



First Quarter 2005

Retirement PLAN WATCH

LINKS and LINES

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New §403(b) Proposed Treasury Regulations

The Internal Revenue Service and the U.S. Treasury Department have recently published new §403(b) Proposed Regulations. While this was long overdue, Legend feels that many provisions of the Proposed Regs will be onerous for you as an employer and for Legend as a vendor.

Among other requirements, the Proposed Regulations mandate that all §403(b) arrangements establish and maintain a written plan document that contains the eligibility provisions, benefits, applicable limits, products available in the plan, and the time and form of benefit distributions. Optional features in a plan would include hardship distributions, loans, acceptance of rollovers and in-service transfers to products approved under the plan. Rev. Ruling 90-24 transfers will be eliminated. (A full synopsis of the Proposed Regulations follows for your perusal.)

Why does the IRS want a §403(b) employer who sponsors a salary-deferral-only program to have a plan document? They want all salary deferral type plans to look like and act like §401(k) plans! There has also been pressure from special interest groups that administer and market §401(k) plans to move §403(b) plans in this direction. We have no doubt what motivates them.

However, (and the IRS admits it!) this is in direct contradiction of the provisions of ERISA that exempt employers from the requirements of ERISA by limiting involvement to the approval of vendors, then taking and remitting contributions to those vendors. Though school districts are not subject to ERISA, ERISA's definition of limited involvement has been adopted by districts in administering their §403(b) plans. The written plan document requirement would fly in the face of these provisions and the intent of ERISA and cause employers offering salary-deferral-only programs untold headaches.

The Treasury Department is accepting comment letters on the Proposed Regulations until February 14, 2005. Legend encourages you to send a comment letter to them, voic-

ing the difficulty you would have complying with these regulations and objecting to such a radical change in the §403(b) rules. The following bullets are examples of items you might include in your comment letter:

- **Establishment and maintenance of a written plan document.** Time and expenses, such as legal fees, are a serious unnecessary burden on non-profit organizations and public school systems which are on strict budgets already!
- **Elimination of Revenue Ruling 90-24 provisions.** This seriously erodes employees' freedom of investment options while employed and after separation from service
- **Optional features in plan documents—hardship withdrawals, loans, acceptance of rollovers, in-service withdrawals, in-service transfers, plan to plan transfers.** Employer control of these provisions, even if just through adoption of the features in the written plan, creates a fiduciary responsibility to oversee the vendors' adherence to the plan provisions
- **Failure to satisfy §403(b) or §415 contribution limits.** Annuities must segregate excess contributions in separate §403(c) accounts; custodial accounts must treat excess contributions under §61, §83 or §402(b). In other words, the vendor must segregate the excess and the excess is immediately includible in the employee's gross income or the employer's whole §403(b) plan would be disqualified. This part of the Proposed Regs will in all probability reduce the number of vendors willing to offer §403(b) products and endanger your whole program
- **Clarification that Qualified Domestic Relations Orders (division of assets in divorce actions) are required for §403(b) plan assets.** This must be included in the written plan document and therefore ultimate responsibility of determining that an Order is qualified falls on the employer

Some good provisions of the Proposed Regulations include:

- Requirement that elective deferrals be remitted to vendors as soon as administratively possible, i.e., no later than 15 business days in the month following the reduction of salary (this must be included in the written plan document too)
- Restrictions on distributions from employer contributions made to §403(b) annuities
- Universal availability requirement. Employers must give written notice each year to employees of right to participate in plan and, if excluding employees who work less than 20 hours per week, those employees must actually work less than 20 hours per week and less than 1000 hours per year

Please take a few moments to compose a letter to the IRS regarding the Proposed Regulations and send it to:

CC:PA:LPD:PR(REG-155608-02), Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

or send your submission electronically via the IRS Internet site at www.irs.gov regs. Click on the *November 2004 Plain Language Regulations* and then scroll down to the fourth entry entitled *Revising Section 403(b) Tax-Sheltered Annuity Contracts*. Click on *Submit Comments* below the descriptive paragraph.

After the comment period, the IRS and Treasury Department will either formally adopt the Proposed Regulations as Final Regulations effective 1/1/2006 or make amendments to the Proposed Regulations pursuant to the comments and then adopt the Proposed Regulations as Final Regulations, probably sometime after 1/1/2006. Legend will keep you abreast of the news on this regulatory front.

Synopsis of New Proposed §403(b) Regulations

In General

On November 15, 2004 the IRS issued its long awaited §403(b) proposed regulations. These proposed regulations cannot be relied on and are generally effective for years after 2005. The last comprehensive guidance was issued in 1964—40 years ago! We have needed more guidance but we certainly weren't ready for this curve ball.

The trend in these regs (as well as the previously issued §457 regs) is to make these plans more similar to §401(k) qualified plans. There are many cross-references in these regs to the §401(k) and §401(a) rules. For example, under the new proposed regs the hardship distributions rules are specifically cross-referenced to the new proposed §401(k) rules, which should become final soon.

Effective Dates

Generally these regulations will be effective for years beginning after 12/31/2005.

Failure to Satisfy the §403(b) Rules

Failure to satisfy §403(b) will have the following effect depending on the type of §403(b) program:

- **§403(b) annuities**
An excess contribution is subject to the rules under §403(c) relating to nonqualified annuities.
- **§403(b) custodial accounts or Retirement Income Church Accounts (RICAs)**
An excess contribution is subject to the rules under §61, §83 or §402(b), governing nonqualified plans

Generally the nonqualified rules provide that the amounts are taxed when there is no longer a substantial risk of forfeiture, which would mean that the monies would become taxable to the participant immediately.

Group Trusts Permitted

The proposed regulations allow a participant's assets to be invested in a group trust. After the regs are made final, the group trust may commingle §403(b) assets with qualified plan assets and IRA assets. A trust includes a custodial account as described in §401(f).

Plan Document Requirement

This is the most disturbing change in the regs. Unlike qualified plans, §403(b) plans are usually established as a multi-vendor program. The regs require an employer to maintain a plan under which the annuities and custodial accounts will be governed. This is one area that the IRS is requesting comments that will be shared with the Department of Labor.

The preamble states that it is intended that the plan document would include all of the material provisions regarding eligibility, benefits, applicable limitations, the products available under the plan, and the time and form under which distributions would be made. Supposedly, an employer could have more than one plan document, i.e., one with each vendor, but care would have to be taken to have uniform plan provisions in this case.

Funding a §403(b)

The basic types of funding vehicles remain: §403(b) annuities, §403(b) custodial accounts where the investments are all in mutual funds and Retirement Income Church Accounts (RICAs). However, the following insurance contracts will not be permitted after 2/13/2005:

- life insurance contracts defined under §7702
- endowment contracts
- health or accident insurance contracts or
- property, casualty or liability insurance contracts

Existing life insurance contracts may still be maintained after this date. New contracts may not be entered into after this date (although we are not supposed to be able to rely on these regs yet!)

Catch-up Contributions

If a participant is eligible for both the 15 years-of-service catch-up and the age 50 catch-up, the first amounts contributed by the participant will be his/her 15 years-of-service catch-up and then the age 50 catch-up contribution.

Qualified Employers

It still remains that a §403(b) program may be offered by only:

- Tax exempt organizations under §501(c)(3)
- Public educational institutions
- Self-employed ministers
- Church/church-related organizations

Universal Availability Rule

The Universal Availability Rule applies to the elective deferral portion of any plan. Other than church plans, this rule applies to all other §403(b) programs.

The nondiscrimination rule for elective deferrals (i.e., the Universal Availability Rule) means that an employer offers an "effective opportunity" to make elective deferrals of more than \$200 to all employees. The following employees may be excluded:

- Employees participating in a §457, §401(k) or another §403(b) of the employer
- Nonresident aliens with no US income
- Certain students – generally on work study programs (subject to the age and service requirements under §410(b))
- Employees who normally work less than 20 hours per week

An employee only works less than 20 hours per week if, (a) for the 12-month period beginning on the date of hire, the employer reasonably expects the employee to work less than 1000 hours during the 12 months and (b) for each plan year thereafter (or anniversary of hire date), the employee actually worked less than 1000 hours in the preceding 12-month period.

Notice 89-23 included additional exclusions that the proposed regs DO NOT adopt. The IRS is asking for comments from the industry and employers to see if we are still interested in keeping them. They are:

- Employees making a one-time election to participate in a governmental plan (described in §414(d)) instead of a §403(b)
- Collectively bargained employees
- Visiting professors for up to one year
- Employees who have taken a vow of poverty

Determining Years of Service

This is used for determining includible compensation and years of service for:

- the special 15 years-of-service catch-up
- the 5 year rule for post-retirement employer contributions
- pre-2002 exclusion allowance calculations

An employee is credited with one year of service for each year s/he completes a year as a full-time employee, as defined by the employer for that position. For example, a university may measure work by the number of courses taught during the annual work period. The annual work period is the university's academic year. A part-time employee is credited with a fractional year based on the definition of full-time for that position.

Special Rule for Former Employees

A former employee is deemed to have monthly includible compensation through the end of the taxable year in which they stop working and for the next 5 taxable years. The amount of monthly compensation is equal to 1/12 of the former employee's compensation during their most recent year of service. A plan may therefore provide that non-elective employer contributions can continue for 5 years up to the lesser of the §415 limit or the amount of the former employee's compensation during the most recent year of service.

Nondiscrimination Rules for ERISA §403(b) Plans

The proposed regulations clarify that ERISA §403(b) Plans (those adopted by non-governmental, non-church-related entities that provide employer contributions) must satisfy the following requirements:

- §§401(a)(11) through §401(a)(15)
 - §401(a)(11) and §417 – Qualified Joint Survivor Annuity and Qualified Pre-retirement Survivor Annuity requirements
 - §401(a)(12) – Merger/transfer rule that requires assets moved to be no less than the value prior to merger/transfer
 - §401(a)(13) – Anti-alienation clause (cannot assign assets to anyone other than via a QDRO)
 - §401(a)(14) – Latest date benefits can be paid is the later of Normal Retirement Age (or age 65), 10th anniversary of plan participation or termination of employment
 - §401(a)(15) – Benefits may not be offset by social security benefits
- §410 – Eligibility requirements (age and service) and coverage testing
- §411 – Vesting rules; protected benefits; and employer discretion not permitted
- §412 – Minimum funding standards

Under Title I of ERISA the following additional provisions apply:

- Reporting and disclosure requirements – Form 5500 (limited filing), Summary Plan Description (SPD), Summary of Material Modifications (SMM)
- Advance notice of contribution reductions
- Fiduciary standards
- Fidelity bonds
- Claim procedures – typically part of the SPD

Distribution Changes

The distribution requirements depend on the type of plan and the type of contribution (i.e., employer vs. elective deferral) that is being distributed. This is a drastic change that will affect primarily §403(b) annuities. The distributable events are broken down to: all elective deferrals, employer contributions distributed from custodial accounts and employer contributions distributed from annuity contracts.

For elective deferrals, the distributable events are:

- Attainment of age 59½
- Severance from employment
- Death
- Disability (as defined under §72(m)(7))
- Hardship (under the §401(k) guidelines)

Hardship distributions may only include the participant's elective deferrals, not the earnings thereon. There is an exception for pre-1989 monies, although earnings since that time are also not available for hardships. The §401(k) regulations, which will apply to §403(b) plans in the future, were written to make it difficult to get a hardship distribution. The new rules would among other things require an employee to sign a much more elaborate certification.

For employer contributions in a custodial account the distributable events are:

- Attainment of age 59½
- Severance from employment
- Death
- Disability (as defined under §72(m)(7))
- Plan termination

These distributable events also apply to amounts transferred to the §403(b) including earnings thereon.

For employer contributions in an annuity the distributable events are:

- Attainment of a stated age or an event (for example after a fixed number of years – Profit-Sharing rule under §1.401-1(b)(1)(ii) applies)
- Severance from employment
- Death
- Disability
- Plan termination

These distributable events also apply to amounts transferred to the §403(b) annuity including earnings thereon.

Separate Accounting Required to Honor Different Distributable Events

If separate accounts are not maintained for elective deferrals and employer contributions, then the earliest that a distribution may be made is the later of:

- any date permitted under the elective deferral rules; and
- any date permitted under the employer contribution rules

Rollover Amounts

Rollover amounts maintained in a separate account may be distributed at any time if the plan permits. If separate accounts are not maintained for rollover amounts, they will be subject to the plan's distribution rules.

Plan Termination Added

Plan termination may be done only if the employer does not establish another §403(b) for 12 months after distribution of all of the assets in the terminated plan. If during the 12 months before termination and 12 months after the final termination distribution, less than 2% of the employees from the terminated plan are eligible to participate in the new §403(b), then the 12-month rule will not apply. This is similar to the §401(k) termination rule.

In a terminated §403(b), assets must be distributed as soon as administratively feasible. This has been defined in a qualified plan to be one year from the termination date.

The proposed regs state that a §403(b) plan may be frozen – i.e., the employer will stop all contributions but will permit only existing employees to participate. Somehow this doesn't seem to agree with the Universal Availability rule!

90-24 Transfers Obsolete

The proposed regulations take away the portability enjoyed by §403(b) plan participants for many years via Revenue Ruling 90-24. Instead, the regs provide two sets of rules – one where the transfer is being made between different §403(b) plans and one where the transfer is being made within the same §403(b) plan (in-service transfers).

If transfers are being made between §403(b) plans, then such transfers are permitted if:

- the participant whose assets are being transferred is an employee of the employer providing the receiving plan
- the distributing plan permits transfers
- the receiving plan accepts transfers
- the assets are at least the same amount before and after the transfer, and
- the receiving plan provides that the distribution restrictions are at least as stringent as the plan they were received from.

If transfers are being made within the same §403(b) plan, then:

- the plan under which the contract/account is issued provides for transfers
- the participant has a benefit after the transfer at least equal to the benefit before the transfer, and
- the contract/account provides that the amounts transferred will be subject to the same or more stringent distribution provisions

If a transfer is a partial transfer, the receiving plan must treat the amount transferred as a continuation of a pro rata portion of the participant's interest in the §403(b). In other words, if there were any after-tax contributions or repayment of a defaulted loan, then the receiving plan must keep track of the cost basis.

Required Minimum Distributions

Generally, the required minimum distribution rules follow the IRA rules. The proposed regs clarify the differences that exist under §403(b) plans, including the pre-1987 account balance rule.

The regs require that in order for a participant to utilize the pre-1987 account rule and not begin distributions prior to age 75 on that balance, the payor not only must keep track of the pre-1987 account balance but must also provide for tracking any distributions that are above the required minimum distribution for the year, that reduce the pre-1987 account balance. Also the payor must provide the participant with the information if requested by the participant.



Access bills and make changes to participant contributions online!

Employers using ADSERV's Billing Services (including Common Remitting Services) can now access their bills via the internet and make changes to participants' accounts online. It's convenient, and it improves processing time and accuracy.

When billing changes are submitted by an employer, the information is downloaded and stored in a "workfile" program on our AS/400 system. When the Employee Benefit Account Department receives the money relating to the employer's account, this bill will be pulled from the "workfile" program and processed.

Procedures on submitting checks remain the same.

A unique access code is required in order for each employer to use this system.

1. Call ADSERV at 1-800-749-4221 (other than NY) or 1-800-749-4321 (NY only) to receive your unique employer access code.
2. If you need technical help during the set-up process, or have any questions about using this process, call the appropriate phone number above and ask for Amy Goode at ext. 281.



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