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PROPOSED REGULATIONS UNDER CODE SECTION 403(b) OF THE INTERNAL REVENUE CODE

I. BACKGROUND. Code Section 403(b) was added to the Internal Revenue Code ("Code") in 1958, and regulations were first issued under Code Section 403(b) in 1964. 403(b) plans were initially less like "plans" and more like individual annuities which an employer purchased on behalf of an employee from an insurance company. Over time, with the enactment of the Tax Reform Act of 1986, Small Business Job Protection Act of 1996, Economic Growth and Tax Relief Act of 2001, and Job Creation and Worker Assistance Act of 2002, 403(b) plans have begun to look more and more like qualified retirement plans under Code Section 401(a).

II. NEW REGULATIONS. On November 16, 2004, the Treasury and the Internal Revenue Service ("IRS") issued proposed regulations for 403(b) plans. The proposed regulations are the first comprehensive guidance on 403(b) plans in over forty years, and attempt to update the regulations for current law, incorporate items of interpretive guidance issued under 403(b) since the 1964 regulations, and reflect the numerous legal changes that have been made to Code Section 403(b). The final regulations will make obsolete many of the previously issued IRS revenue rulings, notices, and announcements. The regulations:

. . . demonstrate the increasing similarity among Section 403(b) arrangements and the other types of retirement plans that provide for salary deferrals (Code Section 401(k) and governmental Code Section 457(b) plans).

Office of Public Affairs, Nov. 15, 2004.

A major effect of the legal changes in section 403(b) has been to diminish the extent to which the rules governing 403(b) plans differ from the rules governing other arrangements that include salary reduction contributions, *i.e.* section 401(k) plans and section 457(b) plans for State and local governmental entities.

Thus, these regulations will reflect the increasing similarity among these arrangements.

Preamble, Prop. Regs.

III. ERISA. 403(b) plans can be sponsored by both public and private employers. 403(b) plans sponsored by private employers are also subject to the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), unless exempt from ERISA due to limited employer involvement under DOL Reg. § 32510.3-2(f). ERISA contains provisions regarding eligibility, minimum coverage, vesting, qualified joint and survivor annuities, fiduciary standards, reporting and disclosure, and claims procedures.

IV. SUMMARY OF CURRENT REQUIREMENTS UNDER CODE SECTION 403(b).

A. **Employers Eligible to Sponsor a 403(b) Plan.** The following employers can sponsor a 403(b) plan for their employees:

1. Code Section 501(c)(3) tax-exempt organizations. Code § 403(b)(1)(A)(i).
2. Public educational organizations. Code § 403(b)(1)(A)(ii).
3. Ministers described in Code § 414(e)(5)(A). Code § 403(b)(1)(A)(iii).

In a controlled group, only entities that are eligible employers may participate in a 403(b) plan.

B. **Employees Eligible to Participate in a 403(b) Plan.** Only common law employees of an eligible employer sponsoring a 403(b) plan may participate in the plan.

C. **Permissible Funding Vehicles.** Amounts contributed to a 403(b) plan may only be invested in certain investment arrangements, including:

1. **Annuity Contracts.** These are nontransferable individual or group annuity contracts issued by a life insurance company. Code §§ 403(b)(1), 401(g).
2. **Custodial Accounts.** The assets of a custodial account must be held by a bank or an approved non-bank trustee or custodian under Code Section 401(f), and the assets must be invested exclusively in regulated investment company stock (*e.g.* mutual funds). Code § 403(b)(7). A custodial account is generally subject to the same rules as applicable to annuity contracts, but are subject to stricter distribution rules.
3. **Retirement Income Accounts.** A retirement income account is a defined contribution program established and maintained by a church or related

organization. Code § 403(b)(9). Certain grandfathered retirement income accounts are defined benefit plans. Retirement income accounts are generally subject to same rules as annuity contracts, and can be funded by annuity contracts or custodial accounts.

D. Permissible Types of Contributions to a 403(b) Plan.

1. **Elective Deferrals.** Participants may elect to defer a percentage of their compensation or a fixed dollar amount to a 403(b) plan on a pre-tax basis, pursuant to the terms of a salary reduction agreement. The rules applicable to salary reduction agreements are similar to those applicable to a cash or deferred arrangement described under Code Section 401(k). A salary reduction agreement applies to compensation that is not currently available to the employee at the effective date of the agreement, and must be legally binding. An employee must be permitted to enter into or modify a salary reduction agreement at least once a year.

2. **Employer Contributions.** An employer may make either fixed or discretionary matching contributions that are based on the participant's elective deferrals or non-elective contributions to a 403(b) plan. An employer may make contributions to a 403(b) plan on behalf of terminated participants for a period of up to 5 years after severance from employment based on the participant's includible compensation during his or her final year of service.

3. **After-Tax Employee Contributions.** Participants may elect to defer a percentage of their compensation or a fixed dollar amount to a 403(b) plan on an after-tax basis.

E. **Vesting.** Code Section 403(b)(1)(C) requires that an annuity contract be non-forfeitable except for the failure to pay future premiums. *See also* Code § 403(b)(6). However, many 403(b) plans contain vesting schedules with respect to employer contributions, although ERISA-covered plans must satisfy certain minimum vesting standards. Salary reduction contributions are always 100% vested. Amounts forfeited may be used to reduce future employer contributions, pay 403(b) plan expenses, or be reallocated among the remaining participants' accounts, as specified in the 403(b) plan.

F. Limitations on Contributions to a 403(b) Plan.

1. **Elective Deferrals.**

a. ***Basic Limit.*** The basic limit on elective deferrals is \$14,000 for 2005 and \$15,000 for 2006, which will increase by cost of living thereafter. Code §§ 403(b)(1)(E), 401(a)(30), 402(g). The Code Section 402(g) limit applies to all elective deferrals made by a participant during a year to a SARSEP, 401(k) plan, 403(b) plan, or a 408(p) simple retirement plan.

b. 15 Year of Service Catch-Up. An employee who has 15 or more years of service with any educational organization, hospital, health and welfare service agency, home health service agency, or church related organization may increase his or her elective deferrals by the lesser of: (i) \$3,000 or (ii) \$5,000 multiplied by the employee's years of service with the employer minus all of the employee's prior elective deferrals with the employer. Code § 402(g)(7). There is a \$15,000 lifetime maximum on this catch-up.

c. Age 50 Catch-Up. A participant age 50 or older, or who attains age 50 by the end of the calendar year, may increase his or her deferral by an additional amount as set forth in Code Section 414(v)(3)(A). This catch-up amount is \$4,000 for 2005 and \$5,000 for 2006, which will increase by cost of living thereafter.

2. **Total Contributions.** "Annual additions" to a 403(b) plan are subject to the limits set forth in Code Section 415(c). Code § 403(b)(1). Annual additions are salary reduction contributions (but not including age 50 catch-ups under Code Section 414(v)), employer non-elective and matching contributions, after-tax employee contributions, and any forfeitures due to a vesting schedule. The limit under Code Section 415(c) is, for 2005, the lesser of \$42,000 or 100% of includible compensation. The \$42,000 dollar limit will increase by cost of living over time. "Includible compensation" generally means the employee's compensation received from an eligible employer that is includible in the participant's gross income, but also including amounts excluded from gross income due to Code Sections 125, 132(f)(4), 457 and/or 403(b), for the most recent period that is a year of service. Code §§ 403(b)(3), (4).

G. **Aggregation.** Under Code Section 415, a participant is generally considered to exclusively control his or her own 403(b) plan, and, therefore, contributions to a 403(b) plan are not aggregated with contributions to a 401(a) plan unless the participant controls the employer. Treas. Reg. § 1.415-8(d). As a result, employers are able to design their retirement plans to achieve significant tax deferrals for employees. This is particularly true for public employers since governmental plans are not subject to most non-discrimination rules.

TYPE OF PLAN	TYPE OF CONTRIBUTION	2005	2006 AND THEREAFTER
403(b) Plan	Elective Deferrals:		
	Basic Limit	\$14,000	\$15,000 ¹
	Age 50 Catch-Up	\$4,000	\$5,000 ¹
	15 Years of Service ³	\$3,000	\$3,000

	Total 403(b) Plan Contributions²	\$42,000	\$42,000¹
401(a) Plan	Total 401(a) Plan Employer Contributions²	\$42,000	\$42,000¹
457(b) Plan	Basic Limit	\$14,000	\$15,000 ¹
	Age 50 Catch-Up ⁴	\$4,000	\$5,000 ¹
	Total 457(b) Plan Contributions²	\$18,000	\$20,000
	Total Plan Contributions	\$102,000	\$104,000
1	This limit is indexed to the cost of living after 2006.		
2	Private colleges and universities are subject to nondiscrimination rules that impact the ability to fully utilize these limits.		
3	An employee who has 15 years of service with a qualified organization can make a catch-up each year to the 403(b) in an amount equal to the lesser of (i) \$3,000 or (ii) \$5,000 times years of service with the organization less total elective deferrals made by the employee during all prior years of employment. There is a total limit under this catch-up of \$15,000. This catch-up is <u>in addition to</u> the age 50 catch-up.		
4	Employees of public colleges and universities can take advantage of the age 50 catch-up in <u>both</u> the 403(b) plan and the 457(b) plan. Employees of private colleges and universities can take advantage of the age 50 catch-up only once. Note that in the event that the special lifetime catch-up under Code Section 457(b) exceeds the age 50 catch-up, then the lifetime catch-up will apply for the last three years prior to normal retirement age.		

H. **Distributions of Benefits.**

1. **Elective Deferrals.** Elective deferrals cannot be distributed prior to an employee's:

- (a) severance of employment,
- (b) death,
- (c) disability within the meaning of Code Section 72(m)(7),
- (d) age 59½, or
- (e) financial hardship (not including income in elective deferrals).

Code § 403(b)(11).

2. **Custodial Accounts.** Amounts invested in a custodial account cannot be distributed prior to an employee's:

- (a) severance of employment,

- (b) death,
- (c) disability within the meaning of Code Section 72(m)(7),
- (d) age 59½, or with respect to elective deferrals,
- (e) with respect to elective deferrals, financial hardship.

Code § 403(b)(7)(A)(ii).

3. Employer Contributions Not Made to a Custodial Account.

Code Section 403(b) does not place any restrictions on when employer contributions not invested in a custodial account can be distributed; provided, however, that distributions made before an employee attains age 59 ½, dies, has a severance from employment prior to age 55, or disabled within the meaning of Code Section 72(m)(7) is subject to a 10% penalty under Code Section 72(t).

I. **Plan Terminations.** No mechanism currently exists to terminate a 403(b) plan.

J. **Revenue Ruling 90-24 Transfers.** Revenue Ruling 90-24 permits a participant to move some or all of his or her 403(b) plan account balance to another 403(b) plan or funding vehicle without incurring taxation. The transferee plan must continue to apply the same distribution restrictions on the funds that were in place under the prior arrangement.

K. **Rollovers.** A participant who receives an eligible rollover distribution under Code Section 402(c)(4) may make a nontaxable rollover to any eligible retirement plan or 403(b) plan that accepts rollovers. Code § 403(b)(8)(A).

L. **Required Minimum Distribution Rules.** The minimum distribution rules under Code Section 401(a)(9) apply to 403(b) plans. Code § 403(b)(10). Under these rules, an employee must begin to receive a distribution by April 1 of the calendar year following the later of: (i) the calendar year in which the employee attains age 70 ½, or (ii) the calendar year in which the employee retires.

M. **Non-Discrimination Requirements for Salary Deferrals.** Salary deferrals must satisfy the universal availability rule. This rule applies to both governmental and non-governmental plans, but not to church plans. Under the universal eligibility rule, if any employee of an eligible employer is permitted to defer salary to a 403(b) plan, then generally all employees of the employer must be permitted to do so. Code §§ 403(b)(1)(D), 403(b)(12)(A)(ii). However, the plan may exclude the following categories of employees without violating the universal availability rule:

1. Employees whose salary deferrals are less than \$200,
2. Non-resident alien employees as described in Code Section 410(b)(3)(C),

3. Employees who normally work less than 20 hours a week, subject to the conditions set forth in Code Section 410(b)(4),

4. Students performing services described in Code Section 3121(b)(10), and

5. Employees eligible to participate in Code Section 401(k) plan or a Code Section 457 plan sponsored by a governmental employer, that permit contributions or deferrals at the election of the employee.

Code § 403(b)(12)(A). Additionally, IRS Notice 89-23, which sets forth a transitional "safe harbor" for testing 403(b) plans, permits the following additional exclusions for purposes of meeting the universal availability rule:

1. Employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan,

2. Employees covered by a collective bargaining agreement,

3. Certain visiting professors, and

4. Employees of a religious order who have taken a vow of poverty.

N. **Non-Discrimination Requirements for Employer and After-Tax Contributions.** Employer or after-tax contributions made to a 403(b) plan must generally satisfy the same coverage and nondiscrimination requirements applicable to Section 401(a) plans:

1. Employer matching and employee after-tax contributions must satisfy the average contribution percentage (ACP) test under Code Section 401(m).

2. Non-elective employer contributions must satisfy the general non-discrimination test under Code Sections 401(a)(4) and (5).

3. Employer contributions and employee after-tax contributions must satisfy a coverage test under Code Section 410(b).

4. 403(b) plan compensation must be limited as required by Code Section 401(a)(17).

Code § 403(b)(12)(A)(i). Governmental plans are deemed to satisfy the statutory non-discrimination requirements in Code Sections 401(a)(4), 401(m) and 410(b). *See* P.L. 105-34 § 1505. Governmental plans must comply with Code Section 401(a)(17). Church plans are exempt from all of these rules.

O. **Transitional Safe Harbor Under IRS Notice 89-23.** Notice 89-23 provides guidance for applying the non-discrimination rules under Code Section

403(b)(12) to 403(b) plans for both salary deferrals and employer contributions. Notice 89-23 sets forth a good faith testing standard, as well as three disparity safe harbor provisions for non-discrimination testing that afford certain employers more flexibility in satisfying the non-discrimination rules.

P. **No Written Plan Document Requirement in Code.** Code Section 403(b) does not require a written plan document; however, ERISA does contain a written plan document requirement for ERISA-covered 403(b) plans. While no written plan document is required by the Code, Code Section 403(b) does require that certain rules be reflected in the underlying annuity contract, custodial account agreement, or retirement plan account, including:

1. For annuity contracts, the non-forfeitability and non-transferability requirement under Code Section 401(g),
2. Direct rollover requirements under Code Section 402(c), *see* Code Section 401(a)(31),
3. Salary deferral limits under Code Section 402(g), *see* Code Section 401(a)(30),
4. Withdrawal limitations under Code Section 403(b)(11), and
5. The required minimum distributions rules and incidental benefit requirements under Code Section 401(a)(9).

V. **PROPOSED REGULATIONS UNDER CODE SECTION 403(b).**

A. **What Does Proposed Mean?** Proposed regulations cannot be relied upon until finalized. They are a non-binding explanation of the IRS' current intent that are intended to be implemented in the future. The November 17, 2004 edition of the IRS Employee Plans News stated the following:

So what does proposed mean? It means nothing, it means everything. The IRS cannot conduct any examination enforcement activity based on them. However, it is necessary not only to be aware of what may be coming but also what it will take to live under them when they are finalized.

B. **Effective Date.** Prop. Treas. Reg. §§ 1.403(b)-0 through 1.403(b)-11 are effective for taxable years beginning after December 31, 2005, with transitional rules for collectively bargaining agreements and church-related organizations. Issued with the proposed treasury regulations under Code Section 403(b) were proposed regulations under Code Sections 402(b), 402(g), and 414(c), all effective for taxable years beginning after December 31, 2005, and temporary regulations under Code Section 3121(a)(5)(D), which became effective November 16, 2004.

C. What Does the IRS Consider a Clarification or Acknowledgement of Current Law?

1. Vesting.

a. *Proposed Regulations.* Prop. Treas. Reg. §§ 1.403(b)-3(a) and (c)(2) confirm that vesting for matching and non-elective employer contributions is permitted. However, the regulations state that any non-vested portion will be treated as if made to a Code Section 403(c) non-qualified annuity plan issued by an insurance company until the contribution becomes vested, at which time it will be treated as a 403(b) plan contribution.

b. *Comments.* The proposed regulations do not state whether the "non-vested" portion is applied against the contribution limits when made or when vested. However, IRS representatives have stated that a non-vested contribution will be treated as an annual addition under Code Section 415(c) when made. Additionally, the proposed regulations do not address how non-vested contributions made to a custodial account will be treated. Finally, the proposed regulations do not address the application of new Code Section 409A to unvested contributions.

2. 401(a)/403(b) Disaggregation.

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-4(b)(2) acknowledges that the Code Section 415 limits for a Code Section 403(b) and 401(a) plan are disaggregated unless the individual is in control of the entity offering the 403(b) plan. Code § 415(k)(4).

3. Coordination of Catch-Up Contribution Limits.

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-4(c)(3)(iv) clarifies that the proper order for coordinating elective deferral limits is to first apply the basic limit under Code Section 402(g)(1), then the 15 years of service catch-up under Code Section 402(g)(7), and then the age 50 catch-up under Code Section 414(v).

b. *Comments.* This ordering method is important because participants may think they are making the age 50 catch-up and saving their 15 years of service catch-up for a later date, when they will actually be using up their lifetime catch-up limit.

4. Contributions for Former Employees.

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-4(d) clarifies that any contribution to a 403(b) plan on behalf of a former employee must be a non-elective contribution, that the Code Section 415(c) limit is based on the former employee's includible compensation

during his or her most recent year of service, and that post-employment contributions can be made for the remainder of the year in which the employee terminates employment and for up to five years thereafter. Prop. Treas. Reg. § 1.403(b)-d(3) also provides that compensation may be treated as continuing for purposes of Code Section 415 for certain former employees who are disabled. Code § 415(c)(3)(C). The Preamble to the Proposed Regulations provides that post-employment elective contributions to a 403(b) plan will be addressed in separate guidance.

b. *Comments.* Note that post-employment contributions made to plans, other than governmental and church plans, must satisfy the non-discrimination rules under Treas. Reg. § 1.401(a)(4)-10(b). Note also that the IRS is concerned that post-employment contributions are often really indirect cash or deferred arrangements (“CODAs”).

5. **Effective Opportunity Under the Universal Availability Rule.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-5(b)(2) clarifies that under the universal availability rule, each eligible employee must be offered an effective opportunity to make, revoke, or modify their deferral election at least once per year. Whether an "effective opportunity" has been afforded depends on the facts and circumstances, including notice of the availability of the election, the period of time during which the election may be made, and any other conditions on elections.

b. *Comments.* The proposed regulations do not state how frequently notice must be given to employees or whether notice can be provided electronically. Some commentators have requested a sample notice from the IRS.

6. **Hardship Withdrawals.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-6(d)(2) provides that hardship distributions follow the rules set forth in Treas. Reg. § 1.401(k)-1(d)(3).

b. *Comments.* IRS representatives have stated that the suspension of elective deferrals is currently the subject of IRS enforcement activity. Commentators have asked for guidance on whether vendors can certify hardship and how vendors coordinate hardship withdrawals.

7. **FICA Withholding.**

a. *Proposed and Temporary Regulations.* Although an elective deferral for purposes of the Code Section 402(g) limits does not include a contribution pursuant to a one-time irrevocable election made on

or before an employee first becomes eligible to participate or a contribution made as a condition of employment, Temp. Reg. § 31.3121(a)(5)-2T clarifies that these types of deferrals are subject to FICA when made, as well as elective deferrals as defined in Treas. Reg. § 1.401(k)-1(a)(3).

b. *Comments.* This change became effective November 16, 2004. The temporary regulation is set to expire on November 15, 2007, in anticipation that the proposed regulations will be finalized before that date.

D. **Important New Rules For 403(b) Plans.**

1. **Written Plan Document.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-3(b)(3) requires a 403(b) plan to be maintained pursuant to a written defined contribution plan document that satisfies the proposed regulations in form and operation. The document must contain all material terms and conditions for benefits under the plan, including:

- (i) universal eligibility rules for elective deferrals,
- (ii) eligibility for other contribution types,
- (iii) benefits,
- (iv) applicable limitations,
- (v) identity of contracts available under the plan, and
- (vi) time and form of benefit distributions.

The plan may also contain optional features not required under Code Section 403(b), such as hardship withdrawals, but these provisions must also be met in form and operation.

b. *Comments.* The proposed regulations allow the plan document requirement to be satisfied by the use of more than one written document, *i.e.* annuity contract, custodial account, salary reduction agreement, employer administrative procedures, and summary plan description. Commentators have requested that Prop. Treas. Reg. § 1.403(b)-3(b)(3) clarify that a reference to specific terms in the underlying annuity contract will satisfy the written plan requirement for such terms. Although numerous commentators have requested that the IRS not require a written plan document, the IRS has stated that it does not believe that an employer can comply with the requirements of Code Section 403(b) unless the plan is set forth in a written plan document. Commentators are

concerned that requiring a plan document for a salary deferral only plan that is not covered by ERISA due to limited employer involvement will cause the plan to be subject to ERISA.

2. Time-Frame for Contributing Elective Deferrals to 403(b) Plan.

a. Proposed Regulations. Prop. Treas. Reg. § 1.403(b)-8(b) requires that elective deferrals made under a 403(b) plan be transferred to the funding vehicle as soon as reasonable, but no later than 15 business days following the month in which the amounts would have otherwise been paid to the employee.

b. Comments. This is the standard that already applies to 403(b) plans subject to ERISA, so this is new only for governmental and church plans. Similar to the rule under ERISA, this is probably a guideline, not a safe harbor, and elective deferrals should be transferred to the funding vehicle as soon as possible.

3. Plan Termination.

a. Proposed Regulations. For the first time, Prop. Treas. Reg. § 1.403(b)-10 permits an employer to terminate its 403(b) plan and to distribute or rollover benefits as soon as administratively practicable upon termination. However, termination is permitted only if the employer (the employer is determined under the Code Section 414 controlled group rules as of the date of the termination) does not make contributions to a successor 403(b) plan for the 12 month period before and after the date of the plan termination.

4. Severance from Employment.

a. Proposed Regulations. Prop. Treas. Reg. § 1.403(b)-2(a)(19) defines severance of employment as having the same meaning as under the Code Section 401(k) regulations. Prop. Treas. Reg. § 1.403(b)-6(h) provides, however, that severance from employment occurs on any date on which the employee ceases to be an employee of an eligible employer, even though the employee may continue to be employed either (i) by another entity that is treated as the same employer where either that other entity is not an eligible employer (such as transferring from a Section 501(c)(3) organization to a for-profit subsidiary) or (ii) in a capacity that is not employment with an eligible employer (*e.g.*, ceasing to be an employee performing services for a public school, but continuing to work for the same state employer).

5. **Plan-to-Plan Transfers.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-10(b) replaces Revenue Ruling 90-24, and permits two types of transfers: plan-to-plan transfers and contract-to-contract exchanges. Amounts transferred must be subject to distribution rules at least as stringent as those under the transferring contract. With respect to plan-to-plan transfers between 403(b) plans sponsored by different employers, the participant whose assets are being transferred must be an employee of the organization sponsoring the receiving 403(b) plan, both 403(b) plans must provide for the transfer and transferred assets before the transfer must be equal to those after the transfer. With respect to contract-to-contract exchanges, the exchange must occur between vendors within the same 403(b) plan, the 403(b) plan must permit the exchange, and the exchanged assets before the exchange must be equal to those after the exchange.

b. *Comments.* The proposed regulations remove the ability of the participant to transfer his or her account to a contract with another vendor that the participant's employer has not approved under its 403(b) plan. The proposed regulations also prevent a transfer to another 403(b) plan after a participant retires or is working for an employer not eligible to sponsor a 403(b) plan. Transfers and exchanges do not require participant consent. The rules confirm that 403(b) plan assets cannot be merged with or transferred to Code Section 401(k) or 457(b) plans.

6. **Distribution of Non-Elective Contributions.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-6(b) restricts the distribution of employer and after-tax employee contributions, other than those made from a custodial account, to the earliest of the participant's:

- (i) severance of employment,
- (ii) occurrence of an event, *i.e.* after a fixed number of years,
- (iii) the attainment of a stated age, or
- (iv) disability.

See Treas. Reg. § 1.401-1(b)(1)(ii).

b. *Comments.* There are already similar restrictions on the distribution of elective deferrals and amounts from custodial accounts.

7. **Universal Availability Rule.**

a. Proposed Regulations.

(i) Prop. Treas. Reg. § 1.403(b)-5(b)(2) provides that an "effective opportunity" to make a cash or deferred election to a 403(b) plan does not exist if there are any other rights or benefits that are conditioned (directly or indirectly) upon a participant making or failing to make a cash or deferred election with respect to a contribution to a 403(b) plan.

(ii) Prop. Treas. Reg. § 1.403(b)-5(b)(4)(E) sets forth a test to determine whether an employee works less than 20 hours per week so that they can be statutorily excluded from the universal eligibility rule. On the date of hire, an employer must reasonably expect the employee to work less than 1,000 hours (as defined in Code Section 410(a)(3)(C)) for the next 12 months. Then, for every subsequent plan year or 12 month period, the employee must have actually worked less than 1,000 hours in the preceding 12 month period.

(iii) Prop. Treas. Reg. § 1.403(b)-5(b)(3) provides that the universal availability rule applies separately to each organization sponsoring the 403(b) plan. If a 403(b) plan covers the employees of more than one State entity, this requirement applies separately to each entity not part of a common payroll. An employer that historically has treated one or more of its various geographically distinct units as separate for benefit purposes may treat each unit as a separate organization if the unit is operated independently on a day-to-day basis.

(iv) The Preamble to the Proposed Regulations provides that Notice 89-23 no longer applies. Thus, the additional permissible exclusions under the universal availability rule for (i) employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan, (ii) employees covered by a collective bargaining agreement, (iii) visiting professors for up to a year, and (iv) employees affiliated with a religious order who have taken a vow of poverty, will no longer be available. The Proposed Regulations request comments on this issue.

b. Comments.

(i) The anti-conditioning rule is the same rule that already applies to Code Section 401(k) plans. Code § 401(k)(4).

(ii) This is basically a 1,000 hour standard, which is already the rule for ERISA-covered 403(b) plans. It is helpful in

that it makes clear that seasonal and part-time workers can be excluded if these rules are satisfied. However, it may make it more difficult for employers who do not track hours of some groups of employees.

8. **Non-Discrimination Requirements.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-5(a)(1) provides that generally, employer contributions and employee after-tax contributions must satisfy the same non-discrimination and coverage rules applicable to qualified plans under Code Section 401(a). The Preamble to the Proposed Regulations provides that Notice 89-23 no longer applies. Governmental plans remain exempt from these requirements, except for Code Section 401(a)(17). Prop. Treas. Reg. § 1.403(b)-5(a)(5). Prop. Treas. Reg. § 1.403(b)-5(a)(3) provides that the definition of compensation under Code Section 414(s) must be used in determining compliance with the non-discrimination rules.

b. *Comments.* Using the definition of Code Section 414(s) definition of compensation for testing will require the employer to maintain two compensation records, one for determining includible compensation and one for non-discrimination testing.

9. **Incidental Life Insurance.**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.403(b)-8(c) prohibits incidental life insurance in a 403(b) plan, but grandfathers incidental life insurance contracts issued up to 90 days from November 16, 2004 (publication date of proposed regulations).

b. *Comments.* Commentators have requested guidance on whether an employer make new contributions to existing contract and whether an employer sponsoring an existing group contract can allow new individuals to join the contract.

10. **Changes to Controlled Group Rules Under Code Section 414(c).**

a. *Proposed Regulations.* Prop. Treas. Reg. § 1.414(c)-5 sets forth controlled group rules for all tax-exempt organizations, except churches. The rules are based on a 80% director/trustee common control test, similar to the controlled group rules contained in Notice 89-23. The regulations also allow permissive aggregation of tax-exempt organizations if they maintain a single plan and the organizations regularly coordinate their day-to-day activities.

b. *Comments.* The controlled group rules are relevant for purposes of the non-discrimination rules, Code Section 415 contribution

limitations, the 15 year of service catch-up contributions, and the minimum required distribution rules.

VI. REMAINING KEY DIFFERENCES BETWEEN 403(b) AND 401(k) PLANS.

A. All employers except a state or local governmental employer can sponsor a 401(k) plan. Code § 401(k)(4)(B). Only certain eligible employers can sponsor a 403(b) plan.

B. Contributions can only be made to certain funding arrangements under Code Section 403(b).

C. There is a 15 years of service catch-up available under a 403(b) plan.

D. Post-employment contributions may be made to a 403(b) plan.

E. The universal availability test applies to Code Section 403(b) elective deferrals, while the average deferral percentage (ADP) test applies to Code Section 401(k) elective deferrals.

F. Code Section 415(c) utilizes the definition of "includible compensation" for purposes of 403(b) plans.

G. There are different consequences for failing to satisfy the Code Section 403(b) or Code Section 401(k) rules, respectively.

H. The IRS will issue a determination letter for 401(k) plans, and a private letter ruling for 403(b) plans.

I. There is a possible exception to ERISA for 403(b) plans with limited employer involvement; this exception is not available for 401(k) plans.