

Understanding Your Tax-Exempt Organization's Retirement Plans: Key Provisions of 403(b) Arrangements

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In 2007, the U.S. Treasury Department published final regulations applicable to 403(b) plans. 403(b) plans are tax-qualified defined contribution retirement plans similar to 401(k) plans. However, a 403(b) plan may only be offered by public educational institutions and Internal Revenue Code (IRC) Section 501(c)(3) tax-exempt organizations, such as hospitals and health systems, colleges and universities and foundations and associations. The final regulations contain two important themes: they consolidate IRS and Department of Labor guidance issued since the last 403(b) regulations were published in December 1964, and they clarify provisions uniquely applicable to 403(b) plans. The final regulations also advance the IRS' stated goal of making 403(b) annuities more like 401(k) plans, while maintaining 403(b) plans as a unique method of providing deferred compensation opportunities to employees of tax-exempt organizations.

The final regulations contain information regarding the adoption and maintenance of a 403(b) plan by an appropriate tax-exempt organization. Of particular importance are the following requirements:

- All 403(b) plans, including those that are otherwise exempt from the Employee Retirement Income Security Act of 1974, as amended (ERISA) must be maintained pursuant to a written plan document.
- Assets may be transferred within a 403(b) plan and to 403(b) plans maintained by other organizations, only so long as certain requirements are satisfied.
- 403(b) plans are subject to nondiscrimination testing requirements applicable to other qualified plans like 401(k) plans.
- 403(b) plan sponsors may terminate their 403(b) plans, provided that their plan documents contain language allowing them to do so and so long as certain requirements are satisfied.

Any plan sponsor that maintains a 403(b) plan or that establishes a 403(b) plan must assure that the various aspects of the final regulations are addressed and satisfied. If the plan sponsor fails to do so, the 403(b) plan could lose its tax-favored status, and employee deferrals and employer contributions that have been contributed to the plan could become immediately subject to income taxation. Thus, if an employer previously established or establishes a 403(b) plan and the plan is determined by the plan sponsor to not be compliant, the sponsor should determine whether the issue resulting in non-compliance can be corrected in accordance with applicable IRS procedures lest the plan lose its favorable tax treatment.

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Written Plan Requirement

The final 403(b) regulations require that all 403(b) plans be maintained pursuant to a written plan document. The document must contain all material terms and conditions of the arrangement, including eligibility to participate, conditions for receipt of benefits, time and form of payment of benefits, and any other provisions impacting eligibility for or payment of benefits. The 403(b) plan document can incorporate other pertinent documents (*e.g.*, annuity contracts – a form of investment device through which assets may be invested) by reference. The plan document also can delegate certain elements of plan operation, including plan administration, to an entity other than the plan sponsor. This latter provision may be particularly helpful, but also necessary to assure that third parties are appropriately empowered to take action with respect to the plan.

Asset Transfers Within and Between Plans

The final regulations contain rules regarding the transfer of assets within and between 403(b) plans. The final regulations permit transfers in the following three scenarios: a change in contract (investments) within the same plan; a transfer of assets from one plan to the plan of another employer; and a repayment or purchase of permissive service credits in a governmental defined benefit plan. Transfers to investment providers within and outside of a particular vendor group are permitted, but only when the employer and the investment provider have entered into a written agreement to share certain specific plan information (typically referred to as an "information sharing agreement").

Plan-to-plan transfers also are allowed, provided that both plans allow such transfer and that the individual requesting the transfer is an employee or former employee of the employer that sponsors the receiving plan. The plan receiving the transfer must preserve the employee's benefits earned under the transferring plan as well as the distribution restrictions applicable under the transferring plan. A transfer that fails to meet the requirements of the

final 403(b) regulations will be treated as a taxable distribution to the employee (if a distribution-triggering event such as termination of employment has not otherwise occurred). In the event of a taxable distribution, the employee is not only subject to ordinary income tax, but possibly also a penalty equal to 10 percent of the amount of the distribution. Thus, assuring that the proper rules regarding plan transfers are followed is important not only to the plan sponsor, but also to plan participants.

Nondiscrimination Testing

Nondiscrimination testing is the process of annually evaluating contributions to a retirement plan to ensure that the contributions do not disproportionately benefit highly compensated employees. The nondiscrimination testing process is complicated, but generally prohibits certain specified differences in contribution levels for highly compensated employees as compared to nonhighly compensated employees. The final regulations confirm that employer contributions to 403(b) plans are subject to all the nondiscrimination tests that apply to employer contributions made to tax-qualified retirement plans. These include special nondiscrimination rules applicable to employer matching contributions (the so-called "average contribution percentage" test). The nondiscrimination requirements generally are applied on an aggregated basis, taking into account all plans of the employer and its related organizations. Thus, if an employer maintains more than one 403(b) plan or a 403(b) plan and a 401(k) plan, it must assure that the 403(b) plan (and the other plans with respect to the 403(b) plan) are taken into consideration when conducting nondiscrimination testing. Plan sponsor should assure that they satisfy the applicable nondiscrimination testing requirements for their plans, and assure that all plans are considered when conducting nondiscrimination testing.

Plan Terminations

The final regulations generally provide that a plan sponsor may terminate its 403(b) plan. This was a

departure from existing law, which severely restricted the ability of 403(b) plan sponsors to unilaterally terminate such an arrangement. The final regulations provided guidance regarding the termination of a 403(b) plan, but such guidance was neither comprehensive nor did it address significant questions that arose regarding plan termination as a result of the regulations. However, On February 22, 2011, the Internal Revenue Service (IRS) published Revenue Ruling 2011-7, which provides additional guidance clarifying the requirements for a plan sponsor to terminate a 403(b) plan, as well as the tax consequences to plan participants if the sponsor terminates such an arrangement.

Revenue Ruling 2011-7 describes the requirements to terminate a 403(b) plan, including those reflected in the final 403(b) regulations. The final regulations included the following:

A 403(b) plan sponsor may amend its plan to include a provision that allows the plan sponsor to terminate the plan (or, in the case of a new plan, include a plan termination provision in that plan).

Certain plans investing assets in custodial accounts or that allow for elective deferrals cannot be terminated if the plan sponsor or a member of its controlled group (as determined under IRC Section 414) contributes to a 403(b) plan during the 12-month period following the date of final distribution of participant assets held under the plan.

All accumulated benefits under the 403(b) plan must be distributed to participants and beneficiaries as soon as practicable after termination of the plan.

In addition, Revenue Ruling 2011-7 also requires the following:

Termination of the 403(b) plan must be by binding action of the duly empowered body of the organization that maintains the plan.

Termination of the 403(b) plan must satisfy all applicable laws, including the requirements of the final regulations as well as applicable vesting requirements applicable to 401(k) and 403(b) plans (*e.g.*, full vesting of participant accounts upon plan termination), and any requirements imposed under the terms of the plan or the applicable investment vehicle.

Plan assets must be disposed of as soon as possible following the effective date of the termination, although distribution of such assets may be in the form of an annuity certificate and not necessarily in the form of cash.

If the plan document and the applicable investment vehicle allows a participant to roll over their benefit to another qualified investment vehicle, participants must be provided appropriate notice of their rollover rights and they must be allowed to elect to do so.

Thus, employers intending to terminate their 403(b) plans should not only review and understand the requirements under the applicable Treasury Regulations, but those under 2011-7 as well.

Important in evaluating the decision to terminate a 403(b) plan are a number of factors. The sponsoring employer should pay particular attention to whether the terms of the plan allow the employer to terminate the 403(b) plan and, if so, whether participant accounts can be "rolled over" to an IRA so that a distribution event resulting in the inclusion of income of each participant's distributed amount does not occur. If the plan document does not allow for plan termination by action of the employer or for rollover of plan assets to another qualified retirement vehicle, the plan sponsor will likely want to amend its plan to include these provisions before implementing any such change to the plan.

Further, the sponsoring employer should consider the impact of terminating the 403(b) plan on

particular funding arrangements, and specifically whether doing so results in a taxable distribution event or a possible transfer of an individual certificate or annuity contract such that a participant's benefit is not immediately taxable to the participant. Absent the ability to roll a participant's benefit to an IRA, transfer of the asset underlying the investment without taxation would likely be preferable.

The sponsoring employer should also consider whether it or any member of its controlled group of related entities maintains a 403(b) plan, and whether the entity sponsoring the other 403(b) plan will make contributions to that arrangement during the 12-month period following distribution of all of the 403(b) plan's assets. If so, the sponsor desiring to terminate its 403(b) plan may be limited in its ability to do so depending on the nature of the investment vehicles offered under its plan and whether the plan holds elective deferrals.

Finally, the sponsoring employer should consider whether the termination of the 403(b) plan results in any unintended consequences. For example, termination of a 403(b) plan may result in surrender charges against the accounts of participants. Surrender charges are typically a percentage of a participant's account and are assessed in decreasing amounts over a period of years based on duration of participation in the plan. Termination of 403(b) plans can occur, but doing so must comply with the final 403(b) regulations, the application of which requires advance planning and awareness of the various legal requirements and the consequences of doing so.

Conclusion

403(b) plans are defined contribution retirement plans similar to 401(k) plans. In order to receive and maintain their tax-favored status, they must meet certain requirements contained in final regulations published in 2007. The final 403(b) regulations require, among other things, a written plan document and that the 403(b) plan satisfy nondiscrimination testing requirements. The final regulations also permit a plan sponsor to allow

certain transfers within and among 403(b) plans and they allow the plan sponsor to terminate the arrangement, provided certain requirements are met. Sponsors of existing and future 403(b) plans should be aware of these provisions and should consider the impact of such provisions on their arrangements. Given the number of long-standing 403(b) plans, termination provisions are of particular interest, and any plan sponsor desiring to terminate its 403(b) plan should assure that appropriate procedures are followed in doing so.

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