

**GEORGETOWN UNIVERSITY LAW CENTER
CONTINUING LEGAL EDUCATION**

REPRESENTING & MANAGING TAX-EXEMPT ORGANIZATIONS

APRIL 28 & 29, 2005

Washington, DC

**Update on Retirement and Deferred Compensation
Planning for Exempt Organizations**

by

**Gregory L. Needles, Esquire
Kimberly A. Butlak, Esquire
Morgan, Lewis & Bockius LLP
Washington, DC**

**UPDATE ON RETIREMENT AND DEFERRED COMPENSATION
PLANNING FOR EXEMPT ORGANIZATIONS**

| | | |
|------|---|----|
| I. | INELIGIBLE DEFERRED COMPENSATION – IMPACT OF NEW § 409A..... | 1 |
| A. | Introduction..... | 1 |
| B. | Consequences of Code § 409A Noncompliance | 2 |
| C. | Ineligible Plans Under Code § 457(f)..... | 3 |
| D. | Requirements of Code § 409A..... | 7 |
| E. | Severance Plans..... | 10 |
| F. | Split-Dollar Life Insurance Arrangements..... | 11 |
| G. | Reimbursement Arrangements | 11 |
| H. | Incentive Plans | 12 |
| I. | Additional Code § 409A Guidance | 12 |
| II. | COMPREHENSIVE PROPOSED REGULATIONS UNDER CODE § 403(b)..... | 12 |
| A. | Introduction..... | 12 |
| B. | Definitions..... | 13 |
| C. | New 403(b) “Plan” Requirement..... | 18 |
| D. | Elective Deferrals Administered Like Code § 401(k) Plans | 19 |
| E. | Nondiscrimination of Elective Deferrals..... | 22 |
| F. | New Nondiscrimination Requirements for Employer Contributions and Employee After-Tax Contributions | 23 |
| G. | QDROs..... | 24 |
| H. | Asset Transfers and Plan-to-Plan Transfers | 24 |
| I. | Severance When No Longer Employed By a 403(b) Eligible Employer..... | 25 |
| J. | Termination Provisions | 25 |
| III. | NEW CONTROL-GROUP RULES FOR TAX-EXEMPT ORGANIZATIONS..... | 26 |
| A. | New Rule Control-Group Rule Applicable to Tax-Exempt Organizations | 26 |
| B. | “Employer” Under Tax-Exempt Control Rules..... | 26 |
| C. | Anti-Abuse Rule | 26 |
| IV. | COMING SOON: ROTH § 401(k) AND ROTH § 403(b)..... | 26 |
| A. | Introduction to Roth..... | 26 |
| B. | Why (and Why Not) Offer a Qualified Roth Contribution Program..... | 26 |
| C. | Establishing and Administering Roth Contributions | 27 |
| D. | More Roth Guidance to Follow..... | 30 |

UPDATE ON RETIREMENT AND DEFERRED COMPENSATION PLANNING FOR EXEMPT ORGANIZATIONS

In discussing what is new and what is on the horizon in the retirement and deferred compensation arena, Part I of this outline addresses the impact of a new law that became effective this year, Internal Revenue Code (“Code”) § 409A, which affects nonqualified deferred compensation arrangements. Part II addresses key provisions of long-awaited, comprehensive proposed regulations under Code § 403(b) that were released last fall and that become effective on January 1, 2006. Part III discusses a new proposed regulation under Code § 414 extending control-group rules to tax-exempt organizations. Finally, Part IV discusses the new proposed regulation governing Roth 401(k) plans, which become effective January 1, 2006. Part IV also highlights issues for an employer when evaluating whether to provide a Roth feature in its 401(k) plan or 403(b) arrangements.

I. INELIGIBLE DEFERRED COMPENSATION – IMPACT OF NEW § 409A. Part I of this outline discusses new Code § 409A, its requirements, and the consequences for noncompliance. Part I also analyzes how a substantial risk of forfeiture is determined under Code § 457(f) versus Code § 409A, then examines the impact of Code § 409A on certain nonqualified deferred compensation arrangements commonly used by tax-exempt employers.

A. Introduction. New Code § 409A became effective this year. It is an umbrella provision that applies *in addition* to the underlying Code section(s) governing an arrangement. Beginning on January 1, 2005, plans must operate in good-faith compliance with Code § 409A; beginning January 1, 2006, plans must also be amended to comply with Code § 409A. If Code § 409A is not complied with, the compensation sought to be deferred is subject to taxation immediately and a penalty and interest are imposed.

1. Plans Generally Affected By Code § 409A.

- (a) Traditional Retirement Vehicles. Code § 409A *does not* apply to traditional retirement vehicles, which are qualified plans under Code § 401(a); cash or deferred arrangements under Code § 401(k); and tax-sheltered annuities, custodial accounts, or retirement income accounts under Code § 403(b). IRC § 409A(d)(1)(A).
- (b) Qualified Deferred Compensation Plans. Code § 409A *does not* apply to qualified deferred compensation plans (so-called “eligible deferred compensation plans” or “457(b) plans”). IRC § 409A(d)(1)(B).
- (c) Nonqualified Deferred Compensation Plans. Code § 409A *does* apply to nonqualified deferred compensation plans. IRC § 409A(d)(1). In particular, Code § 409A applies to:
 - (i) 457(f) plans, as discussed in this outline at Part I.C, below;
 - (ii) Severance plans, as discussed in this outline at Part I.E, below;
 - (iii) Split-dollar life insurance arrangements, as discussed in this outline at Part I.F, below;
 - (iv) Reimbursement arrangements, as discussed in this outline at Part I.G, below; and

(v) Incentive plans, as discussed in this outline at Part I.H, below. For purposes of Code § 409A, a “plan” is just about any arrangement – including an arrangement that applies to only one person. A plan can be unilaterally adopted or negotiated, and it is irrelevant for purposes of Code § 409A whether the arrangement is a plan under the Employee Retirement Income Security Act of 1974 (“ERISA”).

Where the facts and circumstances reflect manipulation around Code § 409A, Treasury will aggregate arrangements to determine what constitutes a plan. Where there is a Code § 409A violation, the violation is imputed to all other like plans of the participant. IRS Notice 2005-1 Q&A-9.

2. Genesis of Code § 409A. Code § 409A became law as part of the American Jobs Creation Act of 2004 (“AJCA”), which President Bush signed into law on October 22, 2004. Pub. L. 108-357. AJCA was primarily intended to replace the extraterritorial export-tax regime, but in order for the bill to pass, it needed to be revenue neutral. Code § 409A was a revenue raiser that could help offset the cost of other provisions. Code § 409A was also seen as a response by Congress to perceived abusive deferred compensation practices. AJCA, JCT 69-04 at 9; Enron Report JCS-3-03 at 13, 19-20.
3. Different Definitions of “Substantial Risk of Forfeiture.” As stated above, any plan subject to Code § 409A must also comply with the underlying Code section governing that plan. For tax-exempt employers, the underlying Code section will most often be § 457(f). Therefore, part of this outline is devoted to the juxtaposition of those two sections. Code §§ 457(f) and 409A both provide that deferred amounts are not taxed until they are no longer subject to a substantial risk of forfeiture, also referred to as vested. The primary issue that arises when applying the two sections is that certain events that constitute a substantial risk of forfeiture under Code § 457(f) are *disregarded* when determining whether a substantial risk of forfeiture exists for purposes of Code § 409A. These issues are addressed in this outline at Part I.C.3, below.

B. Consequences of Code § 409A Noncompliance. If the requirements of Code § 409A are not satisfied, three consequences result:

1. Income Inclusion. Compensation deferred in the year of noncompliance, in addition to compensation deferred in previous years, is includible in the participant’s income to the extent it is not subject to a substantial risk of forfeiture (as defined under Code § 409A) or to the extent that it has not already been *included* in income. IRC § 409A(a)(1)(A).
→ *Practice Tip:* Because Code § 409A reads “included” in income (rather than “includible”), any argument asserted by a participant that the deferred compensation *should have been* included in income in a now closed tax year will be unavailing. (The statute was purposely drafted to thwart thus argument.)

2. Interest Imposed. Amounts previously deferred and not included in income are subject to interest imposed at the federal underpayment rate, plus 1%. IRC § 409A(a)(1)(B).

3. Penalty Imposed. Amounts includible in income are subject to a 20% penalty. IRC § 409A(a)(1)(B).

→ *Practice Tip:* Employers may want to consider indemnifying executives for any penalty and interest that is imposed for Code § 409A noncompliance. Note, however, that the indemnification agreement would also likely be subject to Code § 409A.

→ *Practice Tip:* Employers should also consider expressly reserving in their plan document the right to amend plans to comply with Code § 409A.

C. Ineligible Plans Under Code § 457(f). Most of the arrangements of a tax-exempt employer that are subject to Code § 409A are governed by Code § 457(f). Therefore, it is helpful to review the requirements of Code § 457(f).

Tax-exempt employers use 457(f) plans (so-called “ineligible plans”) to permit executives and other highly compensated employees to defer compensation and to encourage their continued employment with the tax-exempt organization. Because 457(f) plans are not subject to the restrictions of other tax-deferred arrangements (such as qualified plans and eligible deferred compensation plans), 457(f) plans afford more flexibility.

1. Code § 457(f) Income Inclusion and Substantial Risk of Forfeiture.

(a) Income Inclusion of Amounts Deferred Through a 457(f) Plan. Under Code § 457(f), compensation (and earnings thereon) deferred to a nonqualified plan of a tax-exempt employer is includible in income when it is no longer subject to a substantial risk of forfeiture (*e.g.*, upon vesting). IRC § 457(f)(1)(A).

(b) Substantial Risk of Forfeiture Under Code § 457(f). For purposes of Code § 457(f), a “substantial risk of forfeiture” exists where the employee’s right to receive compensation is conditioned, either directly or indirectly, upon his performing (or refraining from performing) substantial services in the future. IRC § 457(f)(3)(B); Treas. Reg. 1.83-3(c).

(i) Valid Risks of Forfeiture. Valid risks of forfeiture under Code § 457(f) exist where the executive vests in deferred compensation upon his termination from service due to his death, disability, or after a period of continued employment, generally at least 2 years. *See, e.g.*, PLR 2003-21-002; PLR 2001-09-006. The IRS has also ruled, although much less frequently, that a substantial risk of forfeiture can exist where a participant’s benefits vest at a change in control, PLR 94-29-

007, or upon an involuntary termination *without* cause. PLR 2003-31-002; PLR 1999-43-008; PLR 89-52-069.

- (ii) Rolling Risks of Forfeiture. Some 457(f) plans allow extensions of the vesting period on amounts deferred. In the typical situation, an executive may have a vested right to deferred compensation in year 3. In year 2, the executive decides that he wants to continue working for the tax-exempt employer and to continue to defer taxation of compensation in his 457(f) plan. The employer and the executive may renegotiate the vesting date and extend it to year 5. In this example, the parties rolled the risk of forfeiture for 2 additional years. The IRS scrutinizes these agreements that extend the risk of forfeiture. The IRS requires that the extension be a joint decision by the employer and executive based on a demonstrable, independent business purpose, such as the renegotiation of the executive's employment agreement. The IRS is skeptical of arrangements where an executive has a recurring or frequent option to extend the risk, or can extend the period shortly before the risk lapses. The only guidance the IRS has issued in this area is a private letter ruling in which it approved a one-time postponement of vesting. PLR 94-31-021. This area, however, continues to be under review by the IRS. As discussed in this outline at Part I.C.2.b, below, for purposes of Code § 409A any extension of a substantial risk of forfeiture is *invalid*.

- (iii) Post-Termination Conditions: Consulting and Non-Compete Agreements. A 457(f) plan may condition receipt of deferred compensation upon adherence to a non-compete agreement or the performance of post-employment consulting services. There is a rebuttable presumption against these conditions, which means that the executive must demonstrate, based on the facts and circumstances, that there is a real likelihood that he will be called upon to either perform or refrain from performing substantial services. He can rebut this presumption by evidence of the employer's practices, his capability, and the employer's desire for him to be available to the employer, as well as for his talents to remain publicly identified with the employer. GCM (Mar. 29, 1978). Other relevant factors may include the executive's age and health, and the likelihood of other employment opportunities available to him. As discussed more fully in this outline at Part I.C.2.b, below,

for purposes of Code § 409A, non-compete agreements are disregarded.

2. Code § 409A Income Inclusion (With Penalties and Interest) and Substantial Risk of Forfeiture.

- (a) Nonqualified Deferred Compensation (Including Compensation Deferred Under a 457(f) Plan) Subject to Code § 409A. Code § 409A applies to compensation to which an employee has a legally binding right in one year but that is paid *more than 2 ½ months after the close of the year* (the later of the employer's or the executive's tax year) in which it is no longer subject to a substantial risk of forfeiture. IRS Notice 2005-1 Q&A-4(c).

This rule is illustrated by the following example: An executive participating in a deferred compensation plan has a vested right to benefits after remaining employed for 5 years or upon termination due to death or disability. The deferred compensation plan requires that he is paid no later than February 1 of the year following the year his compensation vests, and he is paid by that date. The employer's tax year ends on September 30th; the executive's tax year ends on December 31st. Because the executive's compensation is paid before March 15 (2 ½ months after the close of the later of the employer's tax year or the executive's tax year), the executive does not have deferred compensation subject to Code § 409A. The entire amount is includible in the executive's income under Code § 457(f) in the year it was no longer subject to a substantial risk of forfeiture (which, in this example, is the year *before* it was paid). Code § 409A is never implicated. Note that regardless of whether an executive's deferred compensation vests on January 1 or December 31 (or a date in between), it must be paid 2 ½ months after the close of the year.

This rule carries two important considerations:

- (i) The 2 ½ month rule is transitional; it applies only until Treasury releases further guidance on this issue.
- (ii) The substantial risk of forfeiture for purposes of Code § 409A is more restrictive than the substantial risk of forfeiture for Code § 457(f), as discussed more fully in this outline at Part I.C.3, below.

This 2 ½ month rule takes most 457(f) plans out of the reach of Code § 409A. Most 457(f) plans pay the participant upon lapse of a substantial risk of forfeiture. Therefore, the executive is paid within 2 ½ months after the year the compensation vests.

(b) Substantial Risk of Forfeiture Under Code § 409A – Rolling Risks and Non-Competes Disregarded. A substantial risk of forfeiture exists under Code § 409A if:

- (i) A participant’s entitlement to an amount requires the performance of substantial future services or the occurrence of a compensation-related condition, and
- (ii) The possibility of forfeiture is substantial.

The vesting condition must relate to the participant’s performance of service for the employer or the employer’s business goals. For purposes of Code § 409A (unlike Code § 457(f)) an amount will not be considered subject to a substantial risk of forfeiture beyond when the participant could have received the compensation. This means that rolling risks of forfeiture, valid for Code § 457(f), are disregarded under Code § 409A. Also, for purposes of Code § 409A, an amount *is not* subject to a substantial risk of forfeiture solely because the right to receive the amount is conditioned on *refraining* from performing services. This means that non-compete agreements that are valid under Code § 457(f) are disregarded for Code § 409A. IRS Notice 2005-1 Q&A-10. If an executive’s deferred compensation arrangement relies upon a non-compete agreement for purposes of Code § 457(f), then it must comply with 409A, because the non-compete agreement is not a valid substantial risk of forfeiture for purposes of Code § 409A.

Consider the following example: Assume an executive becomes vested in his benefits under a 457(f) plan one year after he terminates from employment, but only if he complies with the provisions of a non-compete agreement. The non-compete is disregarded when determining the existence of a substantial risk of forfeiture for purposes of Code § 409A, and, to avoid immediate inclusion in income, penalty, and interest, the executive must comply with the requirements of Code § 409A, which are discussed in this outline at Part I.D, below.

3. Issues Regarding the “Substantial Risk of Forfeiture.” As stated above in Parts I.C.1(b) and I.C.2(b), the definition of “substantial risk of forfeiture” is different under Code § 457(f) and Code § 409A. This means that a deferred compensation arrangement can have a valid substantial risk of forfeiture under Code § 457(f), but may still be subject to taxation under Code § 409A if the validity of the substantial risk of forfeiture is not recognized under Code § 409A. Therefore, a tax-exempt employer (or its advisors) must be aware of where the Code § 409A definition departs from Code § 457(f). This section highlights special concerns with the definition of a substantial risk of forfeiture for purposes of Code § 409A.

- (a) Rolling Risks of Forfeiture. As stated in Part I.C.2.b, a rolling risk of forfeiture permitted under Code § 457(f) is *disregarded* for purposes of determining whether there is a substantial risk of forfeiture under Code § 409A. Consequently, while the risk of forfeiture may be rolled under Code § 457(f), it must comply with the requirements of Code § 409A, which will apply upon the conclusion of the first vesting period. Under Code § 409A(a)(4)(C), rolling the risk is treated as a “subsequent election” to defer, and two requirements must be met to remain Code § 409A compliant. First, any agreement to extend the vesting schedule must be made *at least 12 months before* the executive would have otherwise vested. Second, the vesting schedule must be extended *for at least 5 years* beyond the original vesting date (called a “push back”). These requirements are discussed in this outline at Part I.D.1(d), below.
- (b) Non-Compete Agreements. As stated above in Part I.C.2.b, a non-compete agreement is *disregarded* for purposes of determining whether there is a substantial risk of forfeiture under Code § 409A. Accordingly, any such arrangement must be Code § 409A compliant. In particular, the plan must provide the date or fixed schedule to determine when the executive is to receive payment (*e.g.*, a date on or after the completion of the non-compete agreement).

D. Requirements of Code § 409A. This section of the outline discusses the requirements of Code § 409A. These requirements can be divided into three general categories: (1) design and operation, (2) funding, and (3) reporting.

1. Design and Operation Requirements of Code § 409A. Effective January 1, 2006, nonqualified deferred compensation plans must contain the following provisions, as well as be operated in accordance with those provisions:

- (a) Plan distributions are permitted only upon:
 - (i) Separation from service;
 - (ii) Disability;
 - (iii) Death;
 - (iv) At a specified time or pursuant to a fixed schedule;
 - (v) A change of control; or
 - (vi) An unforeseeable emergency.
 - *Practice Tip:* While an unforeseeable emergency is a permitted distribution event for purposes of Code § 409A, a distribution provision for unforeseeable emergency other than the disability of the participant may result in there being no substantial risk of forfeiture under a Code § 457(f).
- (b) Acceleration of Distributions. Generally, a participant *may not* accelerate payments from a plan before they are scheduled. IRC

§ 409A(a)(3). Notice 2005-1 contains limited exceptions to this rule, and a special transition rule permits changes to a plan's distribution provisions until December 31, 2005.

(i) New Payment Elections Until December 31, 2005.

Despite the prohibition on accelerations, a plan can be amended to allow new payment elections with respect to amounts deferred before the election. These new payment elections will not be prohibited accelerations, so long as the amendment and the participant's new payment elections are in place on or before December 31, 2005. IRS Notice 2005-1 Q&A-19(c).

Note that this provision has raised concern that the ability to amend may be limited to a correction of an *impermissible payment election*, rather than to make a subsequent election that is a different form of payment permitted under Code § 409A (e.g., converting annuity payments to a lump sum). Because either interpretation is reasonable, participants should be in good-faith compliance if they change their distribution elections before the end of 2005.

(ii) Permitted Exceptions to the Prohibition on Acceleration.

During and after the transition period, IRS Notice 2005-1 Q&A-15 permits accelerations of the time or schedule of payment for any of the following circumstances:

- (1) To fulfill a domestic relations order.
- (2) To comply with a certificate of divestiture. A certificate of divestiture is a document issued by the Office of Government Ethics to a participant who is required to sell an asset to eliminate a conflict between that financial interest and the participant's official responsibilities. The certificate permits the participant to defer recognition of gain that results from the forced sale.
- (3) To permit a de minimus payment or specified amount. A plan that does not provide for de minimus cashout payments may be amended to permit the acceleration of a payment if:
 - (A) The payment is of the participant's entire interest in the plan;
 - (B) The payment is made on or before the later of (I) December 31st of the calendar year in which the participant has a separation from service, or (II) 2 ½ months after the participant's separation from service; and

- (C) The payment is \$10,000 or less.
This amendment can be made with regard to both previously deferred amounts and future deferrals. Also, a plan can be amended with regard to future deferrals to provide that if a participant's interest is less than a specified amount when the amount is otherwise payable under the plan, then the participant's entire interest must be distributed as a lump-sum payment.
- (4) To pay income taxes due upon a vesting event in a 457(f) plan, but the payment amount being accelerated may not exceed the amount of income tax due. This exception recognizes that, even if a participant in a 457(f) plan is paid in the form of an annuity, he is taxed on the present value of his stream of annuity payments (potentially creating a large tax bill, but with no present income to pay it).
- (5) To pay employment taxes on compensation deferred under the plan (regardless if the plan is a 457(f) plan). The payment amount being accelerated may not exceed the total employment taxes due.
- (c) Initial Election of Form of Distribution. Because of the nature of Code § 457(f), where the deferred compensation must be subject to a substantial risk of forfeiture, it is highly unusual for executives to want to defer a portion of their own compensation through a salary or bonus deferral program. Rather, under most 457(f) arrangements, the employer provides the deferred compensation over and above an executive's salary or bonus. Nonetheless, Code § 409A requires that a participant elect his or her form of distribution at the time of initial deferral. As a practical matter, in the majority of cases involving 457(f) plans, there will be no choice. The sole form of distribution will be a lump sum, allowing the participant to receive payment upon vesting to pay taxes and keep the remainder for himself. Where there are forms of distribution from which to choose, the executive must make the election prior to the period he or she otherwise "earns" the deferred compensation.
- (d) Election to Extend Deferral Period or Change Form of Payment. Code § 409A does permit participants to extend their deferral periods or change their forms of payment, or both, provided the following three rules are satisfied.
- (i) Not Effective For 12 Months. A participant can defer his initial election or change the form of payment by making a subsequent

election to defer. A subsequent election to defer is effective no sooner than 12 months after the date it is made.

- (ii) Separation From Service – 12 Months Prior. Where a payment is due to separation from service, any subsequent election to defer must be made at least 12 months before the original payment date.
- (iii) Certain Distribution Events – 5 Year Deferral. The subsequent deferral period must for at least five (additional) years beyond the original date of distribution. As noted above, this rule that will need to be satisfied if an employer and the executive want to roll the risk of forfeiture under Code § 457(f).

2. Funding Requirements Prevent Going Offshore. Sometimes employers place assets designated to pay deferred compensation in a trust, called a “rabbi trust.” In a more aggressive strategy, employers will create the trust under laws of a foreign jurisdiction because, although the trust remains subject to the claims of the employer’s general creditors, the laws of the foreign jurisdiction make it more difficult for assets to be seized. Code § 409A was drafted to deter offshore arrangements. If a rabbi trust holds plan assets and it is placed in a foreign jurisdiction, the participant is subject to tax on the amount placed offshore, plus a 20% penalty, and interest under Code § 409A, even if the participant’s right to compensation remains unvested.
3. Additional Requirement to Report at Deferral. Code § 409A requires an employer to report on IRS Form 1099-MISC or IRS Form W-2 (whichever is applicable) any deferral of compensation of more than \$600 (regardless of whether it is taxable). This reporting requirement is in addition to the requirement that compensation be reported when paid. The separate reporting requirement appears to fulfill two goals: first, to enable the IRS to track deferred compensation better, and second, to facilitate calculation of any penalty and interest charges for noncompliance with Code § 409A for amounts not previously included in income.

- E. Severance Plans. Severance plans are not governed by Code § 457(f). IRC § 457(e)(11). They are, however, governed by Code § 409A. For 2005, the IRS exempted from Code § 409A severance plans that benefit no officer who earns more than \$135,000 (a so-called “key employee”),¹ as well as severance plans that are the product of a collective bargaining agreement. IRS Notice 2005-1 Q&A-19(d). These plans must be Code § 409A compliant by January 1, 2006. The practical impact of Code § 409A on severance plans covering key employees may

¹ Under Code § 409A, a key employee is also a 5% owner or a 1% owner with annual compensation greater than \$150,000. IRC § 416(i)(1)(A).

have more bark than bite. First, it is likely that the 2 ½ month exception will exempt most severance plans from Code § 409A. Under the 2 ½ month exception, discussed in this outline at Part I.C.2(a), above, Code § 409A does not apply if the participant receives all of the severance pay within 2 ½ months after the year it vests. Arguably, severance pay does not vest until the employee is involuntary terminated, and once termination occurs, payment typically occurs shortly thereafter. Furthermore, it is rather painless to structure severance payments to be Code § 409A compliant. Code § 409A permits distributions upon separation from service or upon a specified time (or pursuant to a fixed schedule) provided in the plan when the compensation is deferred.² IRC § 409A(a)(2)(A)(i) and (iv). Therefore, if the plan provides a lump-sum severance payment upon separation from service or provides payment pursuant to a fixed schedule, then the plan complies with Code § 409A's distribution requirements.

- F. Split-Dollar Life Insurance Arrangements. Although not specifically addressed in IRS Notice 2005-1, Code § 409A likely applies to a split-dollar life insurance arrangement where the underlying life insurance policy is owned by the employer (so-called "equity split-dollar"). This conclusion is based on language in the preamble to the final split-dollar regulations stating that equity split-dollar arrangements are nonqualified deferred compensation. 68 Fed. Reg. 54,336 at 54,340 (Sept. 17, 2003).

A myriad of issues arise regarding the effect of Code § 409A on equity split-dollar arrangements. For example, one issue is whether making such a split dollar arrangement Code § 409A compliant would constitute a material modification under the split-dollar rules. Treasury officials have been clear that they are "sensitive" to the issues surrounding equity split-dollar and advise employers to wait until further guidance.

- G. Reimbursement Arrangements. Reimbursement arrangements (*e.g.*, tax-preparation fees, financial planning expenses, country club dues, relocation expenses) are deferred compensation. If the reimbursement arrangement is a fringe benefit or a welfare benefit excludible from gross income, then it is not subject to Code § 409A. If the benefit is not excludible, it is subject to Code § 409A unless it meets the 2 ½ month exception discussed in this outline at Part I.C.2(a), above.

As with severance plans, it is unclear what the vesting event is in a reimbursement agreement. Treasury officials have stated that the vesting event *is not* the occurrence of the event being reimbursed. Their rationale is that the reimbursed condition is not "a condition related to the purpose of the compensation," as required under Code § 409A's definition of a substantial risk of forfeiture. IRS Notice 2005-1 Q&A-10. Therefore, the arrangement likely vests when the executive performs the services that entitle him to the reimbursement.

² A special distribution rule restricts "specified employees" from receiving a distribution within 6 months of separating from service. IRC § 409A(a)(2)(B)(i). A "specified employee" is a key employee of a publicly traded company and therefore inapplicable to a tax-exempt organization.

Assuming a reimbursement arrangement cannot fit into the 2 ½ month exception, then it must comply with Code § 409A – in particular, the distribution requirements (*e.g.*, payment at a specified time or pursuant to a fixed schedule). It is unclear what this means in a practical sense. Technically, to comply with these timing rules as they read now, the arrangement would need to be structured not as a reimbursement but as a direct payment, either to the third party providing the fringe benefit or to the participant. However, this would be a tortured, impractical way to process an executive’s expense reimbursement.

Regulatory relief is clearly called for here. Without regulatory relief, noncompliance of a reimbursement arrangement can lead to disastrous, albeit absurd results, even where the amount of the reimbursement is relatively small. The failure is imputed to *all other similar-type plans* payable to that executive. IRS Notice 2005-1 Q&A-9. For example, if the executive is reimbursed up to \$500 per month for country club dues, this is a defined-benefit type arrangement. If the payment is conditioned on the executive’s request for reimbursement, and it will not comply with Code § 409A. Because similar plan types are aggregated, all non-account balance arrangements (defined-benefit type arrangements) of the executive that are covered by Code § 409A fail. Clearly an unintended result, which would only arise from an extreme application of the statute.

- H. Incentive Plans. Depending on how they are structured, incentive plans that pay an executive a bonus after attaining a performance goal may be subject to Code § 409A. If the executive is not vested until after attaining certain stated goals within a period, and the executive is paid within the 2 ½ month exception described above, then the incentive plan is not covered by Code § 409A. If, however, the incentive plan provides that the executive will be paid in year 2 after vesting in year 1, and the payment is not scheduled to be received within the first 2 ½ months following year 1, then Code § 409A applies. This might be the case where payment is not only contingent on the executive meeting performance goals in year 1, but also on the board certifying the year 1 financial statements, which normally occurs well after the first 2 ½ months of year 2. First, a strong argument can be made that the executive actually does not vest in his or her bonus until board certification and because payment normally follows quickly thereafter, Code § 409A should not apply. Nonetheless, if the IRS were to ignore board certification as the triggering event for vesting, the incentive plan could still comply with Code § 409A’s requirements merely by stating the date that the executive shall receive the distribution, choosing a date that is safely beyond the potential point in time that the board might meet to certify the financials.
- I. Additional Code § 409A Guidance. As noted above, Treasury is working to release proposed regulations under Code § 409A this summer.

II. COMPREHENSIVE PROPOSED REGULATIONS UNDER CODE § 403(b).

- A. Introduction. On November 15, 2004, the Department of the Treasury released proposed regulations under Code § 403(b). 69 Fed. Reg. 67,075 (Nov. 16, 2005).

Code § 403(b) permits tax-exempt organizations with Code § 501(c)(3) status and public educational institutions to provide tax-sheltered annuity contracts (and arrangements treated as tax-sheltered annuities) to its employees to save for their retirement.³ The proposed regulations become effective January 1, 2006.

When finalized, these regulations under are intended to replace the existing regulations, most of which are over 40 years old and do not reflect many major legislative changes. When finalized, the proposed regulations are also expected to consolidate, revise, or supersede over 20 administrative rulings. 69 Fed. Reg. 67,076 at n.2. The proposed regulations contain rules to administer 403(b) arrangements that are more similar to rules governing Code § 401(k) plans.⁴

These requirements may make administering a 403(b) arrangement more complicated, which, in turn, may make it more difficult for small tax-exempt organizations and schools to continue to make available 403(b) arrangements.

B. Definitions. The proposed regulations define key terms applicable to 403(b) arrangements and clarify the requirements for treatment as an annuity, a custodial account, and a retirement income account. Most of these definitions and requirements are based on statutory provisions and therefore remain unchanged. The greatest contribution of this portion of the regulations is the consolidation of information.

1. Annuity. If an annuity satisfies the requirements listed below, employer contributions and elective deferrals to purchase an annuity contract are excluded from income until distributed. Prop. Treas. Reg. § 1.403(b)-3(a).

(a) Annuity – Definition and Requirements. An annuity is a contract that includes payment in the form of an annuity issued by an insurance company qualified to issue annuities in a state. Prop. Treas. Reg. § 1.403(b)-2(a)(2).

The requirements for an annuity to constitute a tax-sheltered annuity under Code § 403(b)(1) are contained in § 1.403(b)-3(a) of the proposed regulations and are as follows:

(i) Not Purchased Under Qualified or Eligible Plan. The annuity cannot be purchased under a qualified retirement plan under Code § 401(a) or an eligible governmental deferred compensation plan under Code § 457(b). (Note that in the case of a non-governmental employer, an annuity would not be

³ Self-employed ministers may also participate in a 403(b) arrangement.

⁴ In § 1450 of the Small Business Job Protection Act of 1996, Pub. L. 104-88, Congress directed that certain rules governing elective deferrals to 403(b) arrangements shall be determined under the rules applicable to cash or deferred elections under Code § 401(k); in particular, to rules governing “the frequency that an employee is permitted to enter into a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement.” The proposed regulations go much further to make 403(b) arrangements like Code § 401(k) plans.

purchased for an eligible tax-exempt deferred compensation plan under Code § 457(b) because that plan must be unfunded under the Code.)

- (ii) Be Vested. Each participant's rights under the annuity are fully vested (except for failure to pay future premiums).
- (iii) Satisfy Applicable Non-Discrimination and Universal Availability Rules. The annuity cannot have the effect of discriminating in favor of highly compensated employees. The applicable discrimination requirements vary depending on the type of employer.
 - (1) Tax-Exempt Organizations. Tax-exempt organizations are subject to all of the following nondiscrimination requirements:
 - (A) Contributions and benefits must not discriminate, as required by IRC § 401(a)(4);
 - (B) Compensation is limited, as required by IRC § 401(a)(17);
 - (C) Matching and after-tax contributions must not discriminate, as required by IRC § 401(m);
 - (D) Minimum coverage is provided, as required by IRC § 410(b); and
 - (E) Elective deferrals are universally available, as required by IRC § 403(b)(12)(A)(ii).Prop. Treas. Reg. § 1.403(b)-5(a) and (b).
 - (2) Churches. Churches are subject to no nondiscrimination requirements. IRC § 403(b)(1)(D).
 - (3) Public Schools. Governmental employers are subject only to the compensation limit imposed by Code § 401(a)(17) and the universal availability requirement for elective deferrals imposed by Code § 403(b)(12)(A)(ii). Prop. Treas. Reg. § 1.403(b)-5(a)(5). Note that a special grandfathering rule applies to participants in a governmental 403(b) arrangement who have been participating continuously in the arrangement since 1995.⁵

⁵ If a participant in a governmental 403(b) arrangement has been continuously participating in the arrangement since December 31, 1995, he is not subject to a compensation limit, provided the arrangement had no compensation limit on July 1, 1993. If the arrangement had a compensation limit on July 1, 1993, then the participant's compensation limit for 2005 is \$315,000. Treas. Reg. § 1.401(a)(17)-1(d)(4)(ii); IRS Notice 2004-72.

- (iv) Comply With Limits on Elective Deferrals. If elective deferrals are permitted, then the annuity must comply with the Code § 402(g) limit. Code § 402(g) limits the amount that can be contributed as an elective deferral in 2005 to \$14,000; in 2006, to \$15,000; and thereafter, to \$15,000, as increased for cost-of-living adjustments.
- (v) Be Non-Transferable. The annuity must be non-transferable.
- (vi) Satisfy Required Minimum Distribution Rules. The contract must satisfy the required minimum distribution rules under Code § 401(a)(9). These rules require that distributions from the annuity begin no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70 ½ or retires from the employer maintaining the annuity. Treas. Reg. § 1.403(b)-3 Q&A-1(c)(1).
 - (1) Introduction of 5% Owner to Determine Required Beginning Date. Note that the proposed regulations introduce to 403(b) arrangements the concept of a 5% owner to determine a participant's required beginning date. As with qualified plans, under the proposed 403(b) regulations the required beginning date for a 5% owner is April 1st of the calendar year following the earlier of the calendar year in which the participant attains age 70 ½ or the retires. Prop. Treas. Reg. § 1.403(b)-6(e)(3). This is a change from the current 403(b) regulations, which expressly disregard the concept of a 5% owner. Treas. Reg. § 1.403(b)-3 Q&A-1(c)(1).
 - (2) Pre-1987 Contributions Not Subject to Required Minimum Distributions. Also note that a participant's balance in the annuity as of December 31, 1986 (but no subsequent earnings thereon) *are not* subject to required minimum distribution rules. This exception *only* applies if this balance has been accounted for separately from post-1986 contributions and all subsequent earnings. Prop. Treas. Reg. § 1.403(b)-6(e)(6). The pre-1986 amount must be distributed to comply with the incidental benefit rule, discussed at (viii), below.
- (vii) Permits Direct Rollovers Out of the Contract. The annuity must provide that if the participant directs his distribution to be paid

to an eligible retirement plan and specifies the plan, then it will be paid in a direct rollover.

- (viii) Satisfies the Incidental Benefit Rule. Distributions from an annuity are treated as having satisfied the incidental benefit rule if they are for a pension, although payments upon disability do as well. (See Part II.B.1(b) of this outline, below, for a discussion of the prohibition on providing incidental life insurance benefits in an annuity.) To that end, any balance not subject to required minimum distribution rules must start being distributed no later than when the Participant attains age 75. CCA 1999-21-058; PLR 93-45-044; IRM 4.72.13.7.3.
 - (ix) Satisfies the Code § 415 Limits. Total employee and employer contributions to an annuity must not exceed the lesser of \$42,000, as increased for cost-of-living adjustments, or 100% of the participant's compensation. IRC § 415(c)(1). Note that a special contribution limit applies for participants of annuities provided by a church. The participant may contribute \$10,000 each year up to a lifetime total of \$40,000, even if that amount is more than 100% of his or her compensation. IRC § 415(c)(7).
 - (b) Incidental Life Insurance Arrangements Prohibited. The proposed regulations no longer treat life insurance contracts purchased after February 14, 2005 as annuities. Prop. Treas. Reg. §§ 1.403(b)-8(c)(2); 1.403(b)-11(d). This provision is a change from the existing regulations and revenue rulings, which permit the purchase of an annuity with life insurance protection, so long as the life insurance benefit is incidental (*e.g.*, no more than 25% of the total cost) and the life insurance contract contains the provisions required under Code § 403(b). Treas. Reg. § 1.403(b)-1(c)(3); Rev. Rul. 74-115. The preamble to the proposed regulations does not explain the basis for the change. One can speculate, however, that it results from the high fees and commissions associated with insurance and low performance of insurance, when used as an investment vehicle. The key advantage of insurance as an investment vehicle is its ability to defer tax, which is irrelevant in an arrangement that already affords tax-deferral.
2. Custodial Account. A custodial account is a plan or a separate account under a plan in which an amount attributable to Code § 403(b) contributions is held by a bank (including a credit union, or corporation subject banking laws) or a nonbank custodian or trustee. Prop. Treas. Reg. § 1.403(b)-8(d)(2). The nonbank custodian or trustee must demonstrate that assets are held in a manner consistent with the requirements for qualified plans. Rev. Proc. 95-4.

A custodial account holds investments for participants. If it satisfies the requirements described below, it is treated as an annuity and employer contributions and elective deferrals are excluded from income until distributed. Prop. Treas. Reg. § 1.403(b)-8(d)(2).

- (a) Invested Only in Mutual Funds. Custodial account assets can be invested *only* in stock of a regulated investment company (more commonly referred to as mutual funds).
- (b) Special Distribution Requirements. Although a custodial account is treated as an annuity, it is subject to slightly different distribution requirements. A distribution from a custodial account is permitted only upon an employee's death, age 59 ½, severance, or disability. If the contributions being distributed are elective deferrals, then they may also be distributed on account of hardship. IRC § 403(b)(7).
See Part II.D.4 of this outline, below, for a discussion of rules regarding hardship distributions, as revised by final 401(k) regulations released in December 2004.
See Part II.I of this outline, below, for a discussion of special circumstances constituting severance from employment.
- (c) Exclusive Benefit Rule. Assets are used for the exclusive benefit of plan participants or their beneficiaries.
- (d) Separate From a Retirement Income Account. The account is not part of a retirement income account under Code § 403(b)(9). Although a custodial account cannot be part of a retirement income account, it can serve as a trust that holds the retirement income account investments, so long as it holds only those assets. Prop. Treas. Reg. § 1.403(b)-9(a)(7).
Largely of only historical significance, three of these four requirements are all that remain of fourteen requirements in proposed regulations released in 1978. 43 Fed. Reg. 5,852 (Feb. 10, 1978), amended by 45 Fed. Reg. 85,786 (Dec. 30, 1980). The originally proposed restrictions were likely relaxed because of the controversy they created in the custodial account industry.
- (e) Annuity Requirements. Because a custodial account is treated as an annuity, it must also satisfy the requirements of an annuity as discussed in this outline at Part II.B.1(a), above.
- (f) Excise Tax on Excess Contributions. Although not a new requirement, the proposed regulations remind us that, unique to custodial accounts, a 6% excise tax is imposed on the participant if elective deferrals are made in excess of the applicable limit and are not distributed in a corrective distribution. IRC § 4973(a)(3); Prop. Treas. Reg. § 1.403(b)-4(f)(1).

3. Retirement Income Account. A retirement income account is a defined contribution program that can be maintained only by a church or church-related organization. IRC § 403(b)(9)(B); Prop. Treas. Reg. § 1.403(b)-9(2). If a retirement income account satisfies the requirements listed below, in addition those described at Part II.B.1.(a) above, it is treated as an annuity and employer contributions and elective deferrals are excluded from income until distributed. IRC § 403(b)(9)(A)(i); Prop. Treas. Reg. § 1.403(b)-9(a).
 - (a) Separate Accounting. The underlying investments in which the retirement income account invests separately account for the retirement income account’s investment.
 - (b) Underlying Investments Dictate Performance. Investment performance is based on gains and losses on the underlying investments.
 - (c) Exclusive Benefit. Assets are used for the exclusive benefit of plan participants or their beneficiaries.
 - (d) Plan Document Requirement. A retirement income account must be maintained pursuant to a plan, evidenced by a plan document that clearly reflects the intent to establish a retirement income account.
- C. New 403(b) “Plan” Requirement. The proposed regulations require 403(b) arrangements to be maintained pursuant to a plan.
1. Requirement To Be Maintained Pursuant To a Plan. The proposed regulations require that a 403(b) arrangement be maintained pursuant to a plan. The “plan” requirement necessitates that there be a written document or documents that contains the material terms and conditions for eligibility, benefits, and applicable limitations, the contracts under the plan, and the time and manner in which distributions can be made.
Existing documents related to a 403(b) arrangement can be combined to satisfy the “plan” requirement (assuming, of course, that those documents contain the requisite conditions on eligibility, vesting, and applicable limitations). These documents could include the participants’ salary-reduction agreements, the funding arrangements, any informal summary plan description, and any written administrative procedures of the employer.
Note that the “plan” requirement does not change the written document requirement applicable to retirement income accounts and ERISA-covered 403(b) arrangements. Retirement income accounts must have a plan document that states (or otherwise evidences clearly) the intent to constitute a retirement income account under Code § 403(b)(9). Prop. Treas. Reg. § 1.403(b)-9(a)(2)(ii). A 403(b) arrangement covered by ERISA (*e.g.*, maintained by a tax-exempt employer that permits employer contributions) must also be maintained pursuant to a written plan. ERISA § 402(a)(1).
 2. Effect of “Plan” Requirement on Non-ERISA Status. Currently, if a tax-exempt organization makes a 403(b) arrangement available to its employees, the

arrangement permits only elective deferrals, and the employer's involvement is essentially limited to the role of payroll conduit, then it is not an employee benefit pension plan, and therefore not subject to ERISA. DOL Reg. § 2510.3-2(f). There is concern that requiring an employer to establish a "plan" will be viewed by the Department of Labor as establishing or maintaining a plan subject to ERISA. The preamble to the proposed regulations states that, according to the Department of Labor, the requirements in the proposed regulations "do not appear" to mandate the establishment of an employee pension plan. 69 Fed. Reg. 67,077 (Nov. 16, 2004).

- D. Elective Deferrals Administered Like Code § 401(k) Plans. The proposed regulations provide rules for administering elective deferrals under a 403(b) arrangement. Because these rules replicate the requirements under Code § 401(k), they will likely increase the complexity in administering a 403(b) arrangement.
1. Transfer of Elective Deferrals. An employer must transfer contributions to the entity holding the assets of the 403(b) arrangement within a time that is reasonable for the proper administration of the plan. Elective deferrals transferred within 15 business days following the month in which they would have otherwise been paid to the participant is considered a reasonable time for the proper administration of the plan. Prop. Treas. Reg. § 1.403(b)-8(b).
 2. Annual Elective Deferral Limit. To determine the limit on elective deferrals that may be contributed to the plan, begin with the Code § 402(g) limit, then apply catch-up contributions special to 403(b) arrangements permitted by Code § 402(g)(7), then catch-up contributions for participants age 50 and older, permitted by Code § 414(v).
 - (a) Elective Deferral Limit Under Code § 402(g). Elective deferrals to a 403(b) arrangement cannot exceed the Code § 402(g) limit. In 2005, this limit is \$14,000; in 2006, this limit will be \$15,000 and will be \$15,000 thereafter, increased for cost-of-living adjustments. Prop. Treas. Reg. § 1.403(b)-4(c)(1).
 - (b) Special Code § 403(b) Catch-Up Contribution Limit. Participants with at least 15 years of service with an educational organization, hospital, health and welfare service agency (including a home health service agency), or church-related organization are eligible for a special contribution limit that applies only to 403(b) arrangements. IRC § 402(g)(7); Prop. Treas. Reg. § 1.403(b)-4(c)(3).

This special catch-up amount is the lesser of:

 - (i) \$3,000;
 - (ii) \$15,000 reduced by the amount of the employee's special catch-up contribution made in previous years; or
 - (iii) The excess of \$5,000 multiplied by the employee's number of years of service with his employer over the amount of his

elective deferrals to a 403(b) arrangement, both in previous years and in that year.

- (c) Age 50 and Over Catch-Up Contribution Limit. As with a 401(k) plan, a participant who is age 50 by the end of the taxable year may defer the following amounts in excess of the elective deferral limit: \$4,000 in 2005; \$5,000 in 2006 and thereafter, as increased for cost-of-living adjustments. IRC § 414(v); Prop. Treas. Reg. § 1.403(b)-4(c)(2).
- (d) Coordination of Catch-Up Contribution Limits. If a participant is permitted to make catch-up contributions under both the special 403(b) catch-up and the age 50 and over catch-up, then a special ordering rule applies. Any amount in excess of the Code § 402(g) limit is applied first as a special Code § 403(b) catch-up contribution (to the extent that one is permitted), then as an age 50 and over catch-up contribution. Prop. Treas. Reg. § 1.403(b)-4(c)(3)(iv).

→ *Practice Tip:* This ordering rule creates a trap for the unwary: employees whose elective deferrals exceed the elective deferral limit for the year may be using up their special Code § 403(b) catch-up contribution amount without realizing they are doing so.

- 3. Loans. Loans from a 403(b) arrangement are subject to the rules under Code § 72(p). In addition, the proposed regulations provide that if, based on the facts and circumstances, the availability of a loan, the making of a loan, or a failure to repay a loan violates the requirements of Code § 403(b), then a loan will be treated as a distribution or as violating the requirements of Code § 403(b). Prop. Treas. Reg. § 1.403(b)-6(f). Factors to consider are whether the loan has a fixed repayment schedule, and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere.

It is unclear from the regulations what authority Treasury has to create these additional loan requirements or why they felt compelled to do so.

- 4. Hardship Distributions. A 403(b) arrangement can permit hardship distributions of elective deferrals (but no earnings thereon) under the same circumstances as permitted for 401(k) plans. Prop. Treas. Reg. § 1.403(b)-6(d)(2). For arrangements that use a safe harbor to determine whether a hardship has occurred, additional rules were added by the final regulations governing Code § 401(k) that were released in December 2004. 69 Fed. Reg. 78,144 at 78,162 (Dec. 29, 2004).

- (a) Changes to Deemed Hardship Standard in Final Regulations Under Code § 401(k).

- (i) Additional Basis for Deemed Hardship. There are two new grounds for a deemed hardship distribution. The first is to pay funeral expenses of the participant's parent, spouse, child, or

- dependent. Treas. Reg. § 1.401(k)-(d)(3)(iii)(B)(5). The second is to pay expenses for the repair of damage to a participant's principal residence that would qualify for the casualty deduction under Code § 165 (without regard to whether the loss exceeds 10% of adjusted gross income). Treas. Reg. § 1.401(k)-(d)(3)(iii)(B)(6). The second basis was added because the final § 401(k) regulations were drafted during one of the worst hurricane seasons in Florida.
- (ii) Definition of "Dependent" For Purposes of Determining a Hardship. While drafting the final regulations under Code § 401(k), the Working Families Tax Relief Act of 2004 was enacted, which changed the definition of "dependent" under Code § 152. For purposes of determining whether a hardship distribution is permitted for medical expenses and post-secondary educational expenses, "dependent" is defined by reference to § 152 *prior to amendment*. Treas. Reg. § 1.401(k)-(d)(3)(iii)(B)(1) and (3). Therefore, distributions for college or medical expenses are permitted for a dependent who is married or who has dependent children. Also, "dependent" for purposes of hardship distributions for medical expenses (other than non-prescription drugs and medicine, other than insulin) has been expanded to include certain non-custodial children. Treas. Reg. § 1.401(k)-(d)(3)(iii)(B)(1).
- (iii) All Distributions Exhausted. Before a distribution will be deemed to satisfy a participant's "immediate and heavy need," the participant must have obtained all distributions (other than hardship distributions) and non-taxable loans currently available under all plans maintained by the employer. Treas. Reg. § 1.401(k)-(d)(3)(iv)(B).
- (iv) Reliance on Written Representation. Absent actual knowledge to the contrary, an employer can rely on an employee's written representation of hardship. Treas. Reg. § 1.401(k)-(d)(3)(iii)(C). This provision provides relief for small employers with 403(b) arrangements that permit hardship distributions but that have limited resources to administer hardship distributions.
- (v) Reduced Length of Contribution Prohibition. A participant is precluded from making contributions to a 403(b) arrangement, as well as all plans maintained by the employer, for 6 months. Treas. Reg. § 1.401(k)-(d)(3)(iv)(E)(2). This provision results from the Economic Growth and Tax Relief Reconciliation Act

of 2001 (“EGTRRA”) requirement that an employee’s suspension from making contributions due to a hardship distribution be reduced from 12 months to 6 months. 69 Fed. Reg. 78,148 (Dec. 29, 2004).

→ *Practice Tip*: Once the proposed 403(b) regulations are finalized, the IRS will begin making the 6 month suspension of deferrals an examination issue.

- (b) Issues Regarding Hardship Distributions. Hardship distributions under the proposed regulations raise several issues, including who can certify and administer the hardship, and how different vendors coordinate suspension of elective deferrals after a hardship distribution. Because the IRS is concerned that that administration (or lack thereof) of hardship distributions from 403(b) arrangements is a source of abuse, the IRS is unlikely to waiver from applying these Code § 401(k) final regulation requirements. Small non-profit organizations and schools who may be unable to provide the level of administration necessary to comply with these requirements can avoid discontinuing a 403(b) arrangement by using the safe harbor to determine a hardship or by simply eliminating the availability of a hardship distribution.

E. Nondiscrimination of Elective Deferrals. Elective deferrals contributed to a 403(b) arrangement are not subject to ADP testing; rather, they must be universally available to all participants. IRC § 403(b)(12)(A)(ii).

- 1. Definition of “Universal Availability.” Universal availability exists if there are no conditions imposed on an employee’s ability to make elective deferrals. Employees must have an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an effective opportunity exists depends on the facts and circumstances, including notice of the availability of the election, the period of time during which the election may be made, and any other conditions on elections. Prop. Treas. Reg. § 1.403(b)-5(b).

→ *Practice Tip*: Employees must have meaningful notice of the availability to make elective deferrals. While there are no specific rules governing how notice must be provided, the IRS generally considers notices in an employee handbook, newsletter, bulletin board, or via e-mail sufficient. If an employee is informed of his ability to make an elective deferral only after asking, he is not considered to have notice of the availability.

- 2. Anti-Conditioning Rule. A participant is not considered to have an effective opportunity to make elective deferrals if any right or benefit is conditioned (directly or indirectly) upon his ability to make (or fail to make) an elective deferral. Prop. Treas. Reg. § 1.403(b)-5(b)(2).

3. “Employer” for Purposes of Universal Availability. Universal availability may be determined looking separately to each common law employer and to geographically distinct and independent operating units. Prop. Treas. Reg. § 1.403(b)-5(b)(3).
 4. Excludable Employees for Purposes of Universal Availability. In determining who is an “employee” for purposes of universal availability, employers may exclude employees who are permitted to make elective deferrals to a Code § 401(k) plan or a Code § 457(b) plan, nonresident aliens, students who are regularly attending classes for the employer or related organization, and employees who normally work fewer than 20 hours per week. Prop. Treas. Reg. § 1.403(b)-5(b)(4)(ii). For purposes of determining whether an employee “normally works” fewer than 20 hours a week, in the year of an employee’s initial employment the employer reasonably expects the employee to work less than 1000 hours for the year, and for years thereafter, the employee never worked 1,000 in a prior year. Prop. Treas. Reg. § 1.403(b)-5(b)(4)(ii)(E).
 → *Practice Tip:* The proposed regulations no longer permit excluding visiting professors, collectively bargained employees, or employees who have taken a vow of poverty, as was permitted under IRS Notice 89-23. 69 Fed. Reg. 67,080 (Nov. 16, 2004).
- F. New Nondiscrimination Requirements for Employer Contributions and Employee After-Tax Contributions. The proposed regulations under Code § 403(b) replace the “good faith” nondiscrimination standard in IRS Notice 89-23 with rules for contributions, coverage, and compensation that apply to qualified plans. Prop. Treas. Reg. § 1.403(b)-5(a)(1).
1. Maximum compensation that can be considered for purposes of a 403(b) arrangements is limited to the Code § 401(a)(17) limit, which is \$210,000 in 2005. See the discussion at Part II.B.1(a)(iii)(3) and n.5 of this outline, above, for a discussion of a special compensation limit for public school employees.
 2. Nondiscriminatory as to contributions and benefits under Code § 401(a)(4).
 3. Nondiscriminatory as to coverage under Code § 410(b).
 4. Nondiscriminatory as to employer matching contributions and employee after-tax contributions under Code § 401(m).
 → *Practice Tip:* Safe harbors also apply to an employer’s matching contributions to a 403(b) arrangement (*e.g.*, providing a minimum matching contribution of \$1 for every \$1 deferred by the employee up to 3% of compensation, and 50¢ for every \$1 deferred for the following 2% of compensation, or providing a unilateral employer contribution of 3% to all participants under the plan). If used, an employer can avoid nondiscrimination testing under Code § 401(m).
 → *Practice Tip:* A 403(b) arrangement can permit employer contributions for former employees. IRC §403(b)(3); Prop. Treas. Reg. §1.403(b)-4(d)(1).

According to informal IRS advice, those contributions will not discriminate in favor of highly compensated employees if the former employees satisfy minimum age and service requirements and, under the facts and circumstances, the contributions do not discriminate *significantly* in favor of the former employees.

- G. QDROs. The proposed regulations clarify that 403(b) arrangements are subject to rules regarding Qualified Domestic Relations Orders (“QDROs”). 69 Fed. Reg. 67,081 (Nov. 16, 2004). Any distribution from a 403(b) program pursuant to a QDRO is treated as a distribution from a plan to which Code § 401(a)(13) applies. Prop. Treas. Reg. § 1.403(b)-10(c).
- H. Asset Transfers and Plan-to-Plan Transfers. The proposed regulations under Code § 403(b) replace the contract-transfer rules in Revenue Ruling 90-24. Prop. Treas. Reg. § 1.403(b)-10(b). The requirements for a transfer under the proposed regulations are as follows.
1. Asset Transfers Within a 403(b) Arrangement. Contract transfers *within a 403(b) arrangement* are permitted under the following conditions:
 - (a) The 403(b) program permits the exchange.
 - (b) The participant’s accumulated benefit after the transfer is at least equal to his benefit before the transfer.
 - (c) Distribution restrictions after the transfer are no less stringent than before the transfer.
→ *Practice Tip*: Elective deferrals are subject to different distribution restrictions than employer contributions and after-tax contributions. When effectuating a contract exchange, if the assets are not properly accounted for after the transfer, all of the contributions will be subject to the more onerous distribution restrictions.
 2. Plan-to-Plan Transfers. Contract transfers *from one 403(b) arrangement to another* are permitted only under the following conditions.
 - (a) The participant is an employee of the employer providing the receiving plan. The employment-relationship condition did not exist in Revenue Ruling 90-24. This condition has caused a controversy among retirees with 403(b) arrangements because it limits their ability to shop for annuity contracts, beyond those already provided through their 403(b) arrangement. The employment-relationship condition reflects the IRS’s concern that certain Code requirements were not being followed, such as required minimum distribution rules and loans rules, under a so-called 90-24 transfer.
 - (b) The transferor plan permits the transfer.
 - (c) The receiving plan permits the transfer.
 - (d) The participant’s accumulated benefit after the transfer is at least equal to his benefit before the transfer. Note that this condition presents the

need to think creatively about how the 403(b) provider will be compensated for the transfer.

- (e) Distribution restrictions after the transfer are no less stringent than before the transfer.

→ *Practice Tip:* When effectuating a plan-to-plan transfer, it is important to remember that custodial accounts are subject to more stringent distribution restrictions than annuity contracts or retirement income accounts. Also, it is important to track certain contributions, as not to lose special treatment under grandfathered rules.

When negotiating contracts with 403(b) vendors, because there is no longer a legal requirement to obtain participant consent for a transfer, employers should consider whether group annuity contracts that require participant consent are appropriate. Similarly, an employer should review restrictions and penalties in group annuity contracts that result from a transfer or withdrawal. When deciding which vendor to use, an employer should also consider (and negotiate with the vendor) the services the vendor will provide in the event of a transfer, such as providing current, electronic records of participants' accounts in a format that the receiving vendor can accept.

- I. Severance When No Longer Employed By a 403(b) Eligible Employer. Because only certain entities can sponsor a 403(b) arrangement, a participant can have a severance from employment even if he remains employed by the same employer. This will occur if he is employed:

1. By another entity that is treated as the same employer but that is ineligible to sponsor 403(b) arrangement (*e.g.*, transferring from a tax-exempt organization to its for-profit subsidiary); or
2. In a capacity that is not employment with an eligible employer (*e.g.*, ceasing to work for a public school but continuing to work for the state). Prop. Treas. Reg. § 1.403(b)-2(a)(19).

Note that if an employee has a severance from employment for purposes of Code § 403(b) but continues to make contributions to a 403(b) arrangement, those contributions are not excludable from income.

- J. Termination Provisions. A 403(b) arrangement may contain a provision permitting an employer to terminate the plan, with distribution of accumulated benefits upon termination. Prop. Treas. Reg. § 1.403(b)-10(a). To the extent that a 403(b) arrangement holds elective deferrals or uses custodial accounts, its termination and distribution of accumulated benefits is permitted only if the employer (and any members of its control group) do not contribute to an alternative 403(b) arrangement separate from the one being terminated. The termination of a 403(b) arrangement is a distribution event.

→ *Practice Tip:* This long awaited guidance removes one of the biggest traps for 403(b) plan sponsors. Heretofore, because there was no government sanctioned policy permitting 403(b) terminations, an employer who wanted to get rid of a plan could not. Rather, it would remain in limbo for years, receiving no additional contributions and gradually decreasing as participant's drew down their benefits. Nonetheless, the employer remained responsible for the continued administration and maintenance of the arrangement, including annual 5500 filings if the plan was covered by ERISA. Furthermore, it had continued fiduciary responsibility under ERISA for the plan's administration.

III. NEW CONTROL-GROUP RULES FOR TAX-EXEMPT ORGANIZATIONS.

- A. New Rule Control-Group Rule Applicable to Tax-Exempt Organizations. On November 15, 2004, Treasury released new control-group rules for tax-exempt employers. Prop. Treas. Reg. § 1.414(c)-5(b). These rules are generally relevant for purposes of nondiscrimination testing, contribution limitations under Code § 415, special Code § 403(b) catch-up contributions, and required minimum distribution rules. 69 Fed. Reg. 67,082 (Nov. 16, 2004).
- B. "Employer" Under Tax-Exempt Control Rules. Under the control-group rules applicable to tax-exempt organizations, an "employer" is the tax-exempt organization, plus any other organization under common control of the tax-exempt organization whose employees participate in plan. Based on the facts and circumstances, "common control" exists if at least 80% of the directors or trustees of one organization are representatives of or controlled (directly or indirectly) by the other organization. A trustee or director is treated as a representative if he is also a director, trustee, agent, or employee of the other organization. A trustee or director is controlled by another organization if the other organization has the power to remove him and designate a new trustee or director. Prop. Treas. Reg. § 1.414(c)-5(b).
- C. Anti-Abuse Rule. If the IRS determines that the structure of one or more tax-exempt organization(s) (including a tax-exempt organization with an organization that is not exempt from tax) or that the positions advanced by those organizations effectively avoids these rules, then the IRS may treat those organizations as aggregated. Prop. Treas. Reg. § 1.414(c)-5(f).

IV. COMING SOON: ROTH § 401(k) AND ROTH § 403(b).

- A. Introduction to Roth. In EGTRRA, Congress enacted new Code § 402A. This provision, which becomes effective on January 1, 2006, allows participants in a 401(k) plan or a 403(b) arrangement to make Roth contributions (*e.g.*, after-tax contributions, the earnings attributable to which will forever be tax-free) if the plan or arrangement includes a qualified Roth contribution program. Code § 402A is modeled after the rules governing Roth individual retirement accounts ("IRAs") under Code § 408A. On March 1, Treasury released Proposed Treasury Regulation § 1.401(k)-1(f), which

provides guidance on establishing and administering a Roth 401(k). 70 Fed. Reg. 10,062 (Mar. 2, 2005). While there is currently no guidance on the Roth 403(b), it will likely be administered substantially similar to the Roth 401(k).

- B. Why (and Why Not) Offer a Qualified Roth Contribution Program. In determining whether to make Roth contributions available in a 401(k) plan or 403(b) arrangement, the cost to establish a system to administer contributions should be weighed against the benefit that certain participants will derive from making Roth contributions instead of elective deferrals.
1. Cost to Establish a Roth Program. The cost in adding a Roth feature to a 401(k) plan or a 403(b) arrangement lies largely in implementing a system to account separately for and track Roth contributions, rollovers, and distributions; amending the plan or arrangement to permit Roth contributions; and updating applicable participant communications to describe the Roth.
 2. Participant For Whom Roth Contributions Are More Beneficial Than Elective Deferrals. The most heavily weighed variables in determining whether to make a Roth contribution are the length of time over which the contribution can grow and the participant's tax bracket, both when making the contribution and receiving the distribution.
 - (a) Time Over Which Contribution Invested. The length of time over which a contribution grows is important because a participant's Roth contribution is made with after-tax dollars. The contribution should be held long enough to accumulate enough earnings so that the tax savings upon distribution outweigh the reduced contribution amount. For example, most participants with \$10x dollars of pay will have only \$8x available for a Roth contribution because the remaining \$2x will be withheld to pay taxes (rather than paid separately and out-of-pocket). This is in contrast to being able to defer the entire \$10x (less FICA and Medicare withholding) in a traditional 401(k) salary deferral contribution. The participant's \$8x contribution needs to be held long enough for the earnings, which are tax-free, to compensate for the reduced upfront contribution.
 - (b) Tax Rate at Contribution and Distribution. Because income tax rates are graduated, if a participant's anticipated tax bracket upon retirement will be low and his bracket is high while he is working, he might fare better by making elective deferrals, taking the tax break now and deferring taxation until he is in a lower bracket.
 - (c) Other General Features That Make Roths Unattractive. Participants close to retirement age should be aware of when they made their first Roth contributions to the plan or arrangement from which they are receiving a distribution. If the contribution and distribution are within 5 years of one another, the distribution is subject to tax. IRC

§ 402A(d)(2)(B). Also, a Roth contribution may not be distributed on account of hardship.

C. Establishing and Administering Roth Contributions. Roth contributions are made with after-tax dollars but are treated as elective deferrals. IRC § 402A(a). They are permitted only to a 401(k) plan or a 403(b) arrangement, and only if the respective plan or arrangement has a qualified Roth contribution program. IRC § 402A(a), (b), and (e)(1).

1. Qualified Roth Contribution Program. A qualified Roth contribution program has the following requirements.

(a) Designation of Contribution As Roth. A qualified Roth contribution program must contain a system whereby a participant may elect to make designated Roth contributions in lieu of all elective deferrals or some elective deferrals otherwise permitted. A participant's designation to treat a contribution as a Roth is irrevocable and must be made before the contribution is made. IRC § 402A(b)(1); Prop. Treas. Reg. § 1.401(k)-1(f)(1)(i).

(b) Separate Accounting. From the time a Roth contribution is made until it is distributed, it must be accounted for separate from other contributions. The separate accounting must track Roth contributions made, withdrawn, and investment in the contract (*e.g.*, Roth contributions that have not yet been distributed). Investment gains and losses (and other credits or charges) must be separately allocated on a reasonable and consistent basis. Plan forfeitures cannot be allocated to a Roth account. IRC § 402A(b)(2); Treas. Reg. § 1.401(k)-1(f)(1)(iii) and (2).

→ *Practice Tip:* Plan sponsors need to determine how Roth 401(k) distributions will fit into the plan's order of distribution (*e.g.*, first, elective deferrals; second, Roth 401(k) contributions; third, rollovers).

(c) Treat Roth Contributions as Taxable Wages. When a Roth contribution is made, the employer must treat the contribution as taxable wages (subject to income tax and employment tax withholding). IRC § 402A(b); Prop. Treas. Reg. § 1.401(k)-1(f)(1) and (2).

2. Amount of Roth Contribution. The amount of Roth contributions and elective deferrals contributed for the year cannot exceed the elective deferral limit in Code § 402(g), as discussed in this outline at Part II.B.1(a)(iv), above. IRC § 402A(c)(2).

3. Elective Deferral Rules Apply. Roth contributions are treated as elective deferrals, except that a Roth contribution is not excludable from gross income. Therefore, Roth contributions must comply with the following elective deferral requirements. 70 Fed. Reg. 10,064 (Mar. 2, 2005).

(a) Fully Vested. Contributions must be 100% vested at all times.

- (b) Distribution Restrictions. No distribution is permitted before an employee's severance from employment, death, disability, attainment of age 59 ½, or hardship (if these distribution events are otherwise permitted under the plan). But see the following *Practice Tip* and the rules regarding qualified distributions in Part IV.C.4 of this outline, below, for the effect of taking a hardship distribution of Roth contributions.
- *Practice Tip:* Distributions from a Roth 401(k) are excludable from income tax only if they are qualified distributions, described below. Distributions at severance or for hardship *cannot be* qualified distributions. Distributions for death, disability, or at age 59 ½ are qualified only if the contributions being distributed were made at least 5 years before the distribution.
- (c) Contribution Limit. The Code § 402(g) annual dollar limit on elective deferrals cannot be exceeded (determined by *combining* Roth contributions and elective deferrals made to the plan). Any applicable catch-up contributions are in addition to the Code § 402(g) limit.
- (d) Nondiscrimination.
- (i) ADP Test Used for Roth 401(k) Contributions. Although Roth contributions to a Code § 401(k) plan are made with after-tax dollars, Roth contributions are tested for nondiscrimination using the actual deferral percentage test ("ADP"), rather than the actual contribution percentage test ("ACP") that is used for after-tax contributions.
- *Practice Tip:* Because universal availability (rather than ADP testing) applies to 403(b) arrangements, Roth contributions to a 403(b) arrangement will likely be nondiscriminatory if they are universally available to all employees. *See* IRC § 403(b)(12)(A)(ii).
- (ii) Benefit, Right, Feature. A Roth 401(k) feature is treated as a benefit, right, or feature subject to nondiscrimination rules under Code § 401(a)(4).
- (e) Rollovers. If a plan permits Roth contributions, the plan document must state that Roth contributions may only be rolled over into another plan maintaining Roth contribution accounts or into a Roth IRA. The plan may permit rollovers of other Roth contributions (from IRAs, other 401(k) plans, and 403(b) arrangements).
- (f) Required Minimum Distribution Rules. Roth contributions are subject to required minimum distribution rules. 70 Fed. Reg. 10,064 (Mar. 2, 2005). But a participant making Roth contributions can plan around these rules by making Roth contributions to a 401(k) plan or 403(b)

arrangement, then rolling them into a Roth IRA, which is not subject to required minimum distribution rules (at least not while the participant is living). IRC § 408A(c)(4).

- (g) Employer-Matching Contributions. For purposes of determining employer-matching contributions on elective deferrals, Roth contributions are treated as elective deferrals. The employer-matching contributions are pre-tax contributions that are subject to tax upon distribution.
- (h) Corrective Distributions. The proposed regulations allow a highly compensated employee to elect whether a corrective distribution should be made from a Roth contribution or from an elective deferral. Income allocable to a corrective distribution of a Roth contribution is includible in gross income, just as income allocable to a corrective distribution of an elective deferral is includible in gross income. Prop. Treas. Reg. § 1.401(k)-2(b)(vi)(C).

→ *Practice Tip:* A corrective distribution of a Roth contribution made *after April 15th* of the year following the excess contribution will be taxed twice: first, when the contribution is made; and second, at the later distribution. IRC § 402A(c)(3). Plans should consider adding a default rule designating corrective distributions as made from elective deferrals.

- 4. Qualified Distributions Exempt From Tax. Qualified distributions of Roth contributions are exempt from tax. IRC § 402A(d). A “qualified distribution” is a payment to a participant on or after attaining age 59 ½ or becoming disabled, or to a beneficiary after the participant’s death. IRC § 408A(d)(2). A distribution made within 5 years of making the Roth contribution *is not* a qualified distribution. IRC § 402A(d)(2)(B). Note also that, unlike a Roth IRA, a distribution of \$10,000 for a first-time home purchase is not a qualified distribution. IRC § 402A(d)(2)(A).

As the law is currently written, if Roth contributions from a 401(k) plan or 403(b) arrangement are rolled into another plan or arrangement that accepts Roths, the 5-year period for qualified distributions begins to run when the participant made the contribution to the original 401(k) plan or 403(b) arrangement. Although Roth IRAs may also be rolled into plans that so permit, there is *no corollary 5-year tacking* applicable to Roth IRAs.

- D. More Roth Guidance to Follow. Treasury is expected to issue guidance regarding the taxation of non-qualified distributions of Roth contributions. Presumably, Treasury will also issue guidance on Roth 403(b) contributions within enough time so that employers and providers of 403(b) arrangements can implement procedures by its effective date, January 1, 2006.