



Second Quarter 2007

Retirement PLAN WATCH

LINKS and LINES

www.advisoryservices.com
www.irs.gov
www.403bregulations.com
www.legendgroup.com

The Legend Group:
800-749-4221 (other than NY)
800-749-4321 (NY only)
561-694-0110 (local)

New Responsibilities under the Final §403(b) Regulations

The final regulations have created additional administrative responsibilities for §403(b) employers that you may need some assistance in coping with. Legend would like to offer the information below and further guidance if requested.

Qualified Domestic Relations Orders (QDROs)

The finalized §403(b) regulations clarify that the §414(p) QDRO rules apply to §403(b) annuity contracts, custodial accounts and church retirement income accounts. The employer or plan administrator is instrumental in processing these legal documents and assuring that the provisions of §414(p) have been adhered to.

Retirement plan assets of both spouses are considered in a divorce settlement, whether held in a §403(b) account, §457 account, §401(k) account, money purchase plan, profit sharing plan, defined benefit (pension) plan or an individual retirement account (IRA).

If, as part of a negotiated settlement, assets in an employer plan such as a §403(b) or §457 are awarded to a participant's ex-spouse, lawyers for the participant and/or the ex-spouse must file a Qualified Domestic Relations Order (QDRO) with the court. A certified copy of such QDRO must be forwarded to the plan administrator for execution of the order. IRA assets are transferred pursuant to a Transfer Incident to Divorce and a separate court order is not necessary.

The QDRO must be clear in its directions to the plan administrator regarding the type of distribution to be made to the ex-spouse (defined in the QDRO as the alternate payee). Three options normally exist:

- (a) the transfer of the alternate payee's interest to a separate account from which the alternate payee may not take any distribution until the participant

(former spouse) (1) reaches age 59½, (2) dies or (3) separates from service;

- (b) the direct rollover of the alternate payee's interest to an IRA or other eligible retirement plan; and

- (c) a lump sum distribution made directly to the alternate payee.

The employer or plan administrator is instrumental in processing these legal documents and assuring that the provisions of §414(p) have been adhered to.

If the QDRO specifies transferring the alternate payee's interest to an IRA or eligible retirement plan in the alternate payee's name, the restrictions noted for a separate account would not apply. The alternate payee could rollover the IRA to another §403(b) account (if the alternate payee is eligible to participate in a §403(b) account) or take distributions from the IRA

when desired (tax penalties may apply if premature distributions are taken, i.e., prior to age 59½). If the alternate payee rolls the award to an employer's retirement plan, distributions would be restricted according to the type of plan. If the alternate payee takes a lump sum distribution, the IRS requires that 20% be withheld for federal income taxes; distributions paid directly to an alternate payee are exempt from the 10% premature penalty.

Domestic relations orders must contain certain information to be deemed a QDRO pursuant to IRC §414(p). Legend can assist an employer by forwarding a sample QDRO containing the alternatives mentioned above to an attorney to help ensure that all options are considered before the court document is drafted. We can also review the draft and certified copy of the QDRO to assure adherence to all legal requirements.

Hardship Distributions

The finalized §403(b) regulations require that §403(b) plan hardship distributions follow the §401(k) hardship guidelines under Treasury Regulation §1.401(k)-1(3). The employer or plan administrator must put procedures in place to assure that hardship distributions are properly monitored.

These distributions are limited to a participant's elective deferrals (but no earnings thereon) as of the date of distribution, reduced by the amount of previous distributions of elective contributions in hardship distributions. Participants who had a §403(b) account balance as of 12/31/88 can add that balance to the amount available for hardship distribution(s) also.

The hardship distribution guidelines allow distributions only if:

- 1) the distribution is due to an immediate and heavy financial need;
- 2) the distribution must be necessary to satisfy that need (i.e., the participant has no other funds or way to meet the need, either through reimbursement by insurance or liquidation of assets);
- 3) the distribution cannot exceed the amount needed by the participant;
- 4) the participant must have first obtained currently available distributions and nontaxable loans from plans maintained by the employer or by any other employer of the participant;
- 5) the participant cannot obtain commercial loans on reasonable terms in an amount sufficient to satisfy the need and
- 6) the participant cannot contribute to the §403(b) plan for six months following the hardship distribution.

Whether a participant has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, the need to pay the funeral expenses of a family member would be considered immediate financial need. A distribution request for the down payment on a vacation home would not constitute an immediate

Hardship distributions are subject to income tax and, if the participant is not age 59½, will be subject to the 10% premature penalty.

and heavy financial need. A need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee, such as college tuition for the participant's children.

A distribution is considered to be an immediate and heavy financial need of the participant if the distribution is for:

- 1) un-reimbursed medical expenses for the participant or his/her dependents;
- 2) purchase of the participant's principal residence (excluding mortgage payments);
- 3) payment of college tuition and related higher education expenses for the participant or his/her dependents;
- 4) payments necessary to prevent eviction from, or foreclosure on the mortgage on, the participant's principal residence;
- 5) for funeral expenses for the participant's parents or dependents; or
- 6) for repair of damage to the participant's principal residence due to casualty (storm, fire, flood, etc.).

Hardship distributions are subject to income tax and, if the participant is not age 59½, will be subject to the 10% premature penalty.

Under the finalized regs, employers will be expected to monitor hardship distributions, or, at the very least, monitor the vendors who make such distributions. Legend can give you guidance for whatever avenue you choose to take.

§403(b) Loans

The finalized regulations also require employers or their plan administrators to monitor loans. In the past, participants might have had accounts with more than one vendor and could have taken loans out with each vendor, possibly violating the loan limits. The loan limit for a participant applies to all plans maintained by his/her employer, not just his/her §403(b) accounts. In other words, the participant does not have a separate



loan limit for his/her §457 account. All loans must be aggregated to apply the limit. The maximum loan limit is the greater of \$10,000 or ½ of the account value (up to \$50,000). This \$50,000 limit is reduced by the highest outstanding loan balance during the previous one-year period.

To calculate a participant's account value you must add the current account balance to any outstanding active loan balance and any loan(s) defaulted in a custodial account in the past plus the interest that has accrued since the default plus any loan(s) defaulted in an annuity contract issued after December 31, 2003. We're assuming here that defaulted loans have not been paid back or offset. (The interest accrues at the original interest rate on the loan(s).) Then that account value is divided in half and the loan limit is applied. To determine how big a loan the



client can take now, we must subtract any outstanding active loans, any defaulted loans and the interest accrued thereon. We must also subtract any amount which exceeds the current loan amounts (both active and defaulted) at any time in the past 12 months from \$50,000.

As you can see by the previous paragraph, an employer must be prepared to contact all of the vendors that hold assets for the participant in any plan maintained by the employer to ascertain account balances, loan balances and default information unless this task is left to a plan administrator or participant self-certification.

For §403(b) custodial account participants who have ever defaulted on a loan from their §403(b) accounts and §403(b) participants who entered into annuity contracts after January 1st, 2004 who default on a loan from those contracts, and that loan has not been repaid or offset, any new loan must be repaid through salary (after-tax) deduction through the employee's employer. Prior to the finalized regs, §403(b) participants were required to self-certify to a vendor, upon application for a loan, whether they had ever defaulted on a loan with another vendor. (If the §403(b) participant has an annuity contract issued prior to January 1st, 2004, that account is "grandfathered" and not subject to this rule.)

Many school districts do not allow salary deductions for loan repayments. If this option is not available to your employee, s/he will be unable to obtain any future loans from his/her §403(b) account(s) if s/he has defaulted a loan in

the past (except for grandfathered annuity contracts). The IRS will be able to catch §403(b) participants who are not truthful in their loan applications and subsequently default again because the Form 1099-R instructions have had a code for loan defaults – Code L – for some years now. If a taxpayer accumulates 2 or more Forms 1099-R with Code L, a red flag will be raised. The second defaulted loan may be deemed a prohibited transaction and subject to a 15% penalty as of the date the loan was issued, with interest accruing on the penalty since that date. In this case, "truth in lending" applies to the one taking the loan!

An employee should seriously consider his/her ability to repay any loan s/he takes from a §403(b) account before taking a loan. If an employee needs to borrow money, s/he should consider all other sources of loans before taking a loan from a §403(b) account.

Employees on Ten Month Pay Schedules

If a school district is willing to arrange for payroll deduction on a §403(b) loan and the employee is paid on a ten month schedule, the loan payments due over the summer hiatus must be prepaid in the last paycheck(s) of the school year in order to avoid default on the outstanding loan. Loans must, by federal law, be paid in equal monthly or quarterly amounts and therefore cannot lapse during a summer hiatus.

Loan Repayment or Offset

A previously defaulted loan can be repaid prior to the participant reaching a normal distributable event, which, for §403(b) accounts, is 1) attaining age 59½, 2) separating from service, 3) becoming disabled (under a very strict definition of disability) or 4) due to the participant's death. If a defaulted loan has not been repaid prior to a normal distributable event, the loan is offset, i.e., it effectively disappears. At this time, the participant is eligible to take further loans without the restriction of payroll deduction repayments.

Under the finalized regs, employers will be expected to monitor loans, or, at the very least, monitor the vendors who offer loans. Legend can give you guidance for whatever avenue you choose to take.

If an employee needs to borrow money, s/he should consider all other sources of loans before taking a loan from a §403(b) account.

Is Your Organization Prepared to Comply with the Final §403(b) Regulations?

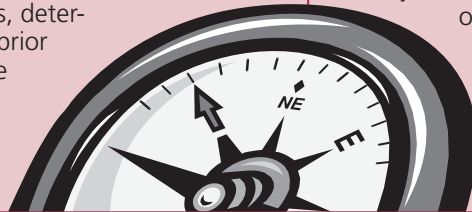
The Internal Revenue Service and U.S. Treasury Department published the Final §403(b) Regulations on July 26, 2007. The effective date for most provisions has been delayed until January 1, 2009. For most employers, these new requirements will likely be onerous. But rest assured that The Legend Group is fully prepared to provide all the necessary support to aid in compliance with each requirement. For over 40 years, Legend has been providing comprehensive retirement programs to not-for-profit employers.

Legend will be able to provide:

- A written plan document that includes the provisions of the Final Regulations, allowing you to offer the optional features that your employees enjoy now. We will update your plan document with the IRS model plan language when it becomes available.
- Assistance in monitoring the optional features that are adopted in your plan document, including loans outstanding with vendors, determining if employees have had prior loan defaults (and are therefore restricted from obtaining new loans), monitoring in-service transfers, exchanges, etc.

- Assistance in monitoring the contribution limits and each vendor's adherence to the prescribed treatment of any excesses.
- Assistance in monitoring each vendor's adherence to the distribution restrictions.
- Assistance regarding the review of annuity contracts for inclusion of proper language regarding employer contributions to such contracts
- Assistance concerning the review of Qualified Domestic Relations Orders for adherence to the requirements of §414(p) of the Code.
- Guidance on complying with the universal availability requirement.

As budgets shrink and compliance requirements grow, Legend is prepared to share our expertise with you so you can concentrate your limited human resources on meeting your own goals— not learning to be retirement plan experts! In our efforts to help you reduce your administrative burden, Legend will provide employers with ongoing technical assistance regarding the rules and regulations affecting their plans.



Retirement PLAN WATCH

ADVISORY SERVICES CORPORATION
P.O. BOX 32427
PALM BEACH GARDENS, FL 33410