

Final Regulations Under Section 403(b)

August 8, 2007

On July 26, 2007, the Treasury Department and the Internal Revenue Service (IRS) issued final regulations under section 403(b) of the Internal Revenue Code that provide updated guidance on section 403(b) contracts and custodial accounts available to employees of public schools and certain tax-exempt organizations. The final regulations, which had been proposed in November 2004, represent the first comprehensive guidance issued under section 403(b) since 1964.

Below are some of the highlights of the final regulations:

- Effective Date: The final regulations are generally effective for taxable years beginning after December 31, 2008, with delayed effective dates for 403(b) plans offered under collective bargaining agreements, certain governmental 403(b) plans, and 403(b) plans sponsored by certain church organizations. Transition rules for some of the new requirements are also available.
- Written Plan Document Requirement: The final regulations adopt the requirement that a 403(b) program be maintained pursuant to a written plan document that satisfies section 403(b) in both form and operation and contains all the terms and conditions for eligibility, limitations, and benefits under the plan. The IRS and the Treasury Department will provide model plan language for public schools. Employers may draft plan documents that incorporate by reference other related documents (such as the insurance policies or custodial accounts). In companion guidance issued in Field Assistance Bulletin 2007-02, the Department of Labor confirmed that an employer can comply with the new requirements in the tax regulations and still qualify for the safe harbor for certain 403(b) programs funded solely with employee contributions, which excludes those programs from ERISA.
- Distribution Limitation: Nongrandfathered contracts not subject to distribution restrictions may offer distributions only after severance of employment or upon the occurrence of an event (such as the attainment of a fixed number of years of service, the attainment of a stated age under the plan, or disability).
- Timely Contribution Requirement: Contributions to 403(b) plans must be transferred to providers within a period no longer than is reasonable for proper plan administration (for

example, elective deferrals transferred within 15 business days following the month in which these amounts would have been paid to the participant).

- Incidental Life Insurance Prohibited: Incidental life insurance, unless grandfathered, may not be part of a 403(b) plan.
- Termination of 403(b) Plans Allowed: A 403(b) plan may terminate and distribute assets to participants with full rollover ability. In order for a 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan; the employer is generally precluded from making 403(b) contributions to a successor plan for 12 months.
- Contract Exchanges: The regulations essentially revoke Revenue Ruling 90-24 as of September 24, 2007. The final regulations provide that investment products may continue to be exchanged on a nontaxable basis if (i) the plan permits the exchange, (ii) the participant's accumulated benefit after the exchange is at least as great as such benefit before the exchange, (iii) the new product imposes distribution restrictions that are at least as stringent as those applicable under the old product, and (iv) the employer and new issuer enter into an agreement to provide to each certain information related to tax compliance requirements.
- Universal Availability of Employee Contributions: The final regulations require that if any employee of an employer that offers a 403(b) arrangement is allowed to make elective deferrals under the 403(b) plan, all employees of the employer must be allowed to make elective deferrals under the 403(b) plan, with certain exceptions, including nonresident aliens, employees eligible for section 457(b) deferrals, students, and employees who normally work fewer than 20 hours per week. There is no exception for union employees, but transition rules permit additional exclusions for limited periods.
- Catch-Up Contribution: Under the final regulations, a 403(b) plan can provide for (i) a catch-up contribution for a participant who is age 50 or older (up to \$5,000 in 2007) and (ii) an additional special catch-up contribution for a participant who has at least 15 years of service. The final regulations confirm that if a participant is eligible for both catch-up contributions, the special 15-years-of-service catch-up contribution is applied first.
- Treatment of Controlled Groups That Include Tax-Exempt Entities: The final regulations impose new controlled group rules on tax-exempt entities. In general, control by one organization of 80% or more of the board members of another organization will cause the organizations to be treated as a single employer. The new controlled group rules have important implications beyond 403(b) plans for tax-exempt organizations, including nondiscrimination testing for welfare and pension benefit plans, calculating plan limits, tracking eligibility and vesting service, and determining eligibility for distributions. The new controlled group rules do not apply to governmental entities or certain church plans.
- Administrative Obligations: The plan document will need to coordinate the responsibilities of the employer and the vendors that are selected to provide 403(b) contracts and custodial accounts. Employers will also need to oversee whether the vendors are fulfilling their administrative obligations. Certain rules, such as loans and hardship provisions, must be

administered on the basis of aggregated contracts and custodial accounts, which will require a much greater level of communication and coordination than in the past.

If you have any questions about the issues raised in this Morgan Lewis LawFlash, please contact any of the following attorneys from our Employee Benefits Practice:

Chicago

Brian D. Hector 312.324.1160 bhector@morganlewis.com

Dallas

Riva T. Johnson 214.466.4107 riva.johnson@morganlewis.com
Heath Miller 214.466.4118 hmillier@morganlewis.com

New York

Craig A. Bitman 212.309.7190 cbitman@morganlewis.com

Philadelphia

Robert L. Abramowitz 215.963.4811 rabramowitz@morganlewis.com
I. Lee Falk 215.963.5616 ilfalk@morganlewis.com
Vivian S. McCardell 215.963.5810 vmccardell@morganlewis.com
Steven D. Spencer 215.963.5714 sspencer@morganlewis.com

Pittsburgh

John G. Ferreira 412.560.3350 jferreira@morganlewis.com
Lauren Bradbury Licastro 412.560.3383 llicastro@morganlewis.com
R. Randall Tracht 412.560.3352 rtracht@morganlewis.com

San Francisco

Mark H. Boxer 415.442.1695 mboxer@morganlewis.com
Eva P. McComas 415.442.1249 emccomas@morganlewis.com

Washington, D.C.

Althea R. Day 202.739.5366 aday@morganlewis.com
Margery Sinder Friedman 202.739.5120 mfriedman@morganlewis.com
Gregory L. Needles 202.739.5448 gneedles@morganlewis.com

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