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403(b) Plans – The IRS as Friend and Foe

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I. INTRODUCTION

The final 403(b) regulations generally have been in full effect since the close of 2009, but anxiety about compliance with the rules remains high. Fortunately, the IRS is planning significant remedial relief for those plan sponsors that have made, and continue to make, good faith efforts to follow the rules. Plan sponsors that have operated their 403(b) plans in compliance with the final regulations since the beginning of 2009 and that adopted a 403(b) plan document by the end of 2009 are in an excellent position to take advantage of an upcoming remedial amendment period, during which plan sponsors will have the ability to correct defects in their written plans. Despite the friendly hand being extended by the IRS on plan document issues, the IRS is well aware of serious, recurring operational defects that plague 403(b) plans, especially in the areas of universal availability, excess contributions, and hardship distributions and plan loans. Plan sponsors should be careful to address weaknesses in these operational areas in addition to taking advantage of documentary compliance programs.

II. THE IRS AS FRIEND: 403(b) COMPLIANCE ASSISTANCE AND PROGRAMS

The 2007 final 403(b) regulations were a sea change for the 403(b) community. One of the most significant changes brought about by the final regulations was the express requirement that 403(b) plans, except certain 403(b) plans sponsored by churches, be maintained pursuant to a written plan.[1] The written plan rule was new for the large number of plans not subject to Employee Retirement Income Security Act of 1974 ("ERISA"), including salary-deferral only "safe harbor" plans and plans sponsored by governmental entities.

Although the regulations are relatively clear as to what a written plan must contain,[2] plan sponsors remain unsurprisingly anxious about whether their plan documents comply with the

[1] Treas. Reg. §1.403(b)-3(b)(3).

[2] "The plan must contain all 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." Treas. Reg. § 1.403(b)-3(b)(3)(i). There are also optional features that an employer may provide for in a plan such as hardship distributions, loans, contract exchanges, plan-to-plan transfers, and acceptance of rollovers.[2] Most important, though, and at the root of the plan document requirement, the plan may allocate responsibility for administrative functions. Treas. Reg. §1.403(b)-3(b)(3)(ii).

precise requirements of the 403(b) regulations. The IRS has taken several steps to reduce this anxiety and assist 403(b) plan sponsors in producing compliant written plans. For example, the IRS informally has taken an expansive view with regard to what a plan sponsor must produce to satisfy the written plan requirement, noting that the written plan could be comprised of a number of items either stapled together or "held together by a big paperclip."[3] "[T]he plan can be composed of a salary reduction agreement, the various contracts that fund the plan, as well as administrative procedures regarding who is eligible, how benefits are made available and what the dollar limitations are."[4] This position may ultimately save some of those plan sponsors that failed to adopt formal, written plans from having to go through a formal correction procedure.

More formally, the IRS has introduced and continues to introduce formal guidance and programs to help 403(b) plan sponsors perfect their plan documents. These efforts, discussed further below, include model public school plan language as well as the forthcoming 403(b) prototype program and the 403(b) plan determination letter program.

A. Revenue Procedure 2007-71: Model Plan Language for a Public School, Guidance for Other Sponsors

On December 17, 2007, the IRS released Revenue Procedure 2007-71, which contained model 403(b) plan language for public schools.[5] The plan is a basic salary deferral only plan that a public school could adopt as its own and rely on to satisfy the 403(b) regulations.[6] A school may also adopt particular language or provisions from the model plan and rely on that language or those provisions to satisfy the regulations.[7] Although the model public school language is now more than three years old, employers can continue to formally rely on it. The IRS also has encouraged non-public school employers to use it as sample language to comply with the requirements of section 403(b) of the Internal Revenue Code ("Code"), although the Revenue Procedure does not provide the specific reliance that it affords public school employers.[8]

Plan sponsors, especially those ordinarily subject to ERISA, that adopted the model document should be aware that although it provides a good base for a custom-drafted 403(b) plan, it imposes more administrative responsibilities on the employer than some may be willing to take on. For example, in administering loans, the model indicates that the "administrator" will approve the loan, with the administrator being described as "the person, committee, or organization appointed to administer the plan."[9] What is missing from the list is the vendor with whom the participant has a contract. If an employer is trying to limit its fiduciary responsibility under the 403(b) plan, loan processing and approval is one area that it will want to defer to the

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[3] IRC 403(b) Tax-Sheltered Annuity Plans – Questions and Answers, http://www.irs.gov/retirement/article/0,,id=172433,00.html (last visited March 23, 2010).

[4] *Id.*

[5] Rev. Proc. 2007-71, 2007-51 I.R.B. 1184.

[6] *Id.*, § 4.02.

[7] *Id.*, § 4.01.

[8] Rev. Proc. 2007-71, § 5.

[9] *Id.* (Appendix).

vendor. If it takes an active administrative role of approving the loan or appointing the fiduciary who will approve the loan, it will fall outside the Department of Labor's ERISA exception for salary-deferral only 403(b) plans and ERISA will apply. Likewise, the administrator, rather than the vendor, has the authority under the plan to approve contract exchanges and plan-to-plan transfers, again jeopardizing the plan's non-ERISA status.

Some employers may not be concerned about taking on fiduciary responsibility under ERISA. To them the advantage of relying on the IRS model document outweighs any additional burden that the plan might impose in regard to administration of particular terms and features. This may be particularly true of small tax-exempt employers where the administration of the 403(b) plan will be relatively uncomplicated. In such instances, the employer will likely rely on the vendor to assist in providing guidance and help in the administration of the plan.

B. Notice 2009-3: Relief for Calendar Year 2009

Initially, the final regulations required 403(b) plan sponsors to adopt a written plan document by January 1, 2009. However, recognizing that (i) there is a unique hierarchy and bureaucracy within many 403(b) plan sponsors, (ii) many plan sponsors were not ready to comply with the written plan document requirements, and that (iii) the IRS had yet to provide a remedial amendment period or a pre-approved prototype or determination letter program for 403(b) plan sponsors to use, the IRS released Notice 2009-3 late in 2008. The Notice, which was not formally published until January 5, 2009, granted relief to those 403(b) plan sponsors that had not yet adopted written plans.

Specifically, the IRS stipulated in 2009-3 that it would not treat a 403(b) plan as failing to satisfy the requirements of section 403(b) of the Internal Revenue Code (the "Code") and the final regulations during the 2009 calendar year provided that the following requirements were met:

- Written Plan: On or before December 31, 2009, the plan sponsor adopted a written 403(b) plan intended to satisfy the requirements of Code Section 403(b) (including the final regulations) that were effective as of January 1, 2009;

- Operational Compliance: During 2009, the plan sponsor operated the plan in accordance with a reasonable interpretation of Code Section 403(b), taking into account the final regulations; and

- Correction of Operational Failures: Before the end of 2009, the plan sponsor made best efforts to retroactively correct any operational failure during the 2009 calendar year to conform to the terms of the written 403(b) plan, with corrections based on the general principles of correction found in the IRS's Employee Plan Compliance Resolution System ("EPCRS").

Although the IRS did not subsequently delay the imposition of the written plan requirement beyond the end of 2009, a remedial amendment period is forthcoming for those 403(b) plans sponsors that have adopted written plans and made best efforts to comply with the regulations. Plan sponsors that adopted a written plan intended to satisfy the regulations by the

end of 2008, or that adopted one by the end of 2009 and satisfied the requirements of Notice 2009-3, are eligible for further relief from imperfections in their written plans.

C. Announcements 2009-34 and 2009-89: The 403(b) Prototype Plan and Determination Letter Programs and the Remedial Amendment Period

403(b) plan sponsors that are not public schools, and public schools that did not adopt the model plan language in Revenue Procedure 2007-71 verbatim, also want to confirm that their written plans comply with the new regulations beyond the period of relief offered by Notice 2009-3. Plan sponsors that maintain qualified pension or 401(k) plans are aware that they can confirm the compliance of these plans with applicable law and regulations through at least two methods: they can 1) adopt a third-party sponsored-prototype plan document that has been pre-approved by the IRS, or 2) they can submit their custom, individually designed qualified plan to the IRS for review and approval through a determination letter process. The prototype plan option requires the sponsor to adhere to a form plan document sponsored by a third party, often one of the plan's vendors. The IRS periodically reviews these plans and grants them favorable opinion letters if they remain in compliance with the law. Many of a plan's features may be provided for in a "fill in the blank" and "check the box" adoption agreement that the sponsor must execute to adopt the prototype plan. Plan sponsors requiring greater plan feature flexibility and control may adopt an individually-designed plan, which can be submitted to the IRS for review under the determination letter program. Provided that the plan is filed with the IRS according to a predetermined filing cycle schedule, and the plan sponsor has timely amended the plan in good faith for changes in the law, the sponsor generally will receive a period of time in which to amend the plan to fix plan document defects.

On May 4, 2009, in Announcement 2009-34, the IRS announced the introduction of the same type of programs, a prototype plan program and a determination letter program, for 403(b) plans. In the Announcement, the IRS also released a draft Revenue Procedure setting forth proposed rules for the prototype plan program. In a separate document, the IRS issued draft sample plan language that it intends prototype plan sponsors will use in drafting 403(b) prototype plans.[10] These provisions are based on the model 403(b) language for public schools and similar sample provisions for the other types of prototype plans. Interested parties were able to comment on the draft documents until June 1, 2009.

Final guidance, though, has yet to be issued on these programs as of the time these materials were prepared. According to an official Treasury Department planning document, guidance on the prototype plan program is designated as a priority item for 2011.[11]

1. The Remedial Amendment Period

Announcement 2009-89 also clearly describes the advantages that the two new programs will offer to 403(b) plan sponsors that choose to participate. Once the programs are introduced,

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[10] The draft sample plan language for 403(b) prototype plans is available on the IRS website at http://www.irs.gov/pub/irs-tege/draft_lrm_403b_prototypes.pdf.

[11] Dept. of Treas., 2010-2011 Priority Guidance Plan 5 (Dec. 7, 2010), http://www.irs.gov/pub/irs-utl/2010-2011_pgp.pdf.

if a 403(b) plan sponsor either adopts a prototype plan that has been pre-approved by the IRS or submits its custom, individually-designed plan to the IRS for a determination letter, the sponsor will be given a period of time ("a remedial amendment period") in which it may amend the written plan to correct any defects. Any correction will be retroactive to January 1, 2010. Moreover, plan sponsors that participate in the programs generally will have reliance, retroactive to January 1, 2010, that their written plans satisfy the regulations. Combined with the relief offered by Notice 2009-3, plan sponsors that participate in the prototype plan or determination letter programs may have relief all the way back to the effective date of the regulations, January 1, 2009.

Significantly, to qualify for the remedial amendment period, an existing plan sponsor must have adopted a written plan intended to satisfy the requirements of the final 403(b) regulations by December 31, 2009.[12] Failure to have adopted such a plan will preclude the plan sponsor from obtaining this valuable relief. As mentioned above, a plan sponsor that maintains its plan pursuant to a number of different written policies may be able to assert that it had adopted a written plan by the end of 2009. Plan sponsors considering this position should carefully review the documentation to ensure that it addresses all of the required elements of a written plan as set forth in the regulations. Employers that cannot demonstrate that they had a written plan in place by the end of 2009 will be ineligible for the remedial amendment period and will need to correct the failure to adopt a written plan through the IRS's correction program, EPCRS. Eligible employers that establish new 403(b) plans in 2010 or later will be eligible for the remedial amendment period if they adopt a prototype plan when they become available or submit their individually designed plan to the IRS once the determination letter program is underway.[13]

As of the time this material was produced, the IRS had not yet established deadlines by which a plan sponsor would be required to adopt a prototype plan document or submit its individually designed plan document to the IRS in order to qualify for the remedial amendment period relief. Presumably, the IRS will release timeframes with the upcoming guidance.

2. The 403(b) Prototype Plan Program

The proposed prototype plan program offers one potential solution for those 403(b) plan sponsors seeking to confirm that they have a written plan that complies with the Code and the final 403(b) regulations. Any company, firm, or individual that expects at least 30 eligible 403(b) plan sponsors to adopt its basic plan document may become a prototype plan sponsor.[14] These prototype plan sponsors, which likely will include annuity and custodial account providers and recordkeepers, draft the basic plan document and adoption agreement and submit it to the IRS for an opinion letter approving the plan.[15] Once a plan is approved, the prototype sponsors will market the plan to eligible 403(b) plan sponsors. Employers with existing 403(b) plans can adopt the basic prototype plan document by executing an adoption agreement that provides for

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[12] Announcement 2009-89.

[13] *Id.*

[14] Notice 2009-34, Draft Revenue Procedure 2009-34, § 7.02.

[15] *Id.*, § 3.

the selection the appropriate custom options (e.g., definition of eligible employees, availability of loans and hardship distributions).[16] Upon adoption, the prototype document will supersede the sponsor's prior written plan. The prototype plan sponsor generally is responsible for amending the prototype plan document to maintain its compliance with changes to the Code and applicable regulations.[17] Employers may occasionally need to select options that suit the operation of the plan that are provided for in prototype plan amendments, but for the most part, a significant amount of the compliance burden will be on the prototype sponsor.

The draft Revenue Procedure sets forth two different types of prototype plans: standardized and nonstandardized plans.[18] Standardized plans are those plans that offer only elective deferrals or that offer employer contributions to all non-excludable employees under a design-based nondiscrimination safe harbor allocation formula.[19] A nonstandardized plan is any 403(b) prototype plan that is not a standardized plan.[20] Employers that adopt standardized plans, and offer only elective deferrals under the plan or are not in a controlled group with any employers not eligible to sponsor a 403(b) plan, may generally rely on the prototype plan's opinion letter for assurance that the prototype plan satisfies the Code and regulations.[21] Other employers that adopt standardized plans and all employers that adopt nonstandardized plans cannot rely on a prototype plan opinion letter for assurance that the prototype plan's contribution provisions comply with the Code's nondiscrimination and minimum participation requirements, but they may rely on the letter for assurance that the other provisions of the prototype plan generally satisfy the Code and regulations. [22] As the Code's nondiscrimination and minimum participation provisions generally do not apply to governmental plans and church plans that do not opt into ERISA, sponsors of these types of 403(b) plans may adopt either standardized or nonstandardized plans and generally rely on the opinion letter.[23]

The final guidance may provide more flexibility than the draft. The IRS has said that the final prototype program Revenue Procedure also will provide for a similar type of pre-approved plan called a volume submitter plan. Volume submitter plans technically are individually designed plans, but like prototype plans they are drafted by a third party, such as a vendor, that submits the plan to the IRS for approval. Volume submitter plans provide employers with more flexibility to modify the pre-approved language, although such modifications may jeopardize an employer's ability to rely on the compliance of the modified language. The IRS has also indicated that the final Revenue Procedure will permit the vesting of employer contributions, perhaps permitting reliance on approved vesting schedules that comply with Code Section 411.

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[16] *Id.*, §§ 5.10.

[17] *Id.*, §§ 8, 11.

[18] *Id.*, § 3.08.

[19] *Id.*, § 6.02.

[20] *Id.*, § 6.03.

[21] *Id.*, §§ 6.01, 6.03.

[22] *Id.*, §§ 6.01, 6.03.

[23] *Id.*, § 6.02.

3. The Determination Letter Program

The IRS has not released significant details about the upcoming determination letter program for individually designed plans, but it will probably work much like the determination letter program that the IRS operates for sponsors of individually designed qualified plans like pension and 401(k) plans.[24] Under this program the employer submits its individually designed plan to the IRS for review and a determination that it complies with the Code. The employer is entitled to rely on the determination letter until the next time the plan is due to be submitted to IRS under a periodic cycle that generally is based on the employer's EIN. The employer must amend the plan in good faith as necessary to maintain compliance with changes in the Code and applicable regulations and, to maintain its reliance on a determination letter, the employer must re-submit the plan to the IRS for review during its cycle.

4. Model, Prototype, or Individually Designed? Employer Options Regarding Plan Document.

The IRS's compliance assistance efforts have created an array of choices for employers. Some employers especially anxious to seek assurance that their 403(b) plan is in compliance may be tempted to take advantage of the prototype program once it gets under way, but also may wonder how much flexibility their plans will lose. Public school employers may prefer to hew closely to the model language. Some employers may even be relying on the generous "paper clip rule," described above, and may question if adopting a prototype or a formally individually designed is worth the trouble.

Is it best to use the IRS model plan, a prototype plan or volume submitter plan offered by a vendor, or an individually designed plan document? Each has its advantages and drawbacks. The IRS model plan is straightforward for simple salary-deferral public school plans, but imposes administrative responsibilities on the employer that may otherwise be delegated to the vendor. The model plan also does not offer non-public school employers the reliance (and the remedial relief) that they can obtain by adopting a prototype. Like an individually designed plan, a non-public school employer's adaptation of the model plan must be submitted for a determination letter in order to receive the benefit of the remedial amendment period. Prototype plans reduce the administrative burden and will offer remedial relief relatively soon, but they typically place fiduciary responsibilities on the employer and eliminate the employer's opportunity to keep its salary deferral plan outside of ERISA. Prototype plans also are often over-inclusive, lengthy and not user friendly. Maintaining an individually designed plan and submitting it for a determination letter may provide an employer more flexibility and a clearer, more flexible document. However, the time and/or cost involved in submitting the plan to the IRS for a determination letter, making the necessary remedial amendments, and making periodic amendments to the plan to keep it in compliance with the frequently changing Code may be prohibitive. Whatever route an employer chooses to take, it will want to make sure that the plan that it drafts or selects clearly describes each party's role. A primary purpose of the 403(b) regulations is to make someone responsible for each of the administrative functions of the plan. If limiting that responsibility is the employer's ultimate goal, how the plan document is drafted is critical to achieving that goal.

[24] Rev. Proc. 2010-6, 2010-1 I.R.B. 193.

5. More Guidance on 403(b) Plans: Correction of Plan Operational Failures, Plan Terminations, and In-Plan Roth Rollovers

The proposed remedial amendment period under the prototype program and the determination letter program will permit eligible 403(b) plan sponsors to correct only failures of their written plans to comply with the Code and regulations. The IRS, however, also has indicated that it intends to revise its correction program, EPCRS, to update its correction procedures for operation failures—those errors that result from failing to administer the plan pursuant to the written plan and/or the Code and regulations. Currently EPCRS provides for the correction of operational failures under 403(b) plans, but has not been revised to account for the final regulations. *Pension and Benefits Daily* reported that an IRS official speaking at the Great Lakes Benefits Conference in Chicago, sponsored by the IRS and the American Society of Pension Professionals and Actuaries, on June 16, 2010, stated that 403(b) operational failure correction procedures were due by June 30, 2010, but that the IRS would likely not meet that deadline.[25] As of the date of this writing, revised correction procedures have not been released.

More specific guidance on terminating 403(b) plans was recently provided under Revenue Ruling 2011-7. Unlike the prior 403(b) rules, the 2007 final 403(b) regulations permit plans to provide for their termination and the distribution of accumulated benefits.[26] In order to effectuate a plan termination, however, several steps must be completed, including the distribution of all accumulated benefits under the plan to all participants and beneficiaries as soon as administratively practicable after plan termination.[27] Revenue Ruling 2011-7 directs 403(b) plan sponsors to Revenue Ruling 89-87 and Internal Revenue Manual 7.12.1.2.3, paragraph 5 (both applicable to qualified retirement plans under Code Section 401(a)) for guidance on what constitutes "as soon as administratively practicable." This guidance states that whether a distribution is made as soon as administratively feasible is determined based on the facts and circumstances of the particular case, but a distribution which is not completed within one year following the date of plan termination is presumed not to have been made as soon as administratively practicable.[28]

Revenue Ruling 2011-7 provides that a plan sponsor can terminate a 403(b) plan either through delivery of a fully paid individual annuity contract or an individual certificate evidencing fully paid benefits under a group annuity contract, or by distributing all amounts in individual and group custodial accounts by payment either to the participant or beneficiary, to an IRA established by the participant or beneficiary, or to another eligible retirement plan.[29] However, in the case of a 403(b) plan with restrictions on distributions from custodial accounts or elective deferrals, the plan sponsor, including the members of its controlled group, cannot

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25 Tom Gilroy, *403(b) Termination Guidance Just Starting; DOL to Answer 403(b) Safe Harbor Questions*, PENSION & BENEFITS DAILY, Jan. 22, 2010.

26 Treas. Reg. §1.403(b)-10(a)(1).

27 *Id.*

28 Rev. Rul. 89-87, 2011-10 I.R.B. 534.

29 *Id.*

make contributions to another 403(b) contract for the period beginning with the termination date and ending twelve months after all assets of the plan have been distributed.[30]

The Small Business Jobs Act of 2010 (Pub. L. No. 111-240) added Code Section 402A(c)(4), effective for distributions after September 27, 2010, which permits 403(b) and 401(a) qualified plans to allow a participant to rollover his or her vested benefits to an in-plan designated Roth account if the benefits are otherwise eligible for distribution under the plan.[31] Amounts rolled over to a Roth contribution account must generally be included in the participant's gross income, but can later be distributed (including earnings) tax free if certain requirements are met.[32] Under guidance issued in late 2010, a participant who elects an in-plan Roth rollover cannot later unwind the rollover.[33]

III. THE IRS AS FOE: COMPLIANCE PITFALLS

Between the model public school language, the 2009 transitional relief, and the upcoming prototype and determination letter programs, the IRS has provided generous relief for those 403(b) plan sponsors that have made good faith efforts to follow the previously released guidance. These 403(b) plan sponsors also should be in an excellent position to avoid operational compliance problems because they have a written plan document in place to guide plan administration and likely also have adopted effective best practices to administer their plans.

Even the most prepared plan sponsors, however, can run afoul of the complex requirements that the Code and the regulations impose on 403(b) plans. The most common operational compliance issues facing 403(b) plans involve the failure to make the plan universally available, excess contributions, plan loans, and hardship distributions. These items are mentioned as the top five items on the IRS's list of the top ten issues for 403(b) and 457(b) plans.[34] The formality imposed by the written plan and the coordination of information required under the new regulations should help alleviate some of these issues, but plan sponsors should keep these problem areas in mind to prevent the now-friendly IRS from becoming their foe.

A. Universal Availability

Compliance with the universal availability rule has long been a problem in the 403(b) community. Although the final regulations restate the rule and reduce the number of exceptions, the basic universal availability rule is not new. In general, the universal availability rule states that, other than for church plans, if an employer offers the opportunity to make salary deferrals to one employee, the employer must offer that opportunity to all employees.[35] Moreover, if any particular employee of an eligible employer is allowed to designate the elective deferrals as Roth

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30 *Id.*

31 Code § 402A(c)(4).

32 Notice 2010-84, 2010-51 I.R.B. 872.

33 *Id.*

34 IRS, EP Examination Process Guide—Section 2—Compliance Monitoring Procedures—Top Ten Issues—IRC 403(b)/457 Plans (Oct. 29, 2010), http://www.irs.gov/retirement/article/0,,id=135262,00.html.

35 Code §403(b)(12)(A)(ii).

contributions, the employer must offer that option to all employees.[36] The regulations permit certain employees to be excluded: (1) student employees, (2) employees eligible for a 401(k), governmental 457(b) or another 403(b) plan of the organization, (3) nonresident aliens with no U.S. source income, and (4) certain employees who normally work less than 20 hours per week.[37] As for church plans, there are no requirements they need to satisfy.

IRS audits have disclosed 403(b) plans that improperly exclude "collectively-bargained employees, visiting professors, employees who have taken vows of poverty, employees who make a one-time election to participate in a governmental non-403(b) plan, and specified categories of employees, such as substitute teachers, janitors, cafeteria workers, and nurses."[38] Unless individual employees in these groups satisfy one of the actual exemptions listed in the paragraph above, employees that fall into these groups generally cannot be excluded from participation in a 403(b) plan.

The 20 hour per week exception also is a particular source of confusion. For the purpose of the universal availability rule, an employee generally works fewer than 20 hours per week if: (1) for the 12-month period beginning on the employee's date of hire, the employer reasonably expects the employee to have fewer than 1,000 hours of service (as defined in Code Section 410(a)(3)(C)) in such period, and (2) for each plan year ending after the close of the 12-month period in clause 1 (or, if the plan so provides, each subsequent 12-month period), the employee has fewer than 1,000 hours of service in the preceding 12-month period.[39] The result of this arrangement is that temporary employees (camp counselors, coaches, etc) who work consistently over 20 hours a week, but only for a short period, need not be offered 403(b) participation. If a plan sponsor intends to exclude individuals on the 20 hour basis, however, it should be prepared to show how hours are tracked and monitored.[40]

In considering the prototype plan and determination letter programs, sponsors should take the opportunity to review their plan documents and ensure that all employees (with minor exceptions) are given the right to participate in the 403(b) plan. Specifically, under the final regulations, an employer must ensure that each employee with a right to make an elective deferral is provided with an "effective opportunity" to elect to have such deferrals made.[41] Effective opportunity was not previously addressed as a requirement of universal availability.[42] In order to satisfy the effective opportunity aspect of the universal availability rules, an employee must be able to start, stop or modify his or her deferral election at least one time during any plan year.[43] Moreover, an effective opportunity does not exist if there are any rights or benefits (other

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36 *See* T.D. 93410, 72 Fed. Reg. 41,128, 41,134.

37 T.D. 93410, 72 Fed. Reg. 41,128, 41,134-135.

38 IRS, EP Team Audit (EPTA) Program—EPTA Compliance Trends & Tips—403(b) Tax-Sheltered Annuity Plan, 457 Plan and Governmental Plan Trends (Apr. 17, 2009), http://www.irs.gov/retirement/article/0,,id=206498,00.html.

39 Treas. Reg. §1.403(b)-5(b)(4)(iii)(B).

40 IRS, EP Team Audit (EPTA) Program, *supra* note 38.

41 Treas. Reg. §1.403(b)-5(b)(2).

42 *Id.*

43 *Id.*

than matching contributions) that are conditioned upon making a deferral election.[44] Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election ("meaningful notice" discussed below), the time period during which an election may be made, and any other conditions on elections.[45]

The employer also is required to provide a meaningful notice to all eligible employees at least once per year advising them of the availability of the 403(b) plan and how they can make a salary reduction election to begin making salary deferrals to the plan.[46] If employees are unaware of their ability to defer, the requirement will not be satisfied. Many vendors have provided their clients with sample notices. However, these notices range widely in their level of detail. Therefore, each employer should carefully review the sample notices and craft their notice to meet the notice requirement. The good news is that the universal availability notice may be provided electronically (*i.e.*, via e-mail).[47]

B. Excess Contributions

Two general contribution limitations apply to 403(b) plan contributions, the limit on total contributions made on behalf of an employee imposed by section 415 ($49,000 for 2011) and the limit on an employee's salary deferral contributions imposed by Code Section 402(g) ($16,500 for 2011).[48] Three unique aspects of 403(b) plans may contribute to frequent aggregate contributions in excess of the limits: 1) the particular aggregation of 403(b) plans sponsored by different employers for the purpose of applying the contribution limits, 2) the complexities of the "special section 403(b) catch-up" available to long-serving employees of certain organizations, and 3) the poor internal controls that result from pre-final 403(b) regulations practices and the involvement of many vendors.

1. Plan Aggregation

The particular way 403(b) plans are aggregated for the purpose of the Code Section 415 limit is one source of complexity in the application of the limits. Under Code Section 415 regulations the employee is deemed to be the sponsor of a 403(b) plan and thus generally all contributions made on the employee's behalf to any 403(b) plan and all contributions made to any plan actually sponsored by the employee (*e.g.*, an individually sponsored SEP) will be aggregated.[49] This problem may arise when professionals work for the sponsor and participate in its 403(b) plan, but also work for another sponsor with a 403(b) plan or have an independent practice through which they individually sponsor a plan. Plan sponsors that employ professionals that may work for another 403(b) plan sponsor or may have active, independent

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44 *Id.*

45 *Id.*

46 *Id.*

47 IRS, IRC 403(b) Tax-Sheltered Annuity Plans - Questions and Answers (Oct. 15, 2009), http://www.irs.gov/retirement/article/0,,id=172433,00.html#u1.

48 Treas. Reg. § 1.403(b)-4(b), (c).

49 Treas. Reg. § 1.415(f)-1(f).

practices (*e.g.*, doctors, dentists), should review their salary deferral forms and other participant enrollment materials to ensure that they alert "participants who plan to contribute to another 403(b) plan or a plan that they sponsor" of a potential contribution issue and encourage them to seek additional assistance.

2. The Special Section 403(b) Catch-Up

A second complicating factor in applying the limits, is the availability of the "special section 403(b) catch-up" (the "special catch-up") for long-serving employees of schools, hospitals, health and welfare service agencies, and church-related organizations.[50] Much like the "age 50 catch up," the special catch-up allows certain employees, in this case those with at least 15 years of service, the ability to boost their annual employee salary deferral contributions beyond the Code Section 402(g) limit.[51] The maximum amount of special catch-up contributions that an employee may make is $15,000 in a lifetime or $3,000 per year and lower limits may apply based on the participant's contribution history and years of service.[52] A participant's maximum special catch up contribution for the year is the least of the three following amounts: 1) $3,000, 2) an amount equal to $15,000 minus the special catch-up contributions made by the employee in prior years, or 3) an amount equal to $5,000 multiplied by the number of years of service the employee has with the sponsor minus the total of all elective deferral contributions made by or on behalf of the employee in prior years.[53] Therefore, to calculate an employee's maximum special catch-up in any year, the sponsor must have an accurate contribution history for the participant and an accurate count of the participant's years of service.[54] Moreover, since many employees in a position to make special catch up contributions are over 50, it is important that the special catch-up contribution be properly coordinated with the age 50 catch-up contribution—the amount contributed in excess of the normal Code Section 402(g) limit is first treated as a special catch-up and then as an age 50 catch-up.[55]

The special catch-up feature is discretionary, so sponsors with written plans that do not offer the feature can weigh whether they want to add this level of complexity to the plan. The ability for participants to make up to $15,000 in additional deferrals later in their careers is valuable, but a smaller plan sponsor with inadequate records may wish to avoid this feature. Responsibility for tracking the prior contributions and service also may be allocated to a vendor offering a compliance coordinator service. For plan sponsors that choose to offer the special catch-up, regardless of whether they or a compliance coordinator will track contributions and service, it is critical that the plan has adequate records, which should be available as payroll data, but may be in the hands of a current or prior vendor. Information sharing agreements, discussed further below, make the collection of data from disparate vendors much simpler.

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50 Treas. Reg. § 1.403(b)-4(c)(3).

51 Treas. Reg. § 1.403(b)-4(c)(3)(iii).

52 Treas. Reg. § 1.403(b)-4(c)(3)(i).

53 *Id.*

54 Treas. Reg. § 1.403(b)-2(b)(21) (definition of year of service). Special year of service counting rules apply to service within a group of church-related organizations. Treas. Reg. § 1.403(b)-4(c)(3)(ii)(B).

55 Treas. Reg. § 1.403(b)-4(c)(3)(iv).

3. Poor Internal Controls

The IRS also simply blames poor internal controls for excess contribution errors. The discipline imposed by the final regulations may help to ameliorate this issue. Before the introduction of the final 403(b) regulations, many 403(b) plans permitted employees to make salary deferral contributions to a nearly limitless number of vendors with little coordination regarding what party was responsible for tracking the level of contributions. This practice, combined with inadequate payroll recordkeeping (perhaps a result of so many vendors), resulted in no one entity monitoring an employee's aggregate level of salary deferral contributions. For example, if payroll personnel and payroll systems were not attuned to monitoring each employee's aggregate salary deferrals for the year, an employee easily could have contributed an amount below the 402(g) limit to each of two vendors, but when the two amounts were aggregated, the total could have exceeded the 402(g) limit. The final regulations address this type of problem squarely by requiring the allocation of plan administration responsibilities. If a plan sponsor has implemented appropriate procedures, or outsourced the responsibility for this type of tracking, excess contribution errors should be greatly reduced. Moreover, if a plan sponsor has reduced the number of vendors to which it will transmit contributions in order to reduce the burden of the new final regulations, catching excess contribution errors should be easier.

C. Plan Loans and Hardship Withdrawals

Much like excess contributions, many prior plan loan and hardship withdrawal failures among 403(b) plans occurred as a result of the inadequate allocation of responsibility and monitoring of participant accounts with multiple vendors. The Code places strict limits on both plan loans and hardship withdrawals. Plan loans from a 403(b) plan are subject to the rules of Code Section 72(p). These rules limit, among other things, the maximum amount of a loan and the length of the loan repayment period.[56] The final regulations also permit participants to take hardship withdrawals from a plan before a normal distribution event, but only permit such distributions in the event of financial hardship if the participant already has obtained all other possible distributions and loans and the employee will be barred from making contributions to all the plans of the employer for six months after the hardship withdrawal.[57] Even then, the amount of the hardship withdrawal is limited to the amount necessary to satisfy the hardship.[58]

The IRS has found that loan programs under 403(b) plans suffer from "failure[s] to make required payments when due, resulting in default of the entire loan; poor documentation; and loans from multiple vendors that in the aggregate exceed the IRC 72(p) limits."[59] Similarly, with regard to hardship distribution programs, the IRS has found that common violations include "inadequate documentation that the distribution is the result of a financial hardship and

[56] Code § 72(p)(2)(A), (B).

[57] Treas. Reg. § 1.403(b)-6(d)(2);

[58] Treas. Reg. § 1.403(b)-6(d)(2); Treas. Reg. § 1.401(k)-1(d)(3).

[59] IRS, EP Examination Process Guide, *supra* note 34.

distributions from multiple vendors that in the aggregate exceed the amount needed to relieve the hardship."[60]

These problems appear to stem from the very problems that the final regulations seek to alleviate: poor communication between vendors and employers (or their designees) and a failure to properly delegate responsibility for coordination. Because participants may have account balances with vendors to which the plan sponsor ceased making contributions on its employees' behalf years ago, the potential for ongoing problems appears great. However, plan sponsors that took advantage of the relief granted by the IRS in Revenue Procedure 2007-7 to disregard the contracts of older and unresponsive former vendors as part of their plans, and that have implemented good information sharing practices with current vendors, should face significantly less risk of these violations due to improved oversight going forward.

An information sharing agreement prevents these plan loan and hardship withdrawal errors by ensuring that all relevant parties continue to share information for compliance purposes even after the employer has terminated a vendor. Revenue Procedure 2007-7 set forth a transition rule, in effect prior to January 1, 2009, providing that 403(b) plan sponsors were merely required to make a reasonable good faith effort to obtain an agreement with those former plan vendors, which had received contributions since January 1, 2005 but not after January 1, 2009, to share information for plan compliance purposes. To the extent plan sponsors were unable to obtain signed agreements, those vendors' contracts are not included in the plan.[61] For vendors that are terminated after January 1, 2009, however, plan sponsors are required to obtain a formal information sharing agreement. Plan sponsors that have not already entered into an information sharing agreement with their current vendors may find it advantageous to do so now, while the relationship is still positive. Obtaining such an agreement at a later date, when the vendor is on the way out, may be more difficult. Regardless, the sponsor should ensure that it includes in its information sharing agreements with current approved vendors a provision that, as long as plan assets are held with the vendor, it must continue to share information, even if later deselected.

IV. CONCLUSION

With the final 403(b) regulations now fully in effect and new IRS guidance on the way, a period of relative stability in the 403(b) market may finally be on the horizon. Plan sponsors, however, should keep aware of the latest written plan options and changes to EPCRS. The IRS's proposed guidance indicates that new written plan relief is limited to those plan sponsors that followed prior guidance, demonstrating that proactive plan sponsors that make good faith efforts to comply with the rules will be more likely to maintain the IRS as a helpful friend. Sponsors should also remain alert to the high-profile traps that have long befallen 403(b) plans—universal availability, excess contributions, plan loans, and hardship withdrawals—while compliance with the letter and the spirit of the final regulations should reduce such problems, these are the issues that IRS continues to identify as areas of concern.

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[60] *Id.*

[61] Rev. Proc. 2007-71, § 8.01.