Employee Benefits update: New regulations for tax-exempt employers

The long-anticipated final 403(b) and tax-exempt controlled group regulations were published on July 26, 2007. Reflecting changes in law through the Pension Protection Act of 2006, the new regulations are not effective until January 1, 2009 (with limited exceptions), but they give tax-exempt employers a great deal to consider before 2009. The final rules are generally consistent with the proposed regulations that were published in November 2004, but they contain some additional guidance and clarification in response to comments.

403(b) Regulations

Hospitals, schools, colleges, universities and other 501(c)(3) organizations with 403(b) plans will need to undertake a full review of those programs. Among the issues affected by the final regulations:

- **Universal Availability.** Elective deferrals (including Roth 403(b) deferrals, if offered) are subject to the universal availability rule, which requires that all eligible employees of an eligible employer be offered an effective opportunity to make elective deferrals if any employee is offered that opportunity. The regulations limit the types of employees who can be excluded from this deferral opportunity to: (1) employees who are eligible to make deferrals under another 403(b) plan, a governmental 457(b) plan or a 401(k) plan of the employer; (2) non-resident aliens; (3) students whose employment is incidental to their education; and (4) employees who normally work fewer than 20 hours per week. Previously available exclusions for other types of employees, including collectively bargained employees, will no longer apply (subject to certain transition rules). Employers wishing to take advantage of the exclusion for employees who normally work fewer than 20 hours per week (or some lower threshold established by the plan) must ensure that no employee with hours below the threshold participates in the plan, because the regulations provide that if one such employee is offered the opportunity to make elective deferrals under the plan, all such employees must be allowed to participate.

  Note: During the 12-month period beginning on the employee's date of hire, an employee will normally be deemed to work fewer than 20 hours per week if the employer reasonably expects the employee to work fewer than 1,000 hours of service during that period. For subsequent plan years, excludability depends on whether the employee actually worked fewer than 1,000 hours of service during the preceding plan year.

  The question of whether an effective opportunity exists depends on the facts and circumstances, including whether employees have been notified of the availability of 403(b) elective deferrals. The regulations further provide that an effective opportunity does not exist if other rights and benefits are conditioned on an employee's election to make (or not make) 403(b) elective deferrals, subject to certain limited exceptions (*e.g.*, for matching contributions subject to Code section 401(m)).

- **Other Nondiscrimination Rules.** Employer and after-tax employee contributions to 403(b) plans will be subject to the same rules as qualified plans, including nondiscrimination testing for contributions or benefits (including the special averaging tests for matching contributions), coverage testing, and the $225,000 limit (as adjusted) on pay that can be taken into account. The new controlled group rules (see below) will apply to this testing.

  Note: Governmental plans are subject only to the $225,000 pay limit, as adjusted.

- **Contribution Limits.** A 403(b) plan must comply with the limits on contributions under Code sections 402(g), 414(v), and 415. The regulations confirm that a participant may make both an age 50 catch-up contribution and a special 403(b) catch-up contribution in the same year, although amounts in excess of the general 402(g) limit for any year must be applied first toward the special 403(b) catch-up contribution limit.

  Note: This means that employees who do not fully use up both catch-up limits, where available, will have a lower lifetime deferral ability, because of the cumulative $15,000 limit on special 403(b) catch-up contributions.

- **Distributions.** The regulations describe the 403(b) restrictions on distributions from annuity contracts and custodial accounts and include rules applicable to distributions from Roth 403(b) accounts. Where no specific 403(b) restriction on distribution applies, the regulations prohibit distribution before severance from employment or the prior occurrence of a specified event (*e.g.*, a fixed number of years or a stated age). They also clarify that there is no restriction on the timing of distributions of after-tax contributions and related earnings.

- **Contract Exchanges/Transfers.** So-called "90-24" transfers are no longer available, but the regulations permit tax-free contract exchanges for changes of investments within the same plan, provided that certain requirements (including distribution restrictions much like those of Revenue Ruling 90-24) are satisfied. Plan-to-plan transfers are also permitted if the transferring participant is an employee or former employee of the employer maintaining the receiving plan (and specified requirements are met). The regulations also allow for the transfer of 403(b) assets to a governmental defined benefit plan for the purchase of service credit.

- **Written Plan.** The regulations require that a 403(b) plan be maintained pursuant to a written plan containing all of the material terms and conditions for eligibility, benefits, contribution limitations, and distributions. A written plan may consist of multiple documents (including the annuity contracts and custodial account agreements themselves), and the plan may allocate responsibility for performing administrative functions among various parties, such as the employer and any third-party service providers (*e.g.*, the annuity contract issuer or the custodian). This written plan requirement applies to all 403(b) plans, including those that are not intended to be ERISA plans.

  Note: The Department of Labor has issued a Field Assistance Bulletin to clarify that, under appropriate circumstances, a 403(b) plan may satisfy the written plan requirement without becoming an ERISA plan.

- **Plan Terminations.** The regulations allow for plan freezes and terminations, and they provide for distribution of a 403(b) plan's assets upon termination if the employer (determined on a controlled group basis) does not make any contributions to any 403(b) plan that is not part of the terminated plan for the period beginning on the plan termination date and ending 12 months after the date on which all of the plan's assets have been distributed. Distribution, for this purpose, includes delivery of a fully paid individual annuity contract.

Controlled Group Regulations

Tax-exempt employers will also need to evaluate the effect of the new controlled group regulations. The regulations provide that exempt organizations will be treated as a single, combined employer for various purposes under the Code where they are under common control. Under the regulations, organizations are under common control if at least 80% of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, another organization.

- A trustee or director is considered to be a representative of another organization if he or she is a trustee, director, agent or employee of that organization.

- An organization controls a trustee or director of another organization if it has the general power to remove the trustee or director and designate a new trustee or director. Existence of the power to appoint and replace a trustee or director is based on the facts and circumstances.

There is also an anti-abuse rule that allows the IRS to treat organizations as part of the same controlled group.

Permissive aggregation is allowed if the organizations maintain a single plan, regularly coordinate their day-to-day exempt activities, and act in a manner that is consistent with the choice to be a controlled group. The regulations authorize the IRS to issue guidance permitting other types of entities to elect to be treated as part of the same controlled group in situations in which there are substantial business reasons for maintaining each entity as a separate corporation or other entity, as long as controlled group treatment is consistent with the regulations' anti-abuse rule. These controlled group rules generally do not apply to governmental entities, churches, or certain church-controlled entities.

Next Steps

Failure to comply with the new rules may result in a loss of favorable tax treatment for some or all plan participants. In preparation for the 2009 effective date, we suggest that employers consider the following questions:

- Does the organization belong to a controlled group? If so, what is the impact on the existing plan structure?
- Does the 403(b) plan have an adequate written plan?
- Is the employer's payroll system set up to monitor contributions, including catch-up contributions, in an appropriate way?
- Do the 403(b) plan's definition of eligible employee and its communication practices ensure compliance with the universal availability requirement?
- Is the employer prepared to perform any necessary nondiscrimination testing?

Other aspects of the regulations may also be important as an employer reviews its plans, but the consideration of the foregoing questions will enable tax-exempt employers to take important first steps toward complying with the new rules. Please contact your Ropes & Gray benefits attorney or consultant with any questions about the regulations, including applicability of the various rules and effective dates to your 403(b) plan.