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What You Need To Know About The New 403(b) Plan Regulations *By Constance M. Hiatt*

This update addresses the new regulations issued by the IRS for 403(b) plans as well as an update on scrutiny of fees under 403(b) plans.

See pg. 3 for focus on heightened security of 403(b) plans.

On July 23, 2007, the Internal Revenue Service ("IRS") issued final regulations for plans under section 403(b) of the Internal Revenue Code ("403(b) plans"). The regulations are effective for plan years beginning in 2009 with certain exceptions. This update will cover the major aspects of the regulations and the Department of Labor's recent notice about ERISA coverage for 403(b) plans.

Written Plan Document

A written plan document is now required for all 403(b) plans. The IRS concluded that the plan document is necessary to allocate responsibilities for administrative functions and to identify who is responsible for compliance with the tax laws. The plan cannot delegate these administrative and tax compliance responsibilities to participants. The plan document must include all material terms and conditions for eligibility, benefits, limits, investments and distributions. The terms of the plan must be followed in the operation of the plan. The plan document can incorporate investment contracts and their terms by reference. If a plan offers multiple investment

providers with multiple contracts, a wrap-around document may be useful. The IRS expects to issue model language for plan documents in the near future.

403(b) Exchanges

The final regulations narrow the circumstances under which transfers can be made from and between 403(b) investments. Under the final regulations, only three types of non-taxable exchanges or transfers are permitted for 403(b) contracts:

1. a change of investment within the same plan;
2. a plan to plan transfer between 403(b) plans; and
3. a transfer to a governmental defined-benefit plan to purchase permissive service credit.

An exchange within the same plan must meet the following requirements:

- the plan must explicitly permit such exchanges;
- the participant's benefit must not be less after the exchange (compared to before); and
- the distribution rules for the transferred amount after transfer must not be more liberal; **and**
- the employer must enter into an information sharing agreement with the issuer to provide information necessary for compliance with the 403(b) rules (employment status, contribution information, etc.).

A plan to plan transfer from one 403(b) plan to another 403(b) plan must meet the following requirements:

- the participant must be an employee (or former employee) of the employer for the recipient plan;

- both plans must provide for such transfers;
- the participant's benefit must be maintained at the same amount (it cannot be less immediately after the transfer);
- the recipient plan must provide that it will maintain the same distribution restrictions on the transferred amount as applied under transferor plan; and
- if the transfer is less than 100% of the participant's account, the recipient plan must continue to account for any *pro rata* portion of after-tax contributions in the participant's account.

The final regulations effectively override the prior guidance on 403(b) transfers under Revenue Ruling 90-24. After 2008, transfers to 403(b) products unassociated with an employer's plan are prohibited by the regulations. In fact, transfers after September 24, 2007 that do not meet the requirements above before January 1, 2009 (by way of subsequent transfers to an employer's or former employer's plan) will no longer qualify under 403(b). Hopefully, future guidance will clarify what happens to 403(b) contracts if they cease to comply with the 403(b) rules.

A transfer from a 403(b) plan to a governmental defined benefit plan to purchase service credit may be made if the service purchase falls within the definition of permissive service credit under section 415(n)(3)(A) of the Internal Revenue Code (the "Code").

Universal Availability (Church Plans Exempt)

Salary deferral contributions to a 403(b) plan are not subject to nondiscrimination testing but are subject to a universal availability rule. The final regulations provide that all employees of the employer must be permitted to make salary deferrals under the 403(b) plan except:

- nonresident aliens;
- employees who are eligible to make salary deferrals to another 403(b) plan, a 401(k) plan or a 457(b) plan;
- students under a work study program; and
- employees working less than 20 hours a week (the employer must expect the employee to work less than 1,000 hours in the upcoming year and the employee must have worked less to 1,000 hours in the preceding year).

The 403(b) plan can require minimal deferrals of \$200 per year. An employer cannot condition other rights and benefits on an employee's choice to defer or not to defer to a 403(b) plan. Employers must provide employees both notice of and the opportunity to defer (or change elections) to employees at least once a year. Section 403(b) plans can elect to have automatic enrollment for salary deferrals.

Nondiscrimination Testing (Church Plans Exempt)

The final regulations confirm that employer contributions to a 403(b) plan are subject to nondiscrimination testing under section 401(a)(4) of the Code. Matching contributions made to a 403(b) plan are subject to nondiscrimination testing under section 401(m) of the Code (the Actual Contribution Percentage test). Both employer contributions and matching contributions to a 403(b) plan must meet the minimum coverage test under section 410(b) of the Code.

Maximum Deferrals and Limits

The total amount of salary deferrals to a 403(b) plan is limited to \$15,500 a year (section 402(g) of the Code) plus any catch up amounts. Deferrals to a 403(b) plan are combined with deferrals to a 401(k) plan for purposes of this limit. The maximum of all contributions including employer contributions, matching and deferrals cannot exceed the Code section 415(c) limit of \$45,000 per year (or 100% of a participant's compensation, if less).

Catch up Contributions

- a catch up contribution of \$5,000 a year (section 414(r) of the Code) is available for participants age 50 or older; and
- a special catch up contribution rule increases the deferred limit by lesser of:
 1. \$3,000,
 2. excess of \$15,000 over prior year 403(b) deferrals with current employer, or
 3. excess of \$5,000 x years with employer, over total prior year deferrals with employer.

3. the employer's involvement is limited to:
 - allowing providers of contracts or custodial accounts to publicize offerings to employees (the employer can limit the number of vendors and products offered to employees),
 - requesting information about the products,
 - summarizing or compiling information about offered products,
 - collecting and transmitting salary deferrals, or
 - holding the contracts; and
4. the employer is not paid to offer the plan or products except to cover reasonable expenses to administer salary deferrals.

DOL FAB 2007-02

The DOL believes the employer can conduct administrative review of program and operation for tax compliance with-

out those acts creating an ERISA-covered plan. DOL Field Assistance Bulletin No. 2007-02 (July 24, 2007). Permitted acts under the exemption from ERISA include testing for limits, improving administrative functions to avoid tax problems, keeping necessary records, and providing employee information to providers. The employer cannot make discretionary determinations such as authorizing distributions, transfers, administering QDROs, authorizing hardship distributions or loans (or administering hardship distributions or loans). Maintenance of a written document to coordinate administration among different issuers and address tax matters is permitted. The plan document can describe the employer's limited role. FAB 2007-02 implies that, if the number of providers is limited, employees must be able to transfer their funds to any provider whose product is compliant with tax rules and who agrees to the plan's division of responsibilities.

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Heightened Scrutiny of Retirement Plan Fees Reaches 403(b) Plans

By Anne C. Hydorn

It's no secret that retirement plan fees are under heightened scrutiny. Over the past year, numerous lawsuits have been filed targeting 401(k) plan fees. Plaintiffs are alleging that fiduciaries have breached their fiduciary duties by causing plans to be charged excessive and unreasonable fees. On July 26, 2007, House Education and Labor Committee Chairman George Miller (D-Calif.) introduced a bill that would require new ERISA covered retirement plan fee disclosures and Congress will likely begin debating the issue sometime this year. The Department of Labor also plans to issue regulations with new fee disclosure rules for 401(k) plans.

All of this attention has brought a new target into the cross hairs. Tax-deferred annuities, or 403(b) plans, appear to be an emerging new focus of plan fee litigation. In July of this year, a major class action lawsuit was filed against the National Education Association (NEA), Nationwide Life Insurance Company, and Security Distributors, Inc. (SDI) by participants in NEA's Valuebuilder Plan, a 403(b) tax-deferred retirement savings program. What was one of the primary allegations? Defendants breached their fiduciary duties by charging excessive and unreasonable fees that materially reduced participant account balances.

In this onslaught of litigation and sharpened focus on retirement plan fees, employers offering 403(b) plans and plan fiduciaries should act promptly and diligently to evaluate and ensure the reasonableness of fees that their service providers are charging. Unfortunately, this may not be an easy task, because inherent in the problem is the somewhat hidden nature of how service providers collect their fees.

The U.S. Securities and Exchange Commission (SEC) has published an article entitled "Evaluating Your Retirement Options" on its website.¹ This article explains the typical investments in a 403(b) plan, such as variable annuities, and explores the questions that should be asked by participants regarding potential fees that might be charged under each of their 403(b) plan investments.

Although participants in 403(b) plans are the targeted audience, the article is equally instructive for plan sponsors. As plan participants become more educated about these issues due to the increased publicity about plan fees, the SEC article poses the types of questions plan sponsors and fiduciaries must be prepared to answer and should also be asking service providers.

The kinds of fees and expenses that might affect a participant's investment return under a 403(b) plan include, but are not limited

to: 12b-1 fees, other revenue-sharing payments, administrative and recordkeeping fees, surrender charges, contingent deferred sales loads, shareholder redemption fees, and other annual fees. When added together, these fees can take a hefty bite out of participants' accounts and significantly dampen their rate of return.

While it remains to be seen how the quickly escalating plan fee litigation will play out, 403(b) plan sponsors and fiduciaries should take appropriate actions now. Plan sponsors should evaluate the extent of their fiduciary duties, if any, to participants in a 403(b) plan. For example, did the plan sponsor select and assist in marketing any of the investments under the 403(b) plan? Additionally, plan sponsors should start asking service providers to disclose and explain their revenue sharing arrangements to discern not only the fees associated with such arrangements, but also whether any conflicts of interests exist. Plan sponsors should also ask for full and adequate disclosures of all fees that will be charged under each investment offered. The Department of Labor advice regarding 401(k) plan fees provides useful guidance to plan sponsors. (See <http://www.dol.gov/ebsa/fiduciaryeducation.html> [under publications].) Service providers should provide these same fee disclosures to plan participants so that participants are able to make fully informed investment decisions.

Any unwillingness by a service provider to cooperate or disclose this information should be a signal to plan sponsors and fiduciaries to evaluate the provider closely. Likewise, if fees under the plan are unreasonably high, plan sponsors should consider changes to reduce fees. Management of these issues is an ongoing responsibility so plan fiduciaries should have a procedure in place to periodically evaluate plan expenses. Plan fiduciaries should also carefully document the actions they take to demonstrate that they have carefully evaluated and monitored fees being paid under their 403(b) plans.

Congressional Proposal

Chairman Miller's proposed bill would require 401(k) fee disclosure, including extensive annual disclosures to participants, comprehensive conflict of interest disclosures, annual participant statements with required content disclosing fees and inclusion of at least one index fund in the investment options menu. We would expect similar standards to evolve for 403(b) plans if this proposed legislation passes.

Items 2 and 3 are only available to employees of:

- hospitals,
- health and welfare service organizations, and
- church related organizations.

The special catch-up must be counted before the age 50 catch-up.

Contributions for Former Employees

The Code section 415(c) limit on total contributions to a 403(b) plan, including deferrals, is the lesser of \$45,000 or 100% of compensation.

Under a special rule for 403(b) plans, compensation for purposes of this limit is deemed to be a former employee's annual compensation for last year of employment (based on average monthly compensation). This deemed compensation extends to a period of five years after year of termination. This permits employers to continue making employer contributions on behalf of a former employee for five years after leaving employment.

Distributions from 403(b) Plan Deferrals

Distributions of elective deferrals can occur upon the earliest of:

- severance from employment,
- death,
- hardship (determined under the 401(k) rules),
- disability, or
- age 59½.

The minimum distribution rules of Code section 401(a)(9) apply to a 403(b) plan (i.e., distributions must commence after later of retirement or age 70½).

Hardship

A hardship distribution is permitted from a 403(b) plan to the extent needed to alleviate hardship caused by:

- expenses for medical care;
- purchase of primary residence (not mortgage payments);
- tuition, fees, room and board for up to 12 months of college or graduate school;
- payments to prevent eviction;

- funeral expenses for parents, spouse or dependents; and
- expense to repair casualty loss.

Hardship distributions are available if these events occur for a participant's designated beneficiary to the extent it would justify a hardship distribution for the participant.

Roth Contributions

A 403(b) plan can permit Roth contributions – i.e., after-tax contributions, subject to the following.

- The plan must separately account for such Roth contributions.
- The limits remain the same – Roth contributions are treated like deferrals for purposes of limits on contributions and distributions rules.
- Qualified distributions are not taxed if such distribution is made after a five-year holding period,
 - Qualified distributions are distributions:
 - made after age 59½, or
 - made after death.
 - A five-year holding period is five tax years from first year of a Roth contribution (begins the first day of tax year during which first Roth contribution is made) (special rule for re-employed veterans).

The total qualified distribution is tax free, including all earnings. If the distribution is not a qualified distribution, earnings are taxed.

Investments Permitted Under a 403(b) Plan

- annuity contracts – issued by a licensed insurance company; or
- custodial accounts – a bank or other approved provider holding mutual funds

ERISA Coverage

If the only contributions are salary deferrals, a 403(b) plan is not covered by ERISA if:

1. participation is voluntary;
2. all rights under the annuity contract or custodial account are enforceable solely by the employee;