[searching for answers]

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What Do Final IRS Regulations Mean for 403(b) Plans in Higher Education?

By Peter Gold and Andrew Stratton

Regulations issued by the IRS on July 26, 2007 finally filled a regulatory vacuum for sponsors of 403(b) plans. This issue of InsightOut™ focuses on three important issues affecting plans for higher education, two of which apply to all 403(b) plans and one (nondiscrimination testing) that applies only to plans subject to ERISA:

- *Plan documents and administration*
- *Nondiscrimination testing for employer contributions*
- *In-service distributions*

Note that there are other new 403(b) rules that could affect public and private colleges and universities that are outside of the scope of this article. For example, the exceptions to the requirement for "universal availability" of pre-tax deferrals no longer include visiting professors.

Background

Section 403(b) permits tax-sheltered annuity or custodial account arrangements using mutual funds for employees of public schools and Section 501(c)(3) tax-exempt organizations, such as hospitals, churches, private schools and colleges, cultural institutions, and charities. The IRS first issued regulations under Section 403(b) in 1964. Since then, the IRS issued only two supplements to these regulations (addressing eligible rollovers and required minimum distributions) while releasing numerous revenue rulings, notices, and other forms of guidance. The IRS consolidated this regulatory mix into a single set of proposed regulations in late 2004 and has now made these regulations final. The regulations are generally effective in 2009.

ERISA does not apply to 403(b) plans maintained by public schools and certain church plans. The 403(b) plans of many 501(c)(3) organizations where the employer merely facilitates the purchase of 403(b) contracts for its employees are also exempt from ERISA under Department of Labor (DOL) regulations. Plans that are exempt from ERISA are also generally exempt from IRS nondiscrimination testing, either because they are governmental plans or because there are no employer contributions. Many 403(b) plans in private higher education are similar to corporate 401(k) plans, with significant employer contributions. These plans are subject to the requirements of ERISA, as well as IRS nondiscrimination rules for employer contributions.

Plan Documents and Administration

As under the proposed regulations, the final regulations require 403(b) programs to be maintained — both legally and operationally — pursuant to a written plan document. While ERISA plans have always been required to have a written plan document, the regulations now specify that the plan must contain all material terms and conditions for eligibility and benefits, applicable limits, the time and form of benefit distributions, and the investment contracts (annuities or custodial accounts) available under the plan. In addition, the written plan document must include any optional plan features that may be available to participants, such as hardship withdrawals, loans, and Roth features.

The investment contracts must also contain certain provisions — e.g., the limits on employee pre-tax deferrals and on incidental benefits, and rules on required minimum distributions and direct rollovers. While investment contracts, as well as other documents, can be incorporated into the plan by reference, the plan document will control in the case of any conflicts. Thus, it may be advisable to include required investment contract provisions in the main plan document as well.

Finally, the plan may allocate responsibility for performing administrative functions to parties other than the employer, but not to participants. Any allocation of responsibilities must identify the party responsible for compliance with IRS rules applicable to the investment contracts available under the plan.

What It Means

Colleges and universities should obtain a thorough legal review of plan documents and investment contracts to assure that all required provisions are included and that there are no conflicts between the main document and any incorporated documents.

It's also critical to assure that the plan is actually operated in accordance with its terms. This requires a careful review of the plan's provisions, the data available to the plan's administrators, and the administrative capabilities of the college or university, its investment providers, and any third-party recordkeeper. Colleges and universities are responsible for assuring that plan-level administrative functions are assigned to the proper party — either the plan sponsor, the investment provider, or a recordkeeper — and are properly executed. This is particularly important for plans with multiple investment providers — typical in higher education. For example, IRS limits on loans and hardship withdrawals must be administered on a plan-wide basis, and the responsibility of aggregating information from the college or university and from multiple vendors must be clearly allocated to someone other than the participants.

Plan sponsors may want to consider moving to a single administrator to avoid the ongoing compliance issues that may occur with multiple vendors. This step is also likely to reduce plan costs borne by participants, improve governance and oversight, and offer enhanced value and service to employees. Vendor consolidation also provides an excellent opportunity to review, improve, and monitor plan investment offerings — resulting in higher participant satisfaction and better outcomes at retirement.

Nondiscrimination Testing for Employer Contributions

The final regulations require that, starting in 2009, ERISA plans test all employer contributions to see if they are discriminatory using the same rules that apply to qualified plans, including:

- The Average Contribution Percentage (ACP) test of Section 401(m) for matching contributions
- The general nondiscrimination test of Section 401(a)(4) for nonelective contributions
- The coverage tests in Section 410(b)

Non-ERISA plans, such as those maintained by public schools, are not subject to the nondiscrimination testing rules.

Employer matching contributions must currently satisfy the ACP test (which also applies to 401(k) plans). Previously, however, employer nonelective contributions (e.g., a fixed three percent of pay for each participant regardless of amount deferred) could be tested under a "good faith, reasonable" interpretation of qualified plan rules or could meet one of the "transitional" safe harbors in IRS Notice 89-23.

Because good faith compliance and the safe harbor alternatives provided by Notice 89-23 are not available after 2008, ERISA plans must now test nonelective contributions under qualified plan rules. This requires these plans to demonstrate that the group of employees eligible to receive the non-elective contribution meets the coverage rules of Section 410(b), and the contributions allocated to the eligible employees do not discriminate under Section 401(a)(4) in favor of highly compensated employees (for 2008, generally those who were paid $100,000 or more in 2007). Note that a plan not meeting the coverage tests on its own must be combined with one or more other plans for the ACP and general nondiscrimination tests.

The regulations also confirm that two or more organizations will be treated as one employer for coverage and general nondiscrimination testing (and other tax purposes) if at least 80 percent of the directors or trustees of one organization are representatives of or are directly or indirectly controlled by another organization. These organizations are known as a "controlled group." Other tax-exempt entities may also choose to be treated as one employer for nondiscrimination testing if they maintain a single plan and regularly coordinate activities.

What It Means

ERISA plans that provide uniform benefits to a broad cross-section of employees of the controlled group will see little or no change in nondiscrimination results in the future if employer contributions have been tested under qualified plan rules.

But, what if a controlled group sponsors more than one plan? Some institutions provide separate plans with different benefits for exempt and non-exempt employees, or for university and health care system employees, for example. Often, these plans will pass the coverage and nondiscrimination tests on a combined basis if overall benefit levels are similar (including an allowance for differences in Social Security benefits), and normally will only require documented testing every three years in order to continue separate annual ACP testing of employer matching contributions.

As noted above, a plan that does not pass coverage must be combined with at least one other plan for ACP testing of employer matching contributions and nondiscrimination testing of non-elective employer contributions. This situation may occur with plans that cover predominantly highly paid employees (e.g., physicians), and will likely require benefit increases for non-highly paid employees (or reductions for highly paid employees) in order to pass nondiscrimination.

Plan sponsors with multiple plans, those potentially affected adversely by the controlled group rules, and those that have relied on a safe harbor or good faith interpretation that differs from current qualified plan rules should make an early assessment of potential problems and solutions in order to avoid surprises in 2009.

In-Service Distributions

Currently, most amounts in a 403(b) plan may be distributed when the employee separates from service, attains age 59½, dies, or becomes disabled. In addition, amounts attributable to employer contributions in an annuity contract (but not a custodial account) as well as elective employee deferrals made before 1989 may be distributed at any time. Plans may be more restrictive than these requirements.

The final regulations retain the grandfather rule for pre-1989 deferrals, but add a new restriction for benefits attributable to employer contributions in an annuity contract issued after 2008. In-service distributions of these amounts may not be made before an event stated in the plan document, such as:

- Attainment of a stated age
- After a fixed number of years
- Disability

Plan sponsors with multiple plans, those potentially affected adversely by the controlled group rules, and those that have relied on a safe harbor or good faith interpretation that differs from current qualified plan rules should make an early assessment of potential problems and solutions in order to avoid surprises in 2009.

The regulations also clarify that employees may make after-tax contributions to the plan and that after-tax contributions are not subject to in-service withdrawal restrictions. They also confirm that 403(b) plans are subject to the same hardship distribution tests and other rules that apply to 401(k) plans, including the restriction that only salary reduction contributions (and not earnings) can be distributed in the event of a hardship.

What It Means

Employers should review their plans and investment contracts to determine if existing in-service distribution provisions (including those for hardship distributions) are at least as restrictive as the new requirements. If not, the plans will need to be amended, and related administrative duties must be assigned. The final regulations provide that any amendment required to comply with this rule may be adopted before 2009 without violating the anti-cutback rules.

Conclusion

The good news is there will be plenty of time to get ready for 2009, and many plans will require few changes. But employers without plan documents, that need to perform extensive nondiscrimination testing or that rely on multiple vendors for compliance, will likely be facing a very busy 2008.

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About the Authors

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