

Update on 403(b) and 457(f) Plans

Representing & Managing
Tax Exempt Organizations

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403(b) Plans

- Top IRS Exam Issues
- Plan Audit Issues
- Recent Guidance
- Pending Guidance

EP Examination Process Guide - Top Issues for IRC 403(b) Plans

- Written Plan
- Universal Availability
- Contribution Issues
 - Excess 402(g) contributions, including special catch-up issues
 - Excess 415 contributions
- Plan Loan Issues
- Hardship Distribution Failures

Written Plan Requirement

- Employers Required to Adopt Written Plan Document on or before December 31, 2009
- Failure to Do So Will Result in No Plan
- Practical Impact
 - Employee Plans Compliance Resolution System (EPCRS)
 - Still awaiting guidance
 - Likely will have late adopter program

Written Plan Requirement

- How to satisfy written plan requirement
 - Review existing documents to see if you satisfy “Paperclip Rule”
 - At a minimum:
 - Eligibility
 - Benefits
 - Dollar limitations
 - Available investments
 - Time and form of distributions

Written Plan Requirement

- If no document, adopt one immediately
 - Model IRS Plan - Rev. Proc. 2007-71
 - Sample Prototype Plan Language – Ann. 2009-34
 - Vendor Documents
 - Prototype
 - Volume submitter
 - Waiting for IRS program to open up
 - Caveat: Vendor's plans will offload administrative responsibility onto employers.

Universal Availability

- General Rule: All employees must be given the right to participate in the 403(b) plan
- Exceptions:
 - Church plans
 - Certain classes of employees

Universal Availability: Excludable Employees

- Student employees
- Employees eligible for a 401(k), 457(b) or another 403(b) plan of employer
- Nonresident aliens with no U.S. source income
- Employees who normally work less than 20 hours per week; determined using the following rules:
 - In employee’s first year, employer “reasonably expects” employee to have fewer than 1,000 hours of service
 - In each subsequent year, employee has fewer than 1,000 hours of service

Universal Availability

– Effective Opportunity:

- Each individual must be provided an “effective opportunity” to elect to have deferrals made
- An employee must be able to start, stop or modify his or her deferral election at least one time during any plan year

Universal Availability

– Annual Notice Requirement:

- Sponsors are 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
- Wide variance in the level of detail for these notices
- Notice may be provided electronically (i.e., via e-mail)

Excess Contributions

- Traps:
 - Plan Aggregation
 - The Special Section 403(b) Catch-Up
 - Poor Internal Controls/Vendor Coordination
- Limits (for 2011):
 - Code Section 415 limit on total contributions made on behalf of employee: \$49,000
 - Code Section 402(g) limit on total contributions made by employee: \$16,500

Excess Contributions: Plan Aggregation

- Code section 415 limit applies to contributions made by or on behalf of an employee to all plans maintained by a sponsor
- Employee is deemed to maintain (or sponsor) a 403(b) for the purpose of the 415 limit
- In applying the 415 limit, all contributions to 403(b) plans in which the employee participates must be aggregated along with contributions made to other plans actually maintained by the employee (e.g., an individually sponsored SEP); but contributions to 401(k) plans or other employer contribution 401(a) plans are not aggregated with contributions to such plans
- Issue for professionals who serve as faculty and have their own practices with individually-sponsored plans (e.g., dentists, doctors)

Excess Contributions: Special Catch-Up

- Special 403(b) catch-up contribution available for long-serving employees of educational institutions, hospitals, health and welfare service agencies, and church-related organizations
- Applies to employees with 15 or more years of service
- Increases amount employee may contribute to plan over the 402(g) employee contribution limit by the least of:
 - 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 employee's years of service with the sponsor minus the total of all elective deferral contributions made by or on behalf of the employee in prior years

Excess Contributions: Special Catch-Up

- Problems:
 - Generally complex rule
 - Requires accurate contribution history and accurate record of employee's years of service
 - To keep accurate records; coordination with Age 50 Catch-Up is required
 - Treat amounts contributed in excess of 402(g) amount first as Special Catch-Up and then as Age 50 Catch-Up

Excess Contributions:

Poor Internal Controls/Vendor Coordination

- Problem: Inadequate payroll practices combined with contributions to multiple vendors left open opportunity for employee contributions in excess of 402(g) limit—if employee allocated contributions to multiple vendors and employer did not detect excess contributions, vendors may not have either
- Solution: The enhanced allocation of administrative responsibility and coordination of information sharing required by final regulations, if properly implemented, should alleviate this type of problem

Plan Loan Failures

- Plan loan rules limit, among other things, the maximum amount of a loan and the length of the loan repayment period
- The IRS has found frequent failures to make repayments when due and loans from multiple vendors under the same plan that in the aggregate exceed the loan limits

Hardship Withdrawal Failures

- Hardship withdrawal rules permit hardship distributions only if the participant already has obtained all other possible distributions and loans; a participant that receives a hardship withdrawal also must be prohibited from making contributions to all plans of the employer for six months after the withdrawal
- The IRS has found inadequate documentation of employee financial hardships and distributions from multiple vendors that exceed the amount required to alleviate the hardship

Plan Loan and Hardship Withdrawal Failures

- Like excess contributions, problems stem from poor internal controls and vendor coordination
- Enhanced coordination of administrative responsibilities and information sharing should alleviate some problems

Plan Audit Issue

- ERISA-covered plans with more than 100 participants required to file financial statements
- Plan required to be audited as well
- 2009 first plan year to be audited
- Qualified opinion because could not certify to opening balance
- Management letter
 - Material weakness in internal controls prior to 2009

Recent Guidance

- Revenue Ruling 2011-7
 - Plan Terminations
- Notice 2010-84
 - In-Service Roth Conversions

Pending Guidance

- New EPCRS Revenue Procedure
 - Expansion of 403(b) issues
- Prototype Program
- Determination Letter Program

457(f) Plans

- Top IRS Exam Issues
- Foreshadowing of What's to Come
 - Notice 2007-62
 - Notice 2008-62

EP Examination Process Guide - Top Issues for IRC 457(f) Arrangements

- Invalid Substantial Risks of Forfeiture
- Cafeteria Style Benefits
- Salary/Bonus Deferrals
- Severance Benefits Paid Upon Voluntary Termination
- Excessive Leave Payouts

Invalid Substantial Risks of Forfeiture

- Non-compete with no substance
 - Not likely to be applied because of length of non-compete period
 - Executive is retiring, etc.
- Post-termination consulting arrangements
 - Services only to be performed upon request
 - No projects described
 - Right to decline services

Cafeteria Style Benefits

- Arrangement allows participant to choose from a number of different types of benefits with any flex-dollars remaining accruing in a 457(f) plan.
- Choice between receipt of immediate benefit or accruing amount in 457(f) plan subject to vesting undermines validity of substantial risk of forfeiture.

Salary/Bonus Deferrals

- A rational person would not forego compensation due him or her and subject it to a substantial risk of forfeiture.
- Presumed not to have a valid substantial risk of forfeiture.

Severance Benefits Paid Upon Voluntary Termination

- Really deferred compensation
- Payout is guaranteed upon termination of employment at the election of the executive
- Does not qualify for the 457(e)(11) exception

Excessive Leave Payouts

- Exception to 457(f) for bona fide leave programs
- IRS generally permits payout of accrued leave upon termination
- If accrued leave is excessive, more than an employee could possibly take, looks more like deferred compensation

Notice 2007-62 Anticipated Changes to Section 457(f) Plans

- Definition of substantial risk of forfeiture:
 - Notice 2007-62 says that future guidance will generally adopt the rules under Section 409A
 - If the guidance is issued, the structure of Section 457(f) plans would have to change since events previously considered substantial risks of forfeiture would no longer be considered substantial risks of forfeiture
- No rolling risk of forfeiture
- No non-competes

Notice 2007-62 Anticipated Changes to Section 457(f) Plans

- Prohibition of salary and bonus deferrals:
 - Elective salary deferrals and bonus deferrals can never be made subject to a substantial risk of forfeiture beyond the date they would otherwise have been received

Notice 2007-62 Anticipated Changes to Section 457(f) Plans

- Severance arrangements will be bona fide severance pay plans if:
 - Payable upon involuntary termination;
 - Payment does not exceed two times the participant's salary, capped at the 401(a)(17) limit, which is \$245,000 for 2011, i.e., \$490,000; and
 - Paid within two years from the year of termination

Notice 2008-62 Recurring Part-Year Compensation

- Situation: School employees who provide services during the school year, but elect to be paid ratably over 12 months. Some of the compensation that the employee earns in one taxable year (e.g., September through December) is paid in the next.
- Notice 2008-62 sets forth an anticipated safe harbor for these recurring part-year compensation arrangements.

Notice 2008-62 Recurring Part-Year Compensation

- To satisfy the anticipated safe harbor, the arrangement:
 - (1) Must not defer payment of compensation beyond the end of 13 months after the beginning of the school year
 - (2) Must not defer more than the Section 402(g) limit, \$16,500 for 2010, from one year to the next



QUESTIONS?

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