There are, however, some exceptions. The regulations will not be effective for 403(b) programs offered by certain church-related organizations until plan years following December 31, 2009. With respect to any 403(b) program offered under a collective bargaining agreement that is ratified and in effect on July 26, 2007, the final regulations will not be effective be-

agreement terminates or July 26, 2010. There are also other special effective dates as noted below (including the application of the universal availability rules under IRS Notice 89-23, and transfers under IRS Revenue Ruling 90-24). Employers can rely on these final regulations from July 26, 2007 until the actual effective date of the final regulations, if such reliance is done on a consistent and reasonable basis.

*DBGC Comment: For most employers, these rules will be effective January 1, 2009. This is one year later than the effective date in the proposed regulations.*

## ANALYSIS OF SELECTED COMPONENTS OF THE FINAL REGULATIONS

Many of the items in the final regulations either do not change or make only minor changes to existing law (*i.e.*, tax treatment, plan loans, qualified domestic relations orders and required minimum distributions, as applicable to 403(b) programs). Rather than cover all topics addressed in the final regulations, this client alert and chart focuses on provisions in which the final regulations change our understanding of the IRS’s position on an issue or make more than a minor change from current law.

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>PLAN DOCUMENT REQUIREMENT / ERISA IMPLICATIONS</b>		
<ul style="list-style-type: none"> <li>▪ Many 403(b) programs do not have written plan documents, in part because the IRS and the Department of Labor (“DOL”) take different positions on written documentation requirements for 403(b) programs. <ul style="list-style-type: none"> <li>▪ The IRS does not currently require 403(b) programs to be in writing.</li> <li>▪ The DOL requires 403(b) programs to be in writing if they are subject to the Employee Retirement Income Security Act of 1974 (“ERISA”).</li> </ul> </li> <li>▪ As a general rule, all retirement plans (including 403(b) programs) are subject to ERISA and must be in writing. An ERISA exception for 403(b) programs allows employers that have only limited involvement with a 403(b) program to treat the program as exempt from ERISA. An employer’s involvement is considered limited if the employer’s role consists of little more than allowing selected 403(b) program vendors to offer 403(b) products to employees and facilitating the withholding and deposit of employee contributions.</li> <li>▪ The IRS has tried for years to encourage employers to take ownership of 403(b) programs offered to their employees by making it clear that the various substantive requirements contained in the Code apply to a 403(b) program regardless of whether it is subject to ERISA. The IRS also imposes on employers the responsibility for and, ultimately, the liability related to compliance with these substantial requirements.</li> <li>▪ An exception from ERISA also applies to certain church sponsored plans.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Effective for taxable years beginning after December 31, 2008, the final regulations require that <b>all</b> 403(b) programs be maintained pursuant to a written plan document. A “plan” is defined as a <b>written</b> defined contribution plan that, in form and operation, satisfies the regulatory requirements of the 403(b) rules and contains <b>all</b> of the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made.</li> <li>▪ The DOL clarified in Field Assistance Bulletin 2007-02 that tax-sheltered annuity programs that comply with the final regulations under Section 403(b) can still be structured so that they are excluded from coverage under Title I of ERISA. It is the DOL’s view that tax-exempt employers can engage in a range of activities to facilitate the operation of a tax-sheltered annuity program under the new IRS regulations and still remain within the safe harbor’s criteria.</li> <li>▪ The plan may incorporate by reference other documents, including insurance policies and custodial account agreements.</li> <li>▪ The plan may allocate to a third party, but not to participants, the responsibility for performing the administrative functions of the plan. The plan must identify who is responsible for the administrative functions (in particular those related to tax compliance).</li> </ul>	<ul style="list-style-type: none"> <li>▪ The plan document requirement is not a significant change for an employer that already treats its 403(b) program as subject to ERISA (and already has a written plan document). Many 403(b) programs, however, are structured to satisfy the limited employer involvement exception. These types of arrangements typically are not in written form and, in many cases, the employer does not even communicate or have an established relationship with the vendors for any of the 403(b) programs in which the employees participate.</li> <li>▪ Several issues may result from the “written” plan requirement: <ul style="list-style-type: none"> <li>▪ First, this could cause a major headache for employers who previously treated 403(b) programs as exempt from ERISA and did not maintain a written plan.</li> <li>▪ Second, to structure a 403(b) program to comply with the safe harbor for exclusion from coverage under Title I of ERISA, the plan documents should describe the employer’s limited role and allocate discretionary determinations to the annuity provider or other third party selected by the provider. To avoid employer involvement outside the safe harbor, the employer should avoid negotiating with annuity providers or account custodians to change the terms of their products.</li> <li>▪ Third, a plan that incorporates other documents by reference must ensure that there is no conflict among the documents. If a plan does incorporate other documents by reference, the plan would govern in the event of a conflict with another document.</li> </ul> </li> </ul>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>CONTROLLED GROUP / AGGREGATION RULES</b>		
<p>Under Sections 414(b) and (c), if two or more employers are linked by 80% or greater common ownership (<i>i.e.</i>, as brother-sister entities with a common parent or as parent-subsidiary entities), regardless of whether the organizations are incorporated, they are treated for most employee benefit purposes as a single employer. Because of the lack of the context of “common ownership” in the tax-exempt area, the IRS has issued internal guidance (through private letter rulings) in the past that 80% or more board control of two entities would cause two tax-exempts to be treated as a single employer for a number of employee benefit purposes.</p>	<ul style="list-style-type: none"> <li>▪ The final regulations specifically provide that the board control test is applicable to determine who is a member of the controlled group for 403(b) program purposes.</li> <li>▪ Exempt organizations that maintain a single plan covering one or more employees from each organization may treat themselves as under common control for purposes of Section 414(c) if the organizations regularly coordinate their day-to-day exempt activities. This permissive aggregation rule applies even if the organizations are not linked by at least 80% board control.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Tax-exempt employers will have more certainty with the 80% board control test as the actual aggregation test for employee benefit purposes (including for a 403(b) program).</li> <li>▪ The final regulations permit tax-exempt employers (that otherwise could not be aggregated under the board control test or any other test) to treat themselves as one employer for 403(b) program purposes if they regularly coordinate their day-to-day activities.</li> <li>▪ All new aggregation rules are written to apply broadly to non-403(b) programs (such as other retirement plans, health plans, group-term life and others).</li> </ul>
<b>PLAN TERMINATION</b>		
<ul style="list-style-type: none"> <li>▪ Currently, an employer that no longer wants to offer a particular 403(b) program to its employees has only one real option: to freeze the 403(b) program and cease contributions.</li> <li>▪ Under current law, it is not possible for a 403(b) program to be terminated and for all of the assets to be distributed to participants or rolled over to another 403(b) plan, an IRA or to a qualified retirement plan that accepts such rollovers as a result of the termination.</li> <li>▪ The only way that 403(b) program benefits currently can be distributed is on the occurrence of specific events under the 403(b) rules (<i>i.e.</i>, termination of employment, disability, death, attainment of age 59½ or, in certain cases, hardship withdrawals).</li> </ul>	<ul style="list-style-type: none"> <li>▪ The final regulations generally allow an employer to amend its 403(b) program to contain a provision that permits termination of the 403(b) program and authorizes all benefits accumulated under the 403(b) program to be distributed on account of termination. Whether a particular 403(b) arrangement may be terminated depends on facts and circumstances.</li> <li>▪ For 403(b) arrangements of employers in a controlled organization, the termination of a 403(b) program will be permitted –for employee elective deferral contributions and employer contributions to a custodial account – only if the employer (taking into account all entities that are treated as the employer under the controlled group rules on the date of termination) does not make contributions to an “alternative” 403(b) program for 12 months following the date of final distribution. A <i>de minimis</i> exception to this rule applies if less than 2% of the employees who were covered under the terminated 403(b) program were eligible to participate in another 403(b) arrangement for the 12-month periods preceding and following the termination date.</li> <li>▪ For a 403(b) program to be considered terminated, <b>all</b> accumulated benefits must be distributed to all participants and beneficiaries as soon as administratively practicable after the termination of the 403(b) program. Purchase of a fully paid individual insurance contract also satisfies this requirement.</li> </ul>	<ul style="list-style-type: none"> <li>▪ This is a very helpful provision for tax-exempt employers with frozen 403(b) plans covering only former employees or for employers that wish to replace 403(b) arrangements with 401(k) plans.</li> <li>▪ Virtually every tax-exempt employer currently maintains some sort of 403(b) program (either active or frozen).</li> <li>▪ As employers considered offering 401(k) plans instead of 403(b) programs during the past 11 years, many were discouraged from adopting 401(k) plans because there was no viable way to terminate the existing 403(b) program and distribute or roll over plan assets.</li> <li>▪ This is the first time an employer can amend its 403(b) program to provide for program termination, and permit the distribution of all program assets to employees (either in cash or by rollover to another 403(b) program, a 401(k) plan or an IRA).</li> </ul>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>UNIVERSAL AVAILABILITY</b>		
<p>The universal availability requirement under Section 403(b)(12) provides that generally, all employees of an employer that offers a 403(b) program must be permitted to make elective deferrals if any employee of the employer may make elective deferrals under the 403(b) program. The Code permits certain employees to be excluded:</p> <ul style="list-style-type: none"> <li>▪ non-resident aliens;</li> <li>▪ employees eligible for 457(b) deferrals;</li> <li>▪ students; and,</li> <li>▪ employees who normally work fewer than 20 hours per week.</li> </ul> <p>IRS Notice 89-23 permits additional exclusions:</p> <ul style="list-style-type: none"> <li>▪ employees who make a one-time election to participate in a governmental plan instead of a 403(b) program;</li> <li>▪ certain visiting professors;</li> <li>▪ employees of a religious order who have taken a vow of poverty; and,</li> <li>▪ employees who are covered by a collective bargaining agreement.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Under the final regulations, the universal availability requirement will not be satisfied unless contributions are made pursuant to a 403(b) plan and the plan (with certain limited exceptions) gives all employees of an employer an effective opportunity to make elective deferrals if any employee of that employer has the right to make elective deferrals. Whether an employee has an effective opportunity to make elective deferrals is determined on the basis all of the relevant facts and circumstances.</li> <li>▪ If a 403(b) plan permits any eligible employee to make Roth contributions to the plan, the final regulations clarify that an employee's right to make elective deferrals also includes the right to designate elective deferrals as Roth contributions.</li> <li>▪ The final regulations contain special rules providing that the universal availability requirement generally applies separately to each common law entity (<i>i.e.</i>, each Section 501(c)(3) organization) or, in the case of a Section 403(b) program that covers the employees of more than one state entity, each entity that is not part of a common payroll. In addition, if, for employee benefit purposes, an employer has historically treated one or more of its geographically distinct units as separate, such employer may continue to treat each unit as a separate entity if the entity is operated independently on a day-to-day basis (subject to certain restrictions).</li> <li>▪ Employers will still be able to exclude certain categories of employees from 403(b) program participation without violating the universal availability requirement. After various transition periods expire between now and 2010, however, employers no longer may use the Notice 89-23 permitted exclusion guidance.</li> <li>▪ If an employee listed in any of the "excludable" categories is permitted to make 403(b) elective deferrals, then no other employee in that category may be excluded.</li> </ul>	<ul style="list-style-type: none"> <li>▪ This change more closely aligns 403(b) programs with 401(k) plans for nondiscrimination testing purposes by allowing the program sponsor to take into consideration or exclude various categories of employees (<i>e.g.</i>, permitting a 403(b) program to exclude employees who participate in the tax-exempt entity's 401(k) plan).</li> <li>▪ The regulations provide some guidance with respect to the exclusion of employees who normally work fewer than 20 hours per week, but employers should still consider the interplay of this provision with ERISA.</li> <li>▪ If a 403(b) program permits one person in an excluded category to make 403(b) contributions, all others in that category must be eligible.</li> <li>▪ The final regulations eliminate several useful exclusions that are currently permissible under the universal availability rules (employees under a collective bargaining agreement, visiting professors, those taking a vow of poverty, and those electing a governmental plan). The preambles contain helpful suggestions with respect to other rules that might achieve the same result for at least certain of these previously excluded groups.</li> <li>▪ Various transition periods apply with respect to the elimination of the exclusions under Notice 89-23.</li> </ul>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>NONDISCRIMINATION</b>		
<ul style="list-style-type: none"> <li>▪ IRS Notice 89-23 provides guidance for applying the nondiscrimination rules under Section 403(b)(12) to 403(b) programs with respect to employee salary deferrals and employer contributions.</li> <li>▪ Notice 89-23 provides that Section 403(b)(12) is satisfied if an employer operates its 403(b) program in accordance with a reasonable, good-faith interpretation of the Code. A tax-exempt entity could either make a good-faith interpretation of how to apply these provisions or could follow the safe harbor provisions outlined for nondiscrimination testing in Notice 89-23.</li> </ul>	<p>Notice 89-23 will no longer apply under the final nondiscrimination rules. The final regulations provide that employer and employee after-tax contributions must satisfy nondiscrimination requirements in the same manner as a qualified plan under Section 401(a). This includes Section 401(a)(4) (relating to nondiscrimination in contributions and benefits); Section 401(a)(17) (limiting the amount of compensation that can be taken into account); Section 401(m) (relating to matching and after-tax contributions); and Section 410(b) (relating to minimum coverage). Compliance with these provisions would be tested using compensation as defined in Section 414(s). These rules do not apply to Section 403(b) elective deferrals (which are subject to the requirement of universal availability).</p>	<ul style="list-style-type: none"> <li>▪ Safe harbor nondiscrimination provisions that are currently available will be eliminated.</li> <li>▪ Section 403(b) programs generally must apply the general nondiscrimination testing rules of Section 401(a)(4) to employer contributions.</li> <li>▪ Good-faith interpretation to satisfy the nondiscrimination rules no longer will be allowed (for state and local public schools and certain church entities).</li> </ul>
<b>MAXIMUM CONTRIBUTION LIMITS</b>		
<p>Although 403(b) programs are no longer subject to the maximum exclusion allowance, which was repealed under the Economic Growth and Tax Relief Reconciliation Act of 2001 for plan years after 2001, they are subject to the annual elective deferral limitation under Section 402(g) and the annual additional limitation under Section 415. Any contributions (other than rollover contributions) made on behalf of a participant under a 403(b) program in excess of these limits (subject to the special 403(b) catch-up and age 50 catch-up contributions) are not excludable from the participant's gross income. The annual elective deferral limitation, which is \$15,500 in 2007, applies to a participant's pretax and designated Roth contributions. The annual additions limitation applies to a participant's pretax, after-tax and employer contributions (matching or nonelective employer contributions) and is the lesser of \$45,000 in 2007 or 100% of the participant's compensation.</p>	<ul style="list-style-type: none"> <li>▪ Excess elective deferrals or annual additions would cause the excess portion to fail the Section 403(b) requirements. Under the final regulations, the term "elective deferral" includes designated Roth contributions and pretax elective contributions.</li> <li>▪ Effective for tax years beginning after December 31, 2008, the final regulations incorporate the rules applicable to 401(k) plans for correcting such excess contributions. In other words, if excess annual deferrals are distributed (with earnings) by April 15 of the year following the year of contribution (or in accordance with regulations under Section 402(g)), or if excess annual additions are distributed in accordance with regulations under Section 415, neither the excess nor the corrective distributions will trigger violations under Section 403(b) or other provisions of the final regulations.</li> <li>▪ A participant's compensation for annual additions limitation purposes is defined as his or her "includable compensation," which is specifically defined in the regulations.</li> </ul>	<p>Under the final regulations, 403(b) plan sponsors may amend their 403(b) programs to incorporate the authority to correct excess elective deferrals and annual additions in the same manner that such excess contributions may be corrected under 401(k) plans.</p>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>CATCH-UP CONTRIBUTIONS</b>		
<ul style="list-style-type: none"> <li>▪ Two separate catch-up contributions are available to eligible 403(b) program participants: <ul style="list-style-type: none"> <li>▪ A special 403(b) catch-up contribution election is available to an employee once he or she has completed at least 15 years of service with the same “qualified organization” (“15-year catch-up contribution”). A “qualified organization” includes any educational organization, hospital, home health service agency, health and welfare service agency, and certain church and church-related organizations.</li> <li>▪ An age 50 catch-up contribution is available for employees age 50 and over under 403(b) programs and qualified retirement plans.</li> </ul> </li> </ul>	<p>Although the 15-year catch-up contributions and the age 50 catch-up contributions have not changed, the regulations do clarify how they are to be coordinated and clarify and expand the definition of a health and welfare service agency to include adoption agencies and agencies that provide either home health services, assistance to individuals with substance-abuse problems or that provide assistance to the disabled.</p> <p>The final regulations state that an employee could be eligible for both, but that any amounts contributed in excess of the annual deferral limit (<i>i.e.</i>, \$15,500 in 2007) must first be treated as a 15-year catch-up contribution and second as an age 50 catch-up contribution. The final regulations also contain several examples that illustrate the application and coordination of the various applicable dollar limits on 403(b) elective deferrals and catch-up contributions.</p>	<p>By explicitly stating that participants may make both catch-up contributions, the final regulations eliminate any concern that employers had regarding a participant’s ability to do so. Employers should review existing administrative practices to make sure this is happening. Coordinating, administering and communicating these provisions to affected participants, however, are likely to remain challenging.</p>
<b>EXCHANGES AND TRANSFERS</b>		
<p>Under Revenue Ruling 90-24, an individual may exchange an annuity contract for another annuity contract without triggering a taxable event as long as the annuity contract received in the exchange is materially similar to the contract being exchanged. Similarly, an individual may transfer funds from one 403(b) funding vehicle to another without triggering taxation if the transferred funds continue to be subject to the same (or more stringent) distribution restrictions imposed on them before the transfer. The transfer may be made regardless of whether a complete or partial interest is transferred, the transfer is directed by the individual, or the individual is a current or former employee or a beneficiary of a former employee.</p>	<ul style="list-style-type: none"> <li>▪ Revenue Ruling 90-24 will no longer apply, but 90-24 type transfers are still possible.</li> <li>▪ The final regulations permit 403(b) funding vehicles to be exchanged for other 403(b) funding vehicles held under the same 403(b) program without triggering taxation if the exchange satisfies the following conditions: <ul style="list-style-type: none"> <li>▪ The plan allows for the exchange;</li> <li>▪ The benefit after the exchange is at least equal to the benefit before the exchange;</li> <li>▪ The distribution restrictions in the other 403(b) program (after the exchange) are at least as stringent as before; and,</li> <li>▪ There is an agreement with the investment provider of the 403(b) program (after the exchange) under which the employer and the provider provide each other with information necessary to make sure that the contract satisfies 403(b) (including employment information, information to apply the distribution and withdrawal rules and loan-related information).</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ On the basis of the proposed regulations, some of our clients were planning to issue communications to 403(b) program participants about the limited future availability of 90-24 transfers. Although 90-24 type transfers will not be going away, employers should now review the new restrictions under the final regulations to determine if these transfers are still practical.</li> <li>▪ In addition, the final regulations provide that these new rules do not apply to exchanges occurring on or before September 24, 2007 (assuming the exchange satisfies the current 90-24 rules).</li> <li>▪ Sponsors will need to develop forms and procedures for implementing transfers to a new provider.</li> </ul>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
	<ul style="list-style-type: none"> <li>As is the case under current law, the final regulations will restrict transfers between 403(b) and 457 plans, but allow transfers from one 403(b) program to another 403(b) program (if conditions similar to those under the above-described internal plan exchange rule are satisfied). Transfers from a 403(b) program to another tax-qualified plan (such as a 401(k) plan) are also prohibited (although, under certain circumstances it will now be possible to terminate the 403(b) program, provide for distributions and allow rollovers to a 401(k) plan).</li> </ul>	
<b>CONTRIBUTIONS FOR FORMER EMPLOYEES</b>		
<p>Under the current rules, an employer may make nonelective contributions under a 403(b) program on behalf of a former employee for the remainder of the year in which the employee terminates employment and up to five years thereafter.</p>	<ul style="list-style-type: none"> <li>The final regulations continue to allow employers to make nonelective contributions for former employees, subject to compliance with the Code's nondiscrimination requirements.</li> <li>The final regulations provide guidance on how includable compensation and years of service are determined for purposes of the nonelective contributions for former employees. Nonelective contributions to former employees are limited to the lesser of the annual Section 415(c)(1) limit (100% of compensation or \$45,000 for 2007) or the former employee's annual includable compensation (which is based on the former employee's average monthly compensation during his or her most recent year of service).</li> <li>Rules for contributions to disabled former employees are also referenced.</li> </ul>	<ul style="list-style-type: none"> <li>Although this rule is not new, it is highlighted here because it has highly specific rules that, if violated, will result in a taxable event for the intended former employee beneficiaries. The final regulations contain helpful guidance on how to determine includable compensation and years of service for such post-termination contributions. Employers should keep in mind that years of service are determined under specific 403(b) regulation provisions, not under a plan, Code or ERISA definition.</li> <li>The application of the nondiscrimination rules to contributions for former employees makes it difficult for employers to make post-termination contributions only to or primarily for former employees who were previously considered "highly compensated."</li> </ul>
<b>"YEARS OF SERVICE" DEFINITION FOR INCLUDABLE COMPENSATION</b>		
<p>A 403(b) participant who is employed by a "qualified organization" <b>and</b> who has completed 15 "years of service" with one or more qualified organizations may make a special 403(b) catch-up contribution (as noted earlier in this alert). In addition, some employers make contributions on behalf of former employees, as permitted under Section 403(b) (as also noted earlier in this alert).</p>	<p>The final regulations define how years of service will be determined for participants who are eligible for the special 403(b) catch-up contribution and for former employees who are eligible for employer contributions made after employment ends.</p>	<p>The final regulations provide a number of useful examples to assist practitioners and employers in determining service for permissible catch-up contributions and contributions for former employees. Employers offering these contributions should keep in mind that these rules are specifically designed for these limited purposes and are <b>not</b> for general application to the participation and vesting requirements under their programs.</p>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>FICA WITHHOLDING</b>		
<p>Under Section 3121(a), wages subject to the Federal Insurance Contributions Act (“FICA”) withholding requirements include all employment-related remuneration that is not covered by an exception. An exception applies to payments made by an employer on behalf of an employee to purchase a Section 403(b) annuity contract; however, there are no exceptions for payments made under salary reduction agreements.</p>	<ul style="list-style-type: none"> <li>▪ The final regulations cross-reference Section 3121(a)(5)(D) concerning the definition of wages for FICA purposes. The temporary regulation under Section 31.3121(a)(5)-2T clarifies the “salary reduction agreement” definition and provides that the term includes programs that provide for payments to be made on the basis of employee elections to reduce compensation under a cash or deferred arrangement.</li> <li>▪ The temporary regulation became effective November 16, 2004 and expires on November 16, 2007.</li> </ul>	<p>Employers that do not currently withhold FICA tax from employee pretax contributions to their 403(b) programs should review their practices to determine whether FICA tax withholding is required. The expansion of the “salary reduction agreement” definition compared to the “elective deferral” definition (which applies for income tax purposes) could subject a broader range of 403(b) program contributions to FICA tax because salary reduction contributions may no longer qualify for the exception applicable to employer payments on behalf of employees who purchase Section 403(b) annuity contracts.</p>
<b>TIMING OF DISTRIBUTIONS</b>		
<p>Congress disfavors early withdrawal from any retirement plan. Consequently, Section 403(b) imposes early distribution restrictions on contributions to a 403(b) program. A 403(b) program may properly distribute amounts any time after an allowable distribution event has occurred (subject to compliance with the minimum distribution rules). The rules vary slightly depending upon the type of 403(b) program, but generally include:</p> <ul style="list-style-type: none"> <li>▪ attainment of age 59½;</li> <li>▪ death;</li> <li>▪ disability;</li> <li>▪ severance from employment; or</li> <li>▪ hardship.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Although the final regulations do not fundamentally change the current rules, they do try to conform the 403(b) program distribution events to those applicable under Code Section 401(k).</li> <li>▪ Termination of a 403(b) program would be a new distribution event under the final regulations. This new development is explained in greater detail elsewhere in this client alert.</li> </ul>	<ul style="list-style-type: none"> <li>▪ These rules are generally the same under current law. The biggest change is that terminating a 403(b) program would be an event that permits distributions.</li> </ul>
<b>SEVERANCE FROM EMPLOYMENT</b>		
<p>The current law provides that “severance from employment” is one of the events that allow a 403(b) program to make distributions to affected employees.</p>	<ul style="list-style-type: none"> <li>▪ The final regulations clarify when an employee’s employment termination is a severance from employment for distribution purposes.</li> <li>▪ A special rule in the final regulations provides that severance from employment can occur on any date on which an employee ceases to be an employee of an eligible employer (e.g., the employer that maintains the 403(b) program), even though the employee may continue to be employed either (i) by another entity that is treated as the same employer (where either that other entity is not an eligible employer (such as transferring from a Section 501(c)(3) organization to a for-profit subsidiary) or (ii) in a capacity that is not employment with an eligible employer (e.g., ceasing to be an employee performing services for a public school but continuing to work for the same state employer).</li> </ul>	<p>This will be an issue for 501(c)(3) employers that also have for-profit subsidiaries or joint ventures, since employees could continue to work in the controlled group but may be considered separated from employment for 403(b) program distribution rules. Defining distribution events will be a critical plan design issue for many employers.</p>

CURRENT LAW	FINAL REGULATION	ANALYSIS/POTENTIAL IMPACT
<b>FAILURE TO SATISFY 403(B) REQUIREMENTS</b>		
<p>Code Section 403(b)(5) provides that all contracts purchased by an employer for an employee are treated as a single contract for purposes of Code Section 403(b).</p> <p>If a 403(b) contract fails to satisfy the Code Section 403(b) requirements, the primary consequence is loss of tax-deferral and income inclusion for the employee. The specific tax result, however, is dependent upon whether the funding vehicle for the program is a Code Section 403(b)(1) annuity contract or a Code Section 403(b)(7) custodial account.</p>	<ul style="list-style-type: none"> <li>▪ The final regulations provide that, if a 403(b) contract includes any amount that fails to satisfy the requirements of Code Section 403(b), then that contract, and any other contract purchased for that individual by the employer, will not constitute a 403(b) program. For example, if an employer fails to maintain a written plan document, then any contract purchased by that employer would not constitute a 403(b) program. Similarly, if an employer is not an eligible employer for purposes of Code Section 403(b), then none of the contracts purchased by that employer constitutes a 403(b) program.</li> <li>▪ Certain limited exceptions may apply in the case of vesting failures or excess contributions (under Code Section 415 or excess deferrals under Code Section 402(g)).</li> <li>▪ The final regulations clarify that any operational failure solely within a specific 403(b) contract generally will not adversely affect the contracts issued to other employees that qualify in form and operation with Code Section 403(b) unless the operational failure relates to nondiscrimination (including a failure to operate the plan in accordance with its provisions or a failure to operate the plan in a manner that satisfies the nondiscrimination rules) or an employer eligibility failure.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Employers will need to carefully monitor 403(b) plan compliance to ensure that failures associated with one contract do not taint other contracts it maintains. Failure to do so could result in unfavorable tax treatment for employees under 403(b) programs in which they participate.</li> <li>▪ The final regulations provide some relief from these aggregation rules for certain operational failures.</li> </ul>
<b>ROTH CONTRIBUTIONS</b>		
<p>Beginning in 2006, 403(b) plans were permitted to allow employees who made salary reduction contributions to designate some or all of those contributions as Roth contributions. Designated Roth contributions are made to a plan on an after-tax basis; however, earnings attributable to the designated Roth contributions accumulate tax-free. To qualify as a Roth contribution, the salary reduction contribution must be irrevocably designated as such by the employee at the time of deferral. Roth contributions must be segregated by the 403(b) plan in a separate account apart from other pretax deferrals that are made to the plan.</p> <p>Qualified distributions from Roth accounts (including earnings) generally are excluded from the employee's gross income. A qualified distribution is one that occurs after a five-year period of participation and that either (i) is made on or after the employee attains age 59½; (ii) is made after the employee's death; or (iii) is attributable to the employee being disabled.</p>	<ul style="list-style-type: none"> <li>▪ The final regulations incorporate the rules that were previously issued with respect to elective deferrals that are designated Roth contributions under a 403(b) plan.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The final regulations adopt the same rules that are generally effective under current law. Employers may want to consider adding the Roth feature to 403(b) plans if not already offered. Certain employees may favor the concept of Roth contributions as a matter of future tax planning.</li> </ul>

Questions regarding the final regulations or any other employee benefit issues may be directed to the members of our Employee Benefits and Executive Compensation Team listed below.

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