TO (B) OR NOT TO (B): IS THAT THE QUESTION?[1] TWENTY-FIRST CENTURY SCHIZOID PLANS UNDER SECTION 403(B) OF THE INTERNAL REVENUE CODE[2]

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[1] Apologies to William Shakespeare and Prince Hamlet, who would not have been a good retirement plan fiduciary. I am not the first person to attempt to link Shakespeare and pensions, however implausibly. *See, e.g.*, Podcast: Shakespeare on Pensions Radio! (Mar. 6, 2008), www.scottishlife.co.uk/scotlife/Web/Site/BeeHive/Podcasts.asp; Jim Doran, *Is This a Pension I See Before Me?*, PENSIONS MANAGEMENT, May 1, 2005, available at http://www.pensions-management.co.uk/news/fullstory.php/aid/1841/Is_this_a_pension_I_see_before_me_.html. Unlike Shakespeare, his rival and contemporary Ben Jonson received from James I a "royal pension of 100 marks per annum for life, with an annual butt of Canary wine." Robert Giroux, *The Man Who Knew Shakespeare*, N.Y. TIMES, Feb. 13, 2000, available at http://www.nytimes.com/books/00/02/13/bookend/bookend.html. Dr. Johnson, the pioneering lexicographer, had a low opinion of pensioners. He defined pension as follows: "[a]n allowance made to any one without an equivalent. In England it is generally [understood] to mean pay given to a [state] hireling for [treason] to his country." SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE (1979).

[2] Acknowledgments and apologies to Robert Fripp and King Crimson. *See* King Crimson, http://www.king-crimson.com (last visited November 9, 2009).

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I. INTRODUCTION

In 1996, I published an article in this law review[3] that discussed in detail the rules governing retirement plans described in Section 403(b) of the Internal Revenue Code ("Code").[4] The year 2008 marked the fiftieth anniversary of the enactment of section 403(b), and so it is an appropriate time to revisit these issues and discuss developments that have occurred since 1996.

Section 403(b) provides a special type of tax-favored retirement arrangement that is available only to three types of employers: (1) organizations that are tax-exempt under Code section 501(c)(3); (2) public educational institutions; and (3) ministers of religion.[5] These arrangements are variously known as "403(b) plans," "403(b) arrangements," and "tax-sheltered annuity arrangements."

[3] David A. Pratt, *Very Serious Business: Sense and Nonsense Under Section 403(b) of the Internal Revenue Code of 1986*, 59 ALB. L. REV. 1197 (1996) [hereinafter Pratt, 1996 Article].

[4] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 23, 72 Stat. 1606, 1620 [hereinafter TAA 58] (codified as amended at I.R.C. § 403(b) (2006)). The Internal Revenue Code of 1986, as amended, is codified at Title 26 of the U.S. Code. Unlike some other U.S.C. Titles, the section numbers of the Internal Revenue Code are always the same as their U.S.C. counterparts, so section 403(b) of the Internal Revenue Code is also section 403(b) of Title 26. I.R.C. § 403(b) (2006), 26 U.S.C. § 403(b) (2006).

[5] I.R.C. § 403(b)(1) (2006). Two recent cases discuss whether an employee organization (in each case, a teachers' union) may establish a 403(b) plan: Montoya v. ING Life Ins. & Annuity Co., No. 07 Civ. 2574(NRB), 2009 WL 2850748, at *8 (S.D.N.Y. Aug. 31, 2009); Daniels-Hall v. Nat'l Educ. Ass'n, No. C 07-5339RBL, 2008 WL 2179530, at *11 (W.D. Wash. May 23, 2008); *see also DOL Files Amicus Brief Supporting Position That NEA Didn't Create Section 403(b) Plan*, 36 Pens. & Ben. Rep. (BNA) 2114 (Sept. 15, 2009).

Like its younger but better-known cousin, the 401(k) plan,[6] the 403(b) plan has morphed into something very different from what was originally envisaged. From its inception, a 403(b) plan could only be made available by an "eligible employer" but, unlike "qualified plans"[7] subject to the rules of Code section 401(a), 403(b) plans were not viewed as a retirement savings vehicle for employees generally. Rather, section 403(b) was enacted to limit the extent to which highly paid employees of tax-exempt employers could defer income taxation by voluntarily deferring a portion of their compensation.[8]

Prior to 1958, employees of certain tax-exempt organizations could defer all or part of their income from the organization through the use of a tax-sheltered annuity arrangement.[9] Under the 1958 legislation, an employee's deferral for income tax purposes was limited to the "exclusion allowance," a calculation based on the employee's compensation and length of service with the employer.[10] From these modest beginnings, section 403(b) has become an integral part of the benefit packages of eligible employers. Many tax-exempt organizations (including private schools, colleges, and

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[6] Section 401(k) was enacted by the Revenue Act of 1978, though cash or deferred profit-sharing plans existed, and had been approved by the Internal Revenue Service ("IRS"), many years before that. Revenue Act of 1978, Pub. L. No. 95-600, § 135(a), 92 Stat. 2763, 2785–87 (codified as amended at I.R.C. § 401(k) (2006)).

[7] A qualified plan is simply a retirement plan that satisfies the numerous qualification requirements set out in Code section 401(a), in form and in operation. I.R.C. § 401(a) (2006). A qualified plan is generally funded through a trust, which is tax-exempt under section 501(a) of the Code. I.R.C. § 501(a) (2006).

[8] According to the legislative history:

> Under section 403 of present law an annuity purchased by an employer under a qualified nondiscriminatory type of plan is taxable at the time the employee receives the annuity payment rather than in the year the payments are made for the annuity by the employer. However, where the employer is a tax-exempt educational, charitable, or religious organization, described in section 501 (c)(3), this deferment of tax in the case of the employee is available with respect to annuities whether or not they are paid under a qualified nondiscriminatory type of plan.
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> It has been called to the attention of your committee that certain of these organizations are paying selected employees all, or almost all, of their compensation in the form of annuities. Usually these are part-time employees of the organization who derive their principal income from other employment, and desire to be compensated by the organization in the form of an annuity rather than money, as a means of deferring tax on funds they in any case intend to save.
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> Your committee does not believe that these organizations should be permitted to trade on this tax-deferment privilege for their employees.

H.R. REP. NO. 85-775, at § 19(a) (1957), *reprinted in* 6 INTERNAL REVENUE ACTS OF THE UNITED STATES: REVENUE ACTS OF 1953-1972 WITH LEGISLATIVE HISTORIES, LAWS AND CONGRESSIONAL DOCUMENTS 15–16 (Bernard D. Reams, Jr. ed., 1985).

[9] *Id.* at 16.

[10] I.R.C. § 403(b)(2), *repealed by* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 632(a)(2)(B), 115 Stat. 38, 113 [hereinafter EGTRRA 2001].

hospitals) use a 403(b) plan as their primary retirement plan while others (such as public school districts) maintain 403(b) arrangements, often funded exclusively by employee deferrals, to supplement their primary plans.[11] As of December 31, 2007, 403(b) plans held a total of $692 billion in assets.[12]

In 1958, and until several years after the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"),[13] the other major federal statute governing retirement plans, the dominant form of retirement plan was the traditional defined benefit plan.[14] 403(b) plans (like 401(k) plans,[15] in the years immediately following the enactment of section 401(k) in 1978) were viewed as being merely supplements to the primary plan.[16]

Since then, the landscape has changed dramatically. First, the number of traditional (defined benefit) pension plans has declined significantly.[17] As Professor Zelinsky has observed,[18] we live in a

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[11] *See, e.g.*, Peter M. Kelly, *Benefit Planning for Tax-Exempt Organizations*, N.Y.U. 43RD ANNUAL INSTITUTE ON FEDERAL TAXATION, CONFERENCE ON EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 7.05 (1985).

[12] Spectrem Group, The 403(b) Market, *available at* http://403bwise.com/features/403bmarket.html. Of that total, 45% was invested in fixed annuities, 34% in variable annuities and 21% in mutual funds. Twenty-six percent was attributable to public (K through 12) schools, 7% to private (K through 12) schools, 44% to higher education, 19% to healthcare and 4% to other employers. *Id.*

[13] ERISA, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 26 U.S.C. and 29 U.S.C. (2006)). Unlike the Internal Revenue Code, the ERISA section numbers do not coincide with the 29 U.S.C. section numbers so, for instance, section 3 of ERISA is 29 U.S.C. section 1002. ERISA § 3, 29 U.S.C. § 1002 (2006).

[14] A defined benefit plan is a pension plan that is not a defined contribution (individual account) plan. ERISA § 3(35), 29 U.S.C. § 1002 (2006); I.R.C. § 414(j) (2006). A defined contribution plan is a pension plan that provides for one or more individual accounts for each participant, and for benefits based *solely* upon the account balance (contributions, plus forfeitures, plus net investment earnings, less expenses). ERISA § 3(34), 29 U.S.C. § 1002 (2006); I.R.C. § 414(i) (2006). A traditional defined benefit plan generally provides monthly benefits for life, the amount being determined by the participant's salary history and length of service. A recent variant is a hybrid plan, such as a cash balance plan, that combines some characteristics of a defined benefit plan and some characteristics of a defined contribution plan. These hybrid plans are classified as defined benefit plans, because benefits are not based *solely* on an account balance.

[15] A 401(k) plan is a tax-qualified plan which includes a "qualified cash or deferred arrangement." I.R.C. § 401(k)(2) (2006). Like a 403(b) plan, a 401(k) plan allows a participating employee (within limits) to defer income taxation by electing to have a portion of his or her compensation from the employer contributed to his or her account under the plan, rather than paid to him or her currently. *See* I.R.C. § 401(k) (2006). Income taxation of the amount deferred is typically postponed until the deferred amount is paid to the employee, which may be many years in the future. I.R.C. § 402 (2006).

[16] Pratt, 1996 Article, *supra* note 3, at 1201.

[17] The number of private-sector defined benefit plans reached a peak of 112,000 in the mid-1980s. At that time, about one-third of American workers were covered by defined benefit plans. The number of plans now stands at about 30,000.

In recent years, many employers have chosen not to adopt defined benefit plans, and defined contribution world, and defined benefit plans are now largely limited to the public sector, very large employers, and multi-employer plans of large national unions such as the Teamsters.[19] Defined contribution plans have increasingly replaced defined benefit plans as the primary retirement savings vehicle.[20] Unlike traditional defined benefit plans, these plans generally require employees to contribute part of the cost, typically through voluntary deferrals, which are then matched by the employer.[21]

Second, 403(b) plans have gradually been subjected to many of the rules that previously applied only to qualified plans.[22] This has greatly increased the complexity of the 403(b) plan rules and has also created difficulties in determining how rules that were designed for qualified plans should be applied to 403(b) plans, which evolved for very different reasons and in very different ways.[23] As originally enacted, section 403(b) was relatively straightforward. The rules, however, have now become a complex mixture of (1) rules applicable only to 403(b) arrangements, (2) rules applicable to qualified plans under section 401(a), which have been extended to 403(b) arrangements, often with modifications, and (3) special rules applicable only to certain types of employers.[24]

Until recently, 403(b) arrangements received little attention from the IRS, and no IRS program existed for approving plan documents, comparable to the determination letter program for qualified plans.[25] The difficulty of complying with the section 403(b) rules is

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others have chosen to terminate their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants were terminated. PENSION BENEFIT GUAR. CORP., AN ANALYSIS OF FROZEN DEFINED BENEFIT PLANS 1 (2005), http://www.pbgc.gov/docs/frozen_plans_1205.pdf.

[18] Edward A. Zelinsky, The Origins of the Ownership Society: How the Defined Contribution Paradigm Changed America 139–40 (2007).

[19] *Id.*

[20] *Id.* at 57–58.

[21] *Id.* at 2–3.

[22] *See infra* Part II (summarizing the evolution of section 403(b)).

[23] *Id.*

[24] For instance, the limitations on contributions and benefits under Code section 415 were designed primarily for plans qualified under section 401(a), but were extended to 403(b) arrangements with complex modifications. *See* I.R.C. §§ 415(c)(4) (repealed 2001), (c)(7) (repealed 1996), (e)(5) (repealed 1996) and (k)(4) (2006). Some 403(b) rules apply to a subset of eligible employers (educational organizations, hospitals, home health service agencies, health and welfare service agencies, and certain churches)—e.g., I.R.C. § 402(g)(8) (2006)—whereas other rules apply only to certain church employers—e.g., I.R.C. §§ 403(b)(9) (2006), 415(c)(7) (repealed 1996). Section 403(b) even uses different definitions of "church" for different purposes. *Compare* I.R.C. § 403(b)(9) (2006) (referring to the definition in section 414(e)(3)(A) (2006)), *with* I.R.C. § 403(b)(12)(B) (2006) (using the definition in section 3121(w)(3)(B)).

[25] The determination letter and prototype approval procedures applicable to qualified plans

illustrated by the fact that, after many years of benign neglect, the IRS discovered, as part of its program of auditing tax-exempt colleges and hospitals, that there was a high level of noncompliance.[26] Substantial sanctions were imposed on certain employers: negotiated compliance settlements relating to defects in 403(b) arrangements were in the "million dollar ranges."[27] In 1995, an IRS official stated that section 403(b) noncompliance was the hottest employee benefit issue for the IRS, and that all future audits of exempt organizations would include a review of their 403(b) arrangements.[28]

The changes to section 403(b)[29] resulted in a serious disconnect between the statutory requirements and the regulations issued under section 403(b) by the Treasury Department and IRS. As a result, the Treasury and IRS have now issued new regulations,[30]

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do not apply to 403(b) plans. Rev. Proc. 2009-6, 2009-1 C.B. 189. The IRS may issue a Private Letter Ruling on a 403(b) arrangement, but few have been requested or issued. Each year, the IRS receives about seventy-five private letter ruling requests relating to 403(b) arrangements, and it issued about 1,000 such rulings between the 1960s and 1995. C. Frederick Reish & Ilene H. Ferenczy, *403(b) Plan Documents: A Step Toward Compliance*, 3 J. PENSION BENEFITS 81, 84 (1995). The IRS has now issued a draft of a preapproved plan document program for 403(b) plans. I.R.S. Ann. 2009-34, 2009-1 C.B. 91; *see also infra* text accompanying note 318.

[26] *See* IRS Considers Broadening Scope of Audits of Tax-Exempt Institutions, Official Says, 21 Pens. & Ben. Rep. (BNA) 953, 953 (May 16, 1994); IRS Will Emphasize Examination Program as Keystone of Its Pension Plan Compliance Program, [Aug. 1991–June 1993 Transfer Binder] Pens. Plan Guide (CCH) ¶ 26,327, at 27,039–14 (Feb. 21, 1992).

[27] Frank P. Sebree, *403(b) Plan Violations Settled in "Million Dollar Ranges," Says IRS Official*, 67 TAX NOTES 387, 387 (Apr. 17, 1995), 67 Tax Notes 387 (LEXIS).

[28] Concern About Section 403(b) Compliance Hottest Benefits Issue, IRS Official Says, 22 Pens. & Ben. Rep. (BNA) 1363, 1363 (June 12, 1995); *see also* IRS Mobilized to Examine Plans for Section 403(b) Errors, Official Says, 22 Pens. & Ben. Rep. (BNA) 1319, 1319 (June 5, 1995). This report quoted Robert J. Architect, quality control officer, IRS Employee Plans Division, who also cited estimates that 90% of 403(b) arrangements violated the rules limiting employee contributions. *Id.*

[29] *See infra* Part II (summarizing the evolution of section 403(b)).

[30] *See* Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury); Treas. Reg. § 1.402(g)(3)-1 (as amended in 2007); *see also* Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 69 Fed. Reg. 67,075 (proposed Nov. 16, 2004) (to be codified at Treas. Reg. pts. 1 and 31) (preamble to proposed regulations for Dep't of Treasury). The Treasury and IRS also issued regulations, Payments Made by Reason of a Salary Reduction Agreement, 72 Fed. Reg. 64,939 (Nov. 19, 2007) (to be codified at Treas. Reg. pt. 31), codifying the IRS administrative position that employment taxes apply to salary reduction contributions that are mandatory or are made pursuant to a one-time irrevocable election, even though, for purposes of section 402(g)(3)(C), an elective deferral does not include a contribution that is made pursuant to an employee's one-time irrevocable election made on or before the employee's first becoming eligible to participate under the employer's plan or a contribution made as a condition of employment that reduces the employee's compensation. *Id.* at 64,940–41.

the first comprehensive 403(b) regulations for forty years,[31] which reflect statutory amendments to section 403(b) up to and including the Pension Protection Act of 2006 ("PPA").[32] These regulations are helpful in many respects. They do, however, include several controversial changes and several other changes that do not appear to be required or (in some cases) even warranted by the statute. The regulations are generally effective in 2009.[33]

Comments submitted to the Treasury and IRS in response to the proposed regulations illustrate two diametrically opposed views of the role of section 403(b) plans in today's retirement system. The first, represented by many provisions of the regulations and discussed in the preamble to the regulations, is that convergence of the 403(b) plan rules and the 401(k) plan rules is appropriate. The second is that differences between the 403(b) plan rules and the 401(k) plan rules are necessary because of fundamental differences between the tax-exempt employers to which 403(b) plans are available and the businesses who are the primary sponsors of qualified plans. Proponents of this view argue that the regulations do not sufficiently respect these differences.

Part II of this article will summarize the evolution of the 403(b) plan rules from 1958 to today. Part III will summarize the more important 403(b) plan rules and the major remaining differences between 403(b) plans and qualified plans. Part IV will discuss reform proposals, and whether retention of section 403(b) plans can be justified on policy (as opposed to historical) grounds.

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[31] As the preamble to the proposed regulations states:

> Like the 2004 proposed regulations, these final regulations are a comprehensive update of the current regulations under section 403(b). These regulations replace the existing final regulations that were adopted in 1964 and reflect the numerous legal changes that have been made in section 403(b) since then and many of the positions that have been taken in interpretive guidance that has been issued under section 403(b).

Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,129 (July 26, 2007) (to be codified at Treas. Reg. pt. 1) (preamble to proposed regulations for Dep't of Treasury).

[32] Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 811, 821, 822, 824, 826, 829, 120 Stat. 780, 996–1002 [hereinafter PPA 2006] (codified as amended in scattered sections of 26 U.S.C.).

[33] Treas. Reg. § 1.403(b)-11 (as amended in 2007). The regulations were originally proposed to be effective for taxable years beginning after December 31, 2005, subject to transition rules. Prop. Treas. Reg. § 1.403(b)-11, 62 Fed. Reg. 67,075, 67,098 (Nov. 16, 2004).

II. THE EVOLUTION OF SECTION 403(B)[34]

A. *Before the Fall: 1958 Through 1985*

As originally enacted, section 403(b)(1) was relatively simple.[35] The amount excluded from income for any taxable year was limited to the "exclusion allowance," namely the excess (if any) of (i) 20% of the employee's "includible compensation," multiplied by the number of the employee's "years of service," over (ii) the aggregate amount contributed by the employer, and excluded from the employee's gross income, for all prior taxable years.[36]

There are three notable features of the original statute. First, it was available only to private employers that were tax-exempt under Code section 501(c)(3).[37] Second, the only permissible funding vehicle was an annuity contract.[38] Third, unlike qualified plans described in section 401(a), or qualified annuity programs described in section 403(a), there was no requirement that a 403(b) plan be nondiscriminatory.[39] It could be, and often was, limited to highly

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[34] *See generally* Pratt, 1996 Article, *supra* note 3 (discussing the evolution of section 403(b)).

[35] I.R.C. § 403(b)(1), as enacted by section 23(a) of the TAA 58 reads as follows:

> General Rule.—If—(A) an annuity contract is purchased for an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a), (B) such annuity contract is not subject to subsection (a), and (C) the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums, then amounts contributed by such employer for such annuity contract on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the exclusion allowance for such taxable year. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72(e)(3) shall not apply.

TAA 58, Pub. L. No. 85-866, § 23(b)(1), 72 Stat. 1606, 1620–21 (codified as amended at I.R.C. § 403(b) (2006)). The section was effective for taxable years beginning after 1957. § 23(g), 72 Stat. at 1623. If the employee's rights were originally forfeitable, but later become nonforfeitable, then the amount that would otherwise have been taxable, as a result of the change, was treated as an amount contributed by the employer as of the time of the change. § 23(b)(6), 72 Stat. at 1621. This provision was repealed in 2002 by the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 411(p)(2), 116 Stat. 21, 50 (codified as amended at I.R.C. § 403 (2006)). Section 411(p)(1) made a conforming change to section 403(b)(1). § 411(p)(1), 116 Stat. at 49–50.

[36] TAA 58, Pub. L. No. 85-866, § 23(b)(2), 72 Stat. 1606, 1621 (codified as amended at I.R.C. § 403(b) (2006)).

[37] Private employers that are tax-exempt under any other subsection of section 501 were not, and are still not, eligible to sponsor a 403(b) plan. TAA 58 § 23(b)(1)(A), 72 Stat. at 1620 (codified as amended at I.R.C. § 403(b), (1) (2006)).

[38] TAA 58, § 23(b)(1)(A), 72 Stat. at 1620.

[39] I.R.C. § 401(a)(4) (2006); Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,129 (July 26, 2007) (to be codified at Treas. Reg. pt. 1) (preamble to final regulations for Dep't of Treasury); I.R.S. Notice 89-23, 1989-1 C.B.

paid employees.[40]

In 1961, Congress expanded the class of eligible employers to allow a state, a political subdivision of a state, or an agency or instrumentality of either, to buy an annuity for an employee who performs services for an educational institution.[41] This change was made in response to a ruling by the IRS that public school systems did not qualify to sponsor a 403(b) plan because they are not organizations described in section 501(c)(3).[42] This change was made retroactively effective for taxable years beginning after 1957,[43] as the Senate Finance Committee "viewed this amendment as a clarification of the law."[44]

In 1974, Congress enacted several substantive changes as part of ERISA.[45] First, Congress authorized an alternative to annuity contracts by allowing employers to contribute to a custodial account invested in regulated investment company stock (i.e., mutual funds).[46] Congress also imposed a 6% penalty tax on the amount of any "excess contributions" to a custodial account.[47] This tax does not apply to excess contributions to an annuity contract.[48]

Second, ERISA added Code section 415, which imposes

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[40] H.R. REP. NO. 99-841 at 4492, 4499 (1986) (Conf. Rep.) *reprinted in* 1986 U.S.C.C.A.N. 4075, 4492, 4499.

[41] Pub. L. 87-370, § 3(a), 75 Stat. 796, 801 (1961) (codified as amended at I.R.C. § 403(b) (2006)). Originally, the statute (as amended) referred to "an educational institution (as defined in section 151(e)(4)"). § 3(a), 75 Stat. at 801. This was subsequently amended to refer to "an educational organization described in section 170(b)(1)(A)(ii)," effective for taxable years beginning after 1976. *See* Pub. L. No. 94-455, § 1901(b)(8)(A), 90 Stat. 1520, 1794 (codified as amended at I.R.C. § 403(b)(1)(A)(ii) (2006)). In 1996, eligibility was extended to Indian tribal governments, but only with respect to contracts purchased in a plan year beginning before 1995. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1450(b), 10 Stat. 1755, 1814 [hereinafter SBJPA] (codified as amended at I.R.C. § 403(b)(1)(A)(ii) (2006)).

[42] S. REP. NO. 87-730, at 3253 (1961) (Conf. Rep.), *reprinted in* 1961 U.S.C.C.A.N. 3252, 3253.

[43] Pub. L. No. 87-370, § 3(b), 75 Stat. 796, 801 (1961) (codified as amended at I.R.C. § 403(b) (2006)).

[44] S. REP. NO. 87-730, at 3254 (1961) (Conf. Rep.), *reprinted in* 1961 U.S.C.C.A.N. 3252, 3254.

[45] ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections in 29 U.S.C. and 26 U.S.C.).

[46] ERISA, Pub. L. No. 93-406, § 1022(e), 88 Stat. 829, 1072 (1974) (codified as amended at I.R.C. § 403(b)(7) (2006) (effective Jan. 1, 1974)).

[47] 26 U.S.C. § 4973 (a)(3), (c) (2006) (originally enacted as ERISA, Pub. L. No. 93-406, § 2002(d), 88 Stat. 829, 1104–05 (1974)).

[48] "[T]he 6 percent tax is not imposed on section 403(b) annuity contracts, since earnings on annuity contracts are not taxable until distributed, even when the annuities are purchased outside the scope of a qualified plan." H.R. REP. NO. 93-1280 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5120–21.

limitations on contributions to and benefits under qualified plans.[49] These limitations apply, with some modifications, to 403(b) plans,[50] so 403(b) plans were then subject to two separate limitations on contributions: the exclusion allowance under section 403(b)(2), and the limitations on "annual addition[s]" under section 415.[51]

The Revenue Act of 1978[52] ("the Act" or "Act") paved the way for twenty-first century retirement planning by enacting Code section 401(k), the statutory basis for 401(k) plans.[53] The Act also provided: (1) for tax-free rollovers of amounts held in 403(b) plans, to an individual retirement account or to another 403(b) plan;[54] and (2) that amounts rolled over to a 403(b) plan would not be considered employer contributions, and thus would not be subject to the contribution limitations (the exclusion allowance and the section 415 limitations).[55]

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[49] ERISA, Pub. L. No. 93-406, § 2004, 88 Stat. 829, 1121 (codified as amended at I.R.C. § 415 (2006)). The limitations became effective for years beginning after 1975.

[50] I.R.C. § 415(a)(2)(B) (2006). *See infra* Part III.H.

[51] Almost all 403(b) plans are defined contribution plans. As originally enacted, the limitation on annual additions to a participant's accounts under a defined contribution plan was the lesser of $25,000 or 25% of the participant's compensation from the employer. For 2009 and 2010, the limitation is the lesser of $49,000 or 100% of the participant's compensation from the employer. I.R.C. § 415(c)(1) (2006). I.R.C. section 415(c)(4) contained three special elections for participants in 403(b) plans maintained by educational institutions, hospitals, and home health service agencies. H.R. REP. NO. 93-1280 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5125–26. These special elections have now been repealed. In 1982, the special elections under section 415(c)(4) (since repealed) were extended to church plans, and a special new limitation was enacted for participants in church 403(b) plans. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 251(c), 96 Stat. 324, 530–31 [hereinafter TEFRA] (codified as amended at I.R.C. § 415(c)(4) (2006) (effective Jan. 1, 1982)).

[52] Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763 (codified as amended at I.R.C. § 401(k) (2006)).

[53] Revenue Act of 1978, Pub. L. No. 95-600, § 135(a), 92 Stat. 2763, 2785 (codified as amended at I.R.C. § 401(k) (2006)).

[54] Revenue Act of 1978, Pub. L. No. 95-600, § 156, 92 Stat. 2763, 2802 (codified as amended at I.R.C. § 403(b)(8) (2006)). The changes were effective for distributions or transfers made after December 31, 1977, in taxable years beginning after that date. § 156, 92 Stat. at 2803, *amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 101(a)(13)(A), 94 Stat. 194, 204 (codified as amended at I.R.C. § 403 (2006)).

[55] I.R.C. § 403(b)(1) (2006), *amended by* Revenue Act of 1978, Pub. L. No. 95-600, § 156(b), 92 Stat. 2763, 2802 (codified as amended at I.R.C. § 401(k) (2006)). The Act also deleted the previous statutory requirement, applicable to 403(b) custodial accounts but not to 403(b) annuity contracts, that the account must be used to provide a "retirement benefit." Proposed Treasury regulations had provided that the account could not be distributed until the participant attained the age of sixty-five, became disabled, died, or terminated employment and attained the age of fifty-five. Congress replaced it with a new requirement that amounts held in a 403(b) custodial account cannot be distributed until the participant dies, separates from service, becomes disabled, or encounters financial hardship. I.R.C. § 403(b)(7)(A) (2006), *amended by* Revenue Act of 1978, Pub. L. No. 95-600, § 154(a), 92 Stat. 2763, 2801 (codified as amended at I.R.C. § 401(k) (2006)). The change was effective for taxable years beginning

In 1982, The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") enacted Code section 403(b)(9), which gave church employers the option of maintaining a "retirement income account" as the funding vehicle for a 403(b) plan.[56] As a result, these church employers—and only these church employers—can fund 403(b) plans through investments other than annuity contracts and mutual funds.[57]

B. The Brave New World: The Tax Reform Act of 1986

The changes enacted through 1985, though significant, did not change the fundamental nature of 403(b) plans. The Tax Reform Act of 1986 ("TRA 86"),[58] which replaced the 1954 Code with the 1986 Code, enacted changes that made 403(b) plans significantly more like qualified plans than ever before.

First and most important, 403(b) plans of employers other than churches[59] were subjected to nondiscrimination rules for the first time.[60] A new "universal availability" rule applies to salary

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after 1978. Revenue Act of 1978, Pub. L. No. 95-600, § 154(b), 92 Stat. 2763, 2801 (codified as amended at I.R.C. § 401(k) (2006)). Again, these distribution restrictions do not apply to 403(b) annuity contracts. According to the legislative history:

> Although present law restricts the favorable insurance company tax treatment of tax-sheltered annuities to retirement annuities, State law generally requires that the owner of an annuity contract be able to obtain the cash surrender value of the contract if the contract is surrendered before annuity payments begin. Consequently, an employee who owns a tax-sheltered annuity contract may be able to surrender the contract before retirement and use the proceeds for purposes other than retirement.
>
> In the case of a regulated investment company, proposed Treasury regulations require that the stock is not to be distributed before the employee attains age 65 unless the employee becomes disabled or dies. Under the proposed regulations, the stock may be distributed after an employee has separated from the service of the employer only if the employee has attained age 55.
>
> The committee believes that the more restrictive rule for distributions of stock of a regulated investment company has imposed an undesirable competitive disadvantage on regulated investment companies.

S. REP. NO. 95-1263, at 95 (1978) (Conf. Rep.), *reprinted in* 1978 U.S.C.C.A.N. 6761, 6858.

[56] TEFRA, Pub. L. No. 97-248, § 251(b), 96 Stat. 324, 530 (codified as amended at I.R.C. § 403(b)(9) (2006)). This change was retroactively effective for taxable years beginning after 1974. § 251(e)(2), 96 Stat. at 353; *see also* S. REP. NO. 97-494, at 325–26 (1982) (Conf. Rep.), *reprinted in* 1982 U.S.C.C.A.N. 781, 1065-66; H.R. REP. NO. 97-760, at 636–38 (1982) (Conf. Rep.), *reprinted in* 1982 U.S.C.C.A.N. 1190, 1407–09.

[57] TEFRA also enacted a special correction period for church 403(b) plans and provided a special rule for existing church defined benefit 403(b) plans. TEFRA, Pub. L. No. 97-248, § 251(d), (e)(5), 96 Stat. 324, 531 (codified as amended at I.R.C. § 403 (2006)).

[58] Tax Reform Act of 1986, I.R.C. § 403 (2006) [hereinafter TRA 86].

[59] For this purpose, "church" means a church as defined in I.R.C. § 3121(w)(3)(A) (2006) or a qualified church-controlled organization as defined in § 3121(w)(3)(B) (2006). I.R.C. § 403(b)(12)(B) (2006).

[60] TRA 86, Pub. L. 99-514, § 1120, 2463, 100 Stat. 2085, 2463–64 (codified as amended at

reduction contributions.[61] With respect to other contributions (i.e., employer matching contributions and employer non-elective contributions), a 403(b) plan is required to comply with Code sections 401(a)(4) (nondiscrimination),[62] 401(a)(5) (additional nondiscrimination rules), 401(a)(17) (the $200,000 indexed limit on the amount of annual compensation that may be taken into account), 401(a)(26) (the minimum participation rule, subsequently limited to defined benefit plans) and 410(b) (the minimum employee coverage rules), in the same manner as if it were a qualified plan.[63]

The universal availability rule affects all eligible employers other than churches. The other nondiscrimination rules now affect only private sector employers, as state and local government employers were subsequently exempted from compliance with all of these rules, with the exception of the section 401(a)(17) compensation limitation.[64]

Second, the Act introduced a separate annual dollar limit on the amount of elective deferrals that could be made by an employee under a 401(k) plan and/or a 403(b) plan.[65] The dollar limit was

I.R.C. §§ 403(b)(1)(D), 403(b)(12) (2006)). Section 403(b)(12) was originally numbered 403(b)(10), and was renumbered by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1011(m)(1)(A), 102 Stat. 3342, 3471 [hereinafter TAMRA of 1988] (codified as amended in I.R.C. § 401 (2006)). By way of contrast, qualified plans had been subject to nondiscrimination rules since 1942, and 401(k) plans had been subject to nondiscrimination rules since they were authorized in 1978. *See* Revenue Act of 1942, Pub. L. No. 77-752, § 162, 56 Stat. 798, 862 (codified as amended at I.R.C. § 401(a)(4) (2006); Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763, 2785 (codified as amended at I.R.C. § 401(k)(3) (2006)). The new 403(b) nondiscrimination rules were effective for years beginning after 1988, subject to a delayed effective date for collectively bargained plans. TRA 86, Pub. L. 99-514, § 1120(c), 100 Stat. 2085, 2464, *amended by* TAMRA of 1988, Pub. L. No. 100-647, § 1011(m)(3), 102 Stat. 3342, 3471 (codified as amended at I.R.C. § 403 (2006)).

[61] I.R.C. § 403(b)(12)(A)(ii) (2006). *See infra* Part III.J.1.

[62] A plan that receives employer matching contributions and/or after-tax employee contributions must generally also satisfy the actual contribution percentage ("ACP") test under I.R.C. § 401(m) (2006).

[63] I.R.C. § 403(b)(12)(A)(i) (2006) (as modified by TAMRA of 1988, Pub. L. No. 100-647, § 1011(m)(2), 102 Stat. 3342, 3471 (codified as amended at I.R.C. § 401 (2006))). *See infra* Part III.J.2.

[64] I.R.C. § 403(b)(12)(C) (2006) (originally enacted as Taxpayer Relief Act of 1997, Pub. L. 105-34, § 1505(c), 111 Stat. 788, 1063 (1997) [hereinafter TRA 97]). Section 1505(d)(2) of the Taxpayer Relief Act further provides that state and local government plans are to be treated as satisfying the requirements of specified Code sections for years before the effective date of this change.

[65] TRA 86, Pub. L. 99-514, § 1105(a), 100 Stat. 2085, 2417–18 (1986) (codified as amended at I.R.C. § 402(g) (2006)). *See infra* Part III.D. The new limitation was generally effective for taxable years beginning after 1986. TRA 86, § 1105(c), I.R.C. § 402 (2006). As originally enacted, a 403(b) plan that provides for salary reduction agreements must comply with the limitation on elective deferrals. This was amended in 1996 to require the individual contracts under the plan, not the plan itself, to comply. I.R.C. § 403(b)(1)(E) (2006) (enacted by TAMRA of 1988, Pub. L. 100-647, § 1011(c)(7)(B), 100 Stat. 3471, 3458 (1988)), *amended by* SBJPA,

originally $7,000 for 401(k) plans and $9,500 for 403(b) plans: for 2009 and 2010, it is $16,500 for both.[66] The Act also provided a higher limit for any employee who has completed at least fifteen years of service with a "qualified organization," under which the annual deferral could be increased by up to $3,000.[67]

Accordingly, 403(b) plan contributions were then subject to three separate limitations: (1) elective deferrals (and only elective deferrals) were subject to the new dollar limit enacted by TRA; (2) employer contributions—including elective deferrals—were limited by the exclusion allowance; and (3) all "annual addition[s]"[68] were subject to the limitations of section 415.

The third major change was the enactment, for the first time, of distribution restrictions for 403(b) plan annuity contracts. The Act added a new section 403(b)(11), providing that distributions attributable to contributions made pursuant to a salary reduction agreement could be paid only when the employee attains age fifty-nine-and-one- half, separates from service, dies, becomes disabled, or incurs a hardship.[69] The Act also modified the distribution rules for section 403(b) custodial accounts by limiting hardship distributions to contributions made pursuant to a salary reduction agreement.[70]

Finally, the Act clarified the application of the minimum distribution rules (generally requiring distributions to begin at age seventy-and-one-half or, if later, on retirement), by subjecting

Pub. L. 104-188, § 1450(c)(1), 110 Stat. 1755, 1814 (1996) (codified as amended at I.R.C. § 403(b), 1003 (2009)). The concern was that, under the original language, a failure with respect to one participant could affect other participants: "The Committee does not believe that employees participating in a tax-sheltered annuity plan should be negatively affected if other employees violate the annual limit on elective deferrals with respect to their individual tax-sheltered annuity contracts (or custodial accounts)." S. REP. NO. 104-281, at 89 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1563.

[66] I.R.C. § 402(g) (2006).

[67] I.R.C. § 402(g)(7) (2006); *see infra* Part III.D.2. This provision was originally designated as I.R.C. § 402(g)(8), renumbered by EGTRRA 2001, Pub. L. No. 107-16, § 611(d)(3)(A), 115 Stat. 38, 98 (codified as amended at I.R.C § 402(g)(7) (2006)). A qualified organization means an educational organization, hospital, home health service agency, health and welfare service agency, church or convention or association of churches. I.R.C. § 402(g)(7)(B) (2006).

[68] The term "annual addition" includes all employer contributions, pre-tax elective deferrals, after-tax employee contributions and forfeitures credited to a participant's account. I.R.C. § 415(c)(2) (2006).

[69] I.R.C. § 403(b)(11) (2006) (originally enacted as TRA 86, Pub. L. 99-514, § 1123(c)(1), 100 Stat. 2085, 2474–75 (1986)).

[70] § 403(b)(7), *amended by* TRA 86, Pub. L. 99-514, § 1123(c)(2), 100 Stat. 2085, 2475 (1986); *see infra* Part III.M. The amendments made by § 1123(c) generally apply to years beginning after 1988, but there are special rules for pre-1989 accumulations. TRA 86, Pub. L. 99-514, § 1123(e), 100 Stat. 2085, 2475, *amended by* TAMRA of 1988, Pub. L. No. 100-647, § 1011A(c)(11), 102 Stat. 3342, 3476 (codified as amended by I.R.C. § 72 (2006)).

403(b) plans to requirements similar to those applicable to qualified plans under Code section 401(a)(9).[71]

C. Major Changes Enacted During the 1990s

In 1992, Congress required qualified plans and 403(b) plans to allow trustee-to-trustee transfers of benefit distributions that are eligible to be rolled over.[72] Before 1996, the regulations limited 403(b) plan participants (but not 401(k) plan participants) to only one salary reduction election in any year.[73] The Small Business Job Protection Act ("SBJPA") continued the trend towards convergence by providing that "[t]he frequency that an employee is permitted to enter into a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement shall be determined under the rules applicable to cash or deferred elections under section 401(k) of such Code."[74]

In 1997, Congress amended section 403(b)(1) to add, as a third category of eligible employers, a minister of religion or an employer of such a minister.[75]

D. Major Changes Enacted by EGTRRA[76]

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[77] made numerous far-reaching changes to the rules

[71] I.R.C. § 403(b)(10) (enacted by TRA 86, Pub. L. 99-514, § 1852(a)(3), 100 Stat. 2085, 2865 (1986)). The minimum distribution rules are generally applicable to benefits accruing after 1986. TRA 1986, Pub. L. 99-514, § 1852(a)(3)(C), 100 Stat. 2085, 2865 (1986). *See infra* Part III.M.

[72] I.R.C. § 403(b)(10), *amended by* Unemployment Compensation Amendments of 1992, Pub. L. 102-318, § 522(a)(1), 106 Stat. 290, 313. The requirement is generally applicable to distributions made after 1992. Unemployment Compensation Amendments of 1992, Pub. L. 102-318, § 522(d), 106 Stat. 290, 313 (codified as amended at I.R.C. § 401 (2006)).

[73] Treas. Reg. § 1.403(b)-1(b)(3) (as amended in 2007).

[74] SBJPA, Pub. L. No. 104-188, § 1450(a), 110 Stat. 1755, 1814 (codified as amended at I.R.C. § 403 (2006)) (effective for taxable years beginning after 1995).

[75] I.R.C. § 403(b)(1)(A)(iii) (2006) (originally enacted as TRA 97, Pub. L. No. 105-34, § 1601(d)(6)(B), 111 Stat. 788, 1089 (1997)). The term "minister" is defined in I.R.C. § 414(e)(5)(A) (2006). In 2004, Congress enacted special rules for certain retirement plans maintained by the YMCA Retirement Fund. *See* Act of Dec. 21, 2004, Pub. L. No. 108-476, § 1, 118 Stat. 3901, 3901 (treating certain arrangements maintained by the YMCA Retirement Fund as church plans).

[76] As originally enacted, the pension changes under EGTRRA 2001 were scheduled to sunset at the end of 2010. EGTRRA 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150 (codified as amended at I.R.C § 415(c)(7) (2006)). Section 811 of the PPA 2006 makes the changes permanent. PPA 2006 § 811, I.R.C. § 1 note (Pensions and individual retirement arrangement provisions of EGTRRA 2001 made permanent) (2006).

[77] EGTRRA 2001 § 901, 29 U.S.C. § 1053 (2006).

governing retirement plans, including 403(b) plans.

First, EGTRRA simplified the calculation of the maximum permissible contributions to a 403(b) plan, and allowed larger annual contributions by repealing the exclusion allowance[78] and increasing the limitation under Code section 415(c) to the lesser of $30,000 (indexed for cost-of-living increases), or 25% of compensation to the lesser of $30,000 (indexed), or 100% of compensation.[79]

EGTRRA provided that, in applying the section 415 limitations to 403(b) plans, "compensation" means includible compensation as defined in Code section 403(b)(3).[80] Under that definition, includible compensation can continue to be taken into account for the five succeeding taxable years; therefore, unlike a qualified defined contribution plan, non-elective contributions can continue to be made to a 403(b) plan for up to five years after the participant ceases to receive any cash compensation from the employer.[81]

EGTRRA repealed the special elections under Code section 415(c)(4),[82] added a special section 415 limitation for church 403(b) plans,[83] and confirmed that, for purposes of section 415, a 403(b) plan is treated as being maintained by each employer with respect to which the participant has control.[84]

EGTRRA allowed tax-free rollovers to be made (1) from a 403(b) plan to any "eligible retirement plan" (previously, rollovers had been allowed only to an IRA or to another 403(b) plan)[85]; and (2) to a

[78] EGTRRA 2001 § 632(a)(2)(B) (repealing I.R.C. § 403(b)(2)). This change is effective for years beginning after 2001. EGTRRA 2001 § 632(a)(4), I.R.C. § 415(c) (2006).

[79] EGTRRA 2001 § 632(a)(1) (amending I.R.C. § 415(c)(1) (2006)). This change is effective for years beginning after 2001. EGTRRA 2001 § 632(a)(4), I.R.C. § 415(c)(1) (2006).

[80] EGTRRA 2001 § 632(a)(3)(D) (codified at I.R.C. § 415(c)(3)(E) (2006)). This change is effective for years beginning after 2001. EGTRRA 2001 § 632(a)(4), I.R.C. § 415(c)(3) (2006).

[81] I.R.C. § 403(b)(3), *amended by* EGTRRA 2001 § 632(a)(3)(D), Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 411(p)(3), 116 Stat. 21,50, 114 (codified as amended at I.R.C. § 403 (2006))).

[82] EGTRRA 2001 § 632(a)(3)(E) (repealing I.R.C. § 415(c)(4)). This change is effective for years beginning after 2001. EGTRRA 2001, Pub. L. No. 107-16, 115 Stat. 38, § 632(a)(4) (codified as amended at I.R.C § 415(c) (2006)).

[83] EGTRRA 2001 § 632(a)(3)(F) (codified as amended at I.R.C § 415(c)(7) (2006)). This change is effective for years beginning after 2001. EGTRRA 2001, Pub. L. No. 107-16, § 632(a)(4), 115 Stat. 38, 114 (codified as amended at I.R.C § 415(c) (2006)).

[84] I.R.C. § 415(k)(4) (originally enacted as EGTRRA 2001, Pub. L. No. 107-16, § 632(b)(1), 115 Stat. 38, 115 (codified as amended at I.R.C § 415(c) (2006). This provision is generally effective for limitation years beginning after 1999. EGTRRA 2001 § 632(b)(2)(A), I.R.C. § 415 (2006)). Control is determined under I.R.C. § 414(b) or (c), as modified by § 414(h) (2006).

[85] I.R.C. § 403(b)(8)(A)(ii), *amended by* EGTRRA 2001, Pub. L. No. 107-16, § 641(b)(1), 115 Stat. 38, 121 (2001). The term "eligible retirement plan" is defined in Code section 402(c)(8)(B) (2006).

403(b) plan from any "eligible retirement plan" (previously, rollovers had been allowed only from another 403(b) plan)[86].

EGTRRA amended the section 403(b) distribution restrictions by replacing the term "separates from service" with "has a severance from employment."[87]

EGTRRA added a new section 403(b)(13), allowing 403(b) plan benefits to be transferred directly to a governmental defined benefit plan, to purchase permissive service credit under that plan or as a repayment of amounts previously distributed.[88]

EGTRRA allowed a 401(k) plan or 403(b) plan to accept "Roth" contributions by permitting a participant to elect that an elective deferral be treated as an after-tax contribution when made.[89] If a participant does so elect, then a "qualified distribution" of that amount (plus earnings) is not taxable.[90]

EGTRRA enacted a nonrefundable income tax credit (the savers' credit) for elective deferrals under, inter alia, a 403(b) plan.[91]

Finally, an individual who will attain age fifty by the end of the calendar year is allowed to make additional elective deferrals (catch-up contributions) under a 401(k) or 403(b) plan, in addition to

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[86] EGTRRA 2001, Pub. L. No. 107-16, § 641(b)(1), 115 Stat. 38, 121 (codified as amended at I.R.C. § 402(c)(8)(B)(vi)), added by EGTRRA 2001, Pub. L. No. 107-16, § 641(b)(2), 115 Stat. 38, 120 (2001). These changes are generally effective for distributions made after 2001. EGTRRA 2001, Pub. L. No. 107-16, § 641(f), 115 Stat. 38, 121 (codified as amended at I.R.C. § 402 (2006)).

[87] EGTRRA 2001, Pub. L. No. 107-16, § 646(a)(2)(A), 115 Stat. 38, 126 (2001) (amending I.R.C. § 403(b)(7)(A)(ii), (b)(11)(A)). This change is effective for distributions made after 2001. EGTRRA 2001 § 646(b), I.R.C. § 403 (2006). The conference report explains this change as follows:

> A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation, or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.

H.R. REP. NO. 107-84, at 256 (2001) (Conf. Rep.), *reprinted in* 2001 U.S.C.C.A.N. 46, 182.

[88] I.R.C. § 403(b)(13) (2006) (originally enacted as EGTRRA 2001, Pub. L. No. 107-16, § 647(a), 115 Stat. 38, 127). This provision is effective for transfers after 2001. EGTRRA 2001 § 647(c), I.R.C. §§ 403, 457 (2006).

[89] I.R.C. § 402A(b)(1) (2006).

[90] I.R.C. § 402A(d)(1) (originally enacted as EGTRRA 2001 § 617(a)). The provision is effective for taxable years beginning after 2005. EGTRRA 2001 § 617(f), I.R.C. §§ 401, 402, 408, 6047, 6051 (2006).

[91] EGTRRA 2001, Pub. L. No 107-16, § 618(a), 115 Stat. 38, 106 (2001) (codified as amended at I.R.C. § 25B (2001)). The credit was originally available for taxable years beginning after 2001 and before 2007. Sections 812 and 833(a) of the PPA 2006 make the credit permanent and provide that the income limits will be indexed for inflation. PPA 2006, Pub. L. No. 109-280, §§ 812, 833(a), 120 Stat. 780, 997–998 (codified as amended at I.R.C. § 25B (2006)).

the amount of deferrals allowed by the normal rules.[92] For 2009 and 2010, the maximum catch-up contribution is $5,500.[93]

E. The Pension Protection Act of 2006

The primary purpose of the Pension Protection Act of 2006 ("PPA")[94] was to enact new funding rules for defined benefit plans. The PPA, however, also included numerous provisions affecting defined contribution plans, including 403(b) plans. [95]

Previously, after-tax amounts could be rolled over directly from a qualified plan to another qualified plan, or from a 403(b) plan to another 403(b) plan, but could not be moved from a qualified plan to a 403(b) plan, or vice-versa.[96] The PPA permits direct rollovers of after-tax amounts from a qualified plan to a defined contribution plan, defined benefit plan, or tax-deferred annuity.[97] The change does *not* allow after-tax funds to be rolled over from a 403(b) plan to a qualified plan.[98]

Before EGTRRA, all contributions to a plan subject to ERISA (or to the Code's vesting rules) were required to vest under either a five-year cliff schedule or a seven-year graded schedule. EGTRRA required that matching contributions vest under either a three-year cliff or a six-year graded schedule.[99] The PPA subjects all employer contributions to covered defined contribution plans to the same vesting requirements as apply to matching contributions.[100] The new rules are effective for contributions for plan years beginning after December 31, 2006.[101] The requirements do not apply to a participant until the participant has an hour of service after the effective date. There are delayed effective dates for collectively bargained plans and certain leveraged ESOPs.[102]

Section 404(c) of ERISA protects fiduciaries of retirement plans

[92] EGTRRA 2001, Pub. L. No 107-16, § 631(a), 115 Stat. 38, 111 (codified as amended at I.R.C. § 414(v) (2006)).

[93] *Id.*

[94] PPA 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (amending both the I.R.C. and ERISA).

[95] PPA 2006, §§ 102, 112, 201, 211, 501, I.R.C. §§ 430–31 (2006), 29 U.S.C. §§ 1021, 1083–84, 1311 (2006).

[96] PPA 2006, § 822(a)(1), I.R.C. § 402 (2006).

[97] PPA 2006 §§ 822, 824, 829, I.R.C. §§ 72, 402–03, 408 (2006).

[98] PPA 2006 § 822, I.R.C. § 402 (2006).

[99] EGTRRA § 633, 29 U.S.C. § 1053 (2006).

[100] PPA 2006 § 904, I.R.C. §§ 411, 1053 (2006); *see also* I.R.S. Notice 2007-7, 2007-1 C.B. 395.

[101] PPA 2006 § 904(c)(1), I.R.C. § 411, 1053 (2006).

[102] PPA 2006 § 904(c)(2), I.R.C. § 411, 1053 (2006).

(including covered 403(b) plans) against liability for the consequences of investment choices made by plan participants, provided that the requirements of the Department of Labor ("DOL") regulations are satisfied. The PPA expands the scope of protection under section 404(c) for plans subject to ERISA.[103] It also amends section 404(c) to provide that participants who fail to make an affirmative investment election will be treated as exercising control over the assets in their accounts if certain requirements are met.[104] This provision is effective for plan years beginning after December 31, 2006. DOL issued final regulations on October 24, 2007.[105]

Effective on the date of enactment of the PPA (August 17, 2006), any state law restricting an "automatic contribution arrangement" (i.e., one that generally meets notice requirements and the new "default investment" requirements) will be preempted.[106] This new rule is not applicable to (1) plans that are not subject to ERISA, or (2) plans that provide for automatic enrollment but do not satisfy the requirements for an "automatic contribution arrangement."[107]

The PPA adds a new prohibited transaction exemption, effective for advice provided after December 31, 2006, for the provision of investment advice to participants and receipt of fees for such advice by a "fiduciary adviser."[108] The exemption does not apply to "plan level" advice, i.e., advice to plan fiduciaries who are selecting investment options, or any plans other than participant directed plans.[109] The exemption is subject to conditions, including a requirement that the advice must be given pursuant to an "eligible investment advice arrangement."[110]

The PPA requires administrators of individual account plans (other than one-person plans) subject to ERISA to provide a benefits statement to each participant at least quarterly, if the participant has a right to direct the investment of assets in his or her

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[103] PPA 2006 § 624, 29 U.S.C. § 1104(c) (2006).
[104] *Id.*
[105] 29 C.F.R. § 2550.404c-5 (2009).
[106] PPA 2006, Pub. L. No. 109-280, § 902(f), 120 Stat. 780, 1035–36 (codified as amended at 29 U.S.C. § 1144, 869–72 (2006)).
[107] PPA 2006, Pub. L. No. 109-280, § 902(b), 120 Stat. 780, 1035–36 (codified as amended at I.R.C. § 401 (2006)).
[108] PPA 2006, Pub. L. No. 109-280, § 601, 120 Stat. 780, 952, 958 (2006) (amending ERISA, Pub. L. No. 93-406, §§ 408(b)(14), 408(g), 88 Stat. 829 (1974)); U.S. Dep't of Labor, Field Assistance Bulletin No. 2006-03, (Feb. 2, 2007), *available at* http://www.dol.gov/ebsa/pdf/fab2007-1.pdf [hereinafter FAB 2007-01].
[109] PPA 2006 § 601, 29 U.S.C. § 1108 (2006).
[110] PPA 2006 § 601(g)(1), 29 U.S.C. § 1108 (2006).

account.[111] Other participants must receive a benefits statement at least annually.[112] The new requirements are generally effective for plan years beginning after 2006, subject to a delayed effective date for collectively bargained plans. DOL has issued guidance on the new requirements.[113]

State and local government plans are generally exempt from the nondiscrimination rules under the Code.[114] Section 861 of the PPA amends the Code to provide that, effective August 17, 2006, all governmental plans will be exempt from the qualified plan nondiscrimination and minimum participation rules.[115] Section 823 directs the Treasury to issue regulations providing that a governmental plan is treated as complying with the minimum distribution rules (retroactive to the original effective date of the requirements) if it complies with a "reasonable good faith interpretation" of those requirements.[116] On July 10, 2008, the IRS and Treasury issued proposed regulations.[117]

Section 625 of the PPA directs DOL to issue final regulations, within one year after the date of enactment, clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan is not subject to the "safest available annuity" standard, but is subject to the normal fiduciary standards, such as prudence.[118]

Section 826 of the PPA directs the Treasury to publish regulations allowing distributions from a 401(k), 403(b), or 457(b) plan, or a plan subject to section 409A, for hardship or unforeseeable emergencies of a participant's beneficiary, to the same extent as for a hardship or unforeseeable emergency of the participant, spouse, or dependent.[119] This would allow distributions to a same-sex spouse or domestic partner, if that person were the participant's beneficiary under the plan.[120] Originally, the IRS took

[111] PPA 2006 § 508(a)(1), 29 U.S.C. § 1025 (2006).

[112] *Id.*

[113] U.S. Dep't of Labor, Field Assistance Bulletin No. 2006-03, (Dec. 14, 2006), *available at* http://www.dol.gov/ebsa/pdf/fab2006-3.pdf, Dec. 14, 2006 [hereinafter FAB 2006-03].

[114] *See* I.R.C. §§ 401(a)(5)(G), 401(a)(26)(G), 401(k)(3)(G) (2006).

[115] PPA 2006, Pub. L. No. 109-280, § 861(c), 120 Stat. 780, 1021 (codified as amended at I.R.C. § 401 (2006)).

[116] PPA 2006 § 823, I.R.C. § 401 (2006).

[117] Reasonable Good Faith Interpretation of Required Minimum Distribution Rules by Governmental Plans, 73 Fed. Reg. 39,630, 39,630 (proposed July 10, 2008) (to be codified at Treas. Reg. pt. 1) (preamble to proposed regulations for Dep't of Treasury).

[118] 29 C.F.R. § 2509.95-1 (2009).

[119] PPA 2006 § 826, I.R.C. § 401 (2006).

[120] *See* Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (codified as 1 U.S.C. § 7 (2006) (defining marriage as between "one man and one woman"; but § 826 may allow for

the position that the provision does not require plans to allow those distributions.[121] Later in 2007, the IRS indicated on its Web site that the provision would be required, effective for plan years starting in 2008, but that for 2007 it was optional. The Worker, Retiree and Employer Recovery Act of 2008 made a technical correction, requiring plans to permit a non-spouse beneficiary rollover for plan years beginning after December 31, 2009.[122]

In addition, the PPA addresses the determination of average compensation for purposes of the IRC section 415 limitations;[123] provides for inflation adjustments of gross income limitations on certain retirement savings incentives;[124] requires regulations on qualified domestic relations orders ("QDROs");[125] requires an additional survivor annuity option;[126] provides that there will be no reduction in unemployment compensation as a result of pension rollovers;[127] provides new tax benefits for long term care insurance;[128] and includes new restrictions on corporate-owned life insurance.[129]

III. 403(B) PLANS AND 401(K) PLANS

The new 403(b) regulations reflect the increasing similarity between 403(b) arrangements and other retirement plans that allow salary deferrals (401(k) plans and eligible deferred compensation 457(b) plans).[130] The preamble addresses three major differences between 403(b) and 401(k): (1) the limitations on the employers and employees to which 403(b) is available; (2) the restricted funding vehicles for 403(b) plans; and (3) the applicable nondiscrimination test (ADP or universal availability).[131]

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same sex beneficiaries under the "hardship" provisions). PPA 2006 § 826, I.R.C. § 401 (2006).

[121] I.R.S. Notice 2007-7, 2007-1 C.B. 395.

[122] I.R.C. § 402(c)(11) (2006), *amended by* Pub. L. No. 110-458, tit. I, subtit. A, §§ 108(f)(1), (2)(A)–(B), (j), 109(b)(3); tit. II, § 201(b), 122 Stat. 5109–5111, 5117; *see also* Worker, Retiree, and Employer Recovery Act of 2008, 16 J. Pensions & Benefits No. 3, at 5, 11 (2009).

[123] PPA 2006 § 832, I.R.C. § 415(b)(3) (2006).

[124] PPA 2006 § 833, I.R.C. § 25B (2006).

[125] PPA 2006 § 1001, I.R.C. § 414 (2006); *see also* Department of Labor Employee Benefits Security Administration, 72 Fed. Reg. 10,070 (Mar. 7, 2007) (to be codified at Treas. Reg. pt. 2530) (preamble to Interim Final Rule for Dep't of Labor).

[126] PPA 2006 § 1004, I.R.C. § 231d (2006).

[127] PPA 2006 § 1105, I.R.C. § 3304 (2006).

[128] PPA 2006 § 844, I.R.C. § 72 (2006).

[129] PPA 2006 § 863, I.R.C. § 101 (2006).

[130] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,129 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[131] *Id.*

Additional differences are noted in footnote 3 of the preamble:

> Other differences between the rules applicable to section 403(b) plans and qualified plans include the following: the definition of compensation (including the five-year rule) in section 403(b)(3); the special section 403(b) catch-up elective deferral in section 402(g)(7); and the section 415 aggregation rules. An additional difference relates to when a severance from employment occurs for purposes of section 403(b) plans maintained by State and local government employers.[132]

A. Eligible Employers

The only employers eligible to sponsor a 403(b) plan are public educational organizations (e.g., a state university or public school district);[133] private organizations that are tax-exempt under I.R.C. section 501(c)(3);[134] and certain ministers of religion.[135] By contrast,

[132] *Id.* at n.3.

[133] The organization must be described in section 170(b)(1)(A)(ii)—i.e., one which "normally maintains a regular faculty and curriculum and . . . has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." Treas. Reg. § 1.170A-9(c)(1) (as amended in 2008). This includes public schools, state colleges, and state universities; both faculty and nonacademic employees may be covered. Treas. Reg. § 1.403(b)-2(b)(8), (9), (10), (14), (20) (as amended in 2007). The services may be performed "directly or indirectly for [the educational] institution." I.R.S. Priv. Ltr. Rul. 78-01-019 (Oct. 7, 1977); I.R.S. Priv. Ltr. Rul. 77-47-057 (Aug. 25, 1977). Elected or appointed officials holding positions in which persons that are not education professionals may serve, however, are not eligible. Rev. Rul. 73-607, 1973-2 C.B. 145. Such ineligible elected or appointed persons include regents, trustees, or members of a school board. *Id.*; *see* Treas. Reg. § 1.403(b)-2(b)(10) (as amended in 2007) ("[A] person occupying an elective or appointive public office is not an employee performing services for a public school unless such office is one to which an individual is elected or appointed only if the individual has received training, or is experienced, in the field of education."); Rev. Rul. 73-607, 1973-2 C.B. 145 ("[A] person occupying . . . public office is not an employee performing services for an educational institution . . . ."). If an organization performs both educational and non-educational activities, it will qualify as an educational organization only if the non-educational activities are incidental to the primary educational purpose. Treas. Reg. 1.170A-9(c)(1) (as amended in 2008). Employees of state departments of education are eligible. *See* Rev. Rul. 73-607, 1973-2 C.B. 145; I.R.S. Priv. Ltr. Rul. 94-38-031 (Sept. 23, 1994). State teachers' retirement systems are not considered educational organizations for this purpose, and thus may not establish 403(b) arrangements for their employees. Rev. Rul. 80-139, 1980-1 C.B. 88 ("[A]mounts contributed by the state teachers' retirement system . . . are not excludable from the employees' gross income under section 403(b) of the Code."). Two recent cases discuss whether an employee organization (in each case, a teachers' union) may establish a 403(b) plan. *See* Montoya v. ING Life Ins. & Annuity Co., No. 07 Civ. 2574, 2009 WL 2850748, at *1 (S.D.N.Y. Aug. 31, 2009); Daniels-Hall v. Nat'l Educ. Ass'n, No. C 07-5339RBL, 2008 WL 2179530, at *1 (W.D. Wash. May 23, 2008); *see also DOL Files Amicus Brief Supporting Position That NEA Didn't Create Section 403(b) Plan*, 36 Pens. & Ben. Rep. (BNA) 2114, 2114 (Sept. 15, 2009).

[134] A tax-exempt organization described in section 501(c)(3) is one which is "organized and operated exclusively for religious, charitable, scientific, [public safety testing], literary, or

educational purposes, or to [encourage] amateur sports competition . . . or for the prevention of cruelty to children or animals . . . ." I.R.C. § 501(c)(3) (2006). This definition includes charities, social welfare agencies, private hospitals, private schools, religious institutions, and research facilities. *Id.* In addition,

> no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual, [2] no substantial part of the [organization's] activities [may consist of] carrying on propaganda, or otherwise attempting, to influence legislation (except as [permitted by] subsection [501](h)), and [3] [the organization may] not participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office.

Id. In order to be recognized as a 501(c)(3) organization, the organization must generally apply to the IRS for a determination letter by filing Form 1023. Rev. Rul. 74-15, 1974-1 C.B. 126. "Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code." *Id.* This application requirement does not apply to church and related organizations, and other organizations excepted under section 508 (such as organizations established before October 10, 1969). I.R.C. § 508(b), (c) (2006). A public institution, such as a public hospital, may qualify as a 501(c)(3) organization if it is a separate entity, does not have enforcement or regulatory powers, and serves an exclusive purpose described in section 501(c)(3). Rev. Rul. 67-290, 1967-2 C.B. 183 ("The power of eminent domain is not considered a regulatory or enforcement power . . . [and] is not clothed with a power beyond those . . . described in section 501(c)(3) of the Code."); *see also* Rev. Rul. 60-384, 1960-2 C.B. 172 ("A state or municipality itself, however, would not qualify as an organization described in section 501(c)(3) since its purposes are clearly not exclusively those described in section 501(c)(3) of the Code."). Accordingly, it does not qualify for exemption from federal income tax under that section. *But see* Rev. Rul. 74-15, 1974-1 C.B. 126 ("[A] wholly-owned State instrumentality may, under certain circumstances, qualify for exemption from Federal income tax under section 501(c)(3) of the Code."). A state university may also qualify. *See* Johnson v. Comm'r, 56 T.C. 944, 948 (1971) (noting that Iowa State University falls within section 501(c)(3), since it was "organized and operated exclusively for educational purposes, no part of the net earnings inures to the benefit of any private individual, no substantial part of the activities amounts to the carrying on of propaganda . . . on behalf of any candidate for public office"). A cooperative hospital service association, described in section 501(e), is treated as a charitable organization eligible to sponsor a 403(b) arrangement for its employees. Rev. Rul. 72-329, 1972-2 C.B. 226. Certain other entities have been ruled ineligible for section 501(c)(3) status. *See* Rev. Rul. 74-14, 1974-1 C.B. 125 (holding that a public housing authority with investigatory powers is not exempt under section 501(c)(3) because such powers are regulatory or enforcement powers); Rev. Rul. 68-294, 1968-1 C.B. 46 ("[W]here the particular branch or department under whose jurisdiction the activity in question is being conducted is an integral part of a state or municipal government the provisions of section 501(c)(3) of the Code would not be applicable."); Rev. Rul. 62-66, 1962-1 C.B. 83 ("[A]n activity constituting an integral part of a state or municipal government cannot so qualify [under section 501(c)(3)] inasmuch as the organization engaged therein would still be the state or municipal government, which cannot qualify as an organization described in section 501(c)(3) of the Code."). Governmental agencies generally are not 501(c)(3) organizations. If an organization, however, exclusively serves a purpose described in section 501(c)(3), and is a separate entity from the government, then it may establish a 403(b) arrangement, provided that the organization does not have enforcement or regulatory powers beyond those described in section 501(c)(3). *See* Rev. Rul. 60-384, 1960-2 C.B. 172. The 403(b) Examination Guidelines instruct IRS agents to check whether the employer is eligible to sponsor the 403(b) arrangement. I.R.S. Ann. 95-33, 1995-19 I.R.B. 14. The guidelines also point out that loss of tax-exempt status automatically causes the arrangement to fail to satisfy the requirements of section 403(b), requiring the agent to consider collecting income and employment taxes. *Id.*

[135] I.R.C. § 403(b)(1)(A)(iii) (2006). An Indian tribal government is treated as a 501(c)(3) organization with respect to certain pre-1995 contracts. SBJPA, Pub. L. No. 104-188, §

a 401(k) plan can be adopted by any private sector employer, a rural cooperative, or an Indian tribal government. State and local government employers are ineligible to sponsor a 401(k) plan,[136] subject to grandfathering of plans adopted before enactment of the TRA 86.[137]

The preamble to the proposed regulations stated that:

> Issues have been raised about the application of section 403(b) to tax-exempt entities that have State or local government features. These proposed regulations do not attempt to address when an entity is a State (treating a local government or other subdivision as a State) and when it is a section 501(c)(3) organization that is not a State. Thus, for example, these regulations do not provide guidance on the conditions under which a tax-exempt charter school is, or is not, a State entity.[138]

The preamble[139] also clarified that an employer that is both a 501(c)(3) organization and an instrumentality of a State (1) cannot adopt a 401(k) plan, (2) can adopt an eligible deferred compensation (section 457(b)) plan, but only if it is funded, and (3) can adopt a 403(b) plan for any or all of its employees.[140]

If the employer was never eligible to maintain a 403(b) plan, the arrangement was never eligible for tax-deferral under section 403(b), and section 83 or 403(c) dictates the tax consequences.[141] If the employer loses its tax-exempt status, the exclusion from taxable income does not apply to any contributions made while the employer is ineligible.[142] The regulations prohibit an employer that ceases to be eligible from making any further contributions to the

1450(b), 110 Stat. 1755, 1814–15 (codified as amended at I.R.C. §§ 403(b), 1003 (2006)). Availability of a 403(b) plan was originally limited to section 501(c)(3) organizations, because the purpose of the legislation was to limit salary deferrals by employees of such organizations. In 1961, section 403(b) was extended to public educational institutions in response to a ruling by IRS that, because public school districts are not 501(c)(3) organizations, they were not covered by section 403(b). I.R.C. § 501(c)(3) (2006); *see supra* note 37 and accompanying text; *see also supra* note 75 and accompanying text (concerning the YMCA Retirement Fund).

136 I.R.C. § 401(k)(4)(B)(ii) (2006).

137 TRA 86, Pub. L. No. 99-514, § 1116(f)(2)(B), 100 Stat. 2085, 2457 (codified as amended at I.R.C. § 403(k)(3)(A) (2006)).

138 Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 69 Fed. Reg. 67,075, 67,078 (proposed Nov. 16, 2004) (to be codified at Treas. Reg. pts. 1 and 31) (preamble to final regulations for Dep't of Treasury).

139 *Id.*

140 *Id.*

141 I.R.C. §§ 83, 403(c) (2006).

142 Treas. Reg. § 1.403(b)-10(a)(2) (as amended in 2007).

section 403(b) plan for subsequent periods.[143] In this event, the plan can be frozen or the plan could be terminated in accordance with the rules regarding 403(b) plan termination.

Tax-deferred treatment for employees of ineligible employers is not available unless: (1) the plan can satisfy all of the requirements for a qualified plan under section 401(a),[144] and the deferral arrangement can also satisfy the requirements for a qualified cash or deferred arrangement under section 401(k);[145] or (2) the arrangement can satisfy all of the requirements for an eligible deferred compensation plan under section 457.[146] Either is highly unlikely, and so elective deferrals and employer contributions under an attempted 403(b) arrangement maintained by an ineligible employer will almost always be currently taxable to the employees.[147]

[143] *Id.*

[144] *See* I.R.C. § 401(a) (2006) (defining a qualified trust as "[a] trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees" which satisfies the requirements listed in the thirty-seven subsections that follow).

[145] *See* I.R.C. § 401(k)(2), (4) (2006). Under a qualified cash or deferred arrangement ("CODA"), (1) employees may elect either to defer compensation into the qualified plan or be paid in cash; (2) amounts attributable to elective deferrals may not be distributed from the plan until a qualifying event occurs; (3) the employee must have a nonforfeitable right to such amounts; (4) an employee is not required to complete more than one year of service, or reach 21 years of age, as a condition of participation in the CODA; and (5) other benefits (except matching contributions) may not be contingent on a participant electing to defer under the CODA. § 401(k)(2). Furthermore, a state or local government may only maintain a qualified CODA if it was adopted before May 6, 1986. § 401(k)(4)(B). Elective deferrals under a *nonqualified* CODA are currently taxable to the employee. Treas. Reg. §§ 1.401(k)-1(a)(5)(iii) (as amended in 2009), 1.402(a)-1(d)(1) (as amended in 2005).

[146] I.R.C. § 457(b) (2006) requires, inter alia, that (1) annual deferrals be limited to $7,500 (indexed), with an increased limit for the last three years ending before normal retirement age, and (2) all amounts deferred, all property and rights purchased with such amounts, and all income attributable thereto, must remain (until made available to the participant or beneficiary) solely the property of the employer and subject to the claims of its general creditors. I.R.C. § 457(b)(2)-(3), (6) (2006). Even if the IRC's requirements can be surmounted, in the case of a nongovernmental employer (other than a church) there is a direct conflict between section 403(a) of ERISA, which, with limited exceptions, requires plan assets to be held in trust, and section 457(b)(6), which requires section 457 deferrals to remain the property of the employer. ERISA, Pub. L. No. 93-406, § 403(a), 88 Stat. 829, 992–93 (codified as amended at 29 U.S.C. § 1103(a) (2006)).

[147] *See* I.R.C. §§ 83, 403(c) (2006). In the case of employer contributions not made pursuant to a salary reduction agreement, the employee is currently taxable only to the extent that the contribution is vested. If the employer becomes an eligible employer before the contribution vests, the employee will not be taxed at the time of vesting if the value of his or her benefit (including investment earnings credited on employer contributions) does not exceed the § 415 limitation.

B. Who Is Eligible to Participate?

In order to participate in either a 403(b) plan or a 401(k) plan, the individual must be an employee (or a retired or former employee) of the organization, rather than an independent contractor.[148] Any contributions made for an independent contractor will be currently taxable.[149] Leased employees described in section 414(n) are eligible to participate in a 401(k) plan, but apparently may not participate in a 403(b) plan. Section 414(n) provides that a leased employee is treated as an employee of the recipient of his or her services for purposes of certain IRC provisions, but the enumerated provisions do not include section 403(b).[150]

A minister who is an employee under the common law tests is eligible for a 403(b) arrangement, even if his or her earnings are treated as self-employment income for Social Security purposes.[151]

If an employer is the sole owner of a limited liability company ("LLC"), so that the LLC is a "disregarded entity" for federal tax purposes, the employees of the LLC may also participate in a 403(b) plan or a 401(k) plan maintained by the parent.[152]

C. Compensation

Under either a qualified plan or a 403(b) plan, the definition of compensation is important for several purposes, the most important of which are (1) testing compliance with the nondiscrimination rules,[153] and (2) testing compliance with the limitations on contributions and benefits.[154] Under a qualified plan,

[148] I.R.C. § 403(b)(1) (2006); Treas. Reg. § 1.403(b)-2(b)(9) (as amended in 2007); Rev. Rul. 73-417, 1973-2 C.B. 332; Rev. Rul. 72-203, 1972-1 C.B. 324; Rev. Rul. 70-136, 1970-1 C.B. 12; Rev. Rul. 66-274, 1966-2 C.B. 446.

[149] Haugen v. Comm'r, 30 T.C.M. (CCH) 1247 (1971); *see* Rev. Rul. 66-274, 1966-2 C.B. 446 ("Since the physician in this case is not an employee of the hospital . . . section 403(b) of the Code [is] not applicable to amounts contributed in his behalf . . . toward the purchase of an annuity contract.").

[150] I.R.C. § 414(n)(3) (2006). The legislative history of TRA 1986 assumes that the leased employee rules do apply to 403(b) arrangements. H.R. REP. NO. 99-841, II-419 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4522; STAFF OF THE J. COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 678 (Comm. Print 1987). Many (if not most) individuals who are described as leased employees, however, are in fact common law employees of the recipient of their services.

[151] I.R.C. § 1402(c) (2006); Treas. Reg. § 1.403(b)-2(b)(9) (as amended in 2007); Rev. Rul. 68-395, 1968-2 C.B. 375.

[152] I.R.S. Priv. Ltr. Rul. 03-34-040 (Aug. 22, 2003); *see also* I.R.S. Priv. Ltr. Rul. 03-41-023 (Oct. 10, 2003) (discussing section 301.7701 relating to disregarded entities).

[153] I.R.C. §§ 401(a)(4), 403(b)(12), 410(b) (2006).

[154] § 415.

"compensation" is generally the employee's taxable compensation (plus deferrals) for the current year.[155]

Under section 403(b), the employee's "includible compensation" is defined as the employee's compensation from the employer which is includible in gross income (disregarding any foreign earned income exclusion under section 911) for the most recent period (ending not later than the close of the taxable year) which may be counted as one "year of service."[156] Includible compensation includes salary reduction contributions.[157] Compensation earned while the employer was not eligible to maintain a 403(b) plan is disregarded.[158]

The definition of "includible compensation" includes a five-year look-back:[159] a former employee is deemed to have monthly includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of each of the next five taxable years.[160] The amount of the monthly includible compensation is equal to one-twelfth of the former employee's includible compensation during the former employee's most recent year of service.[161] As a result, employer non-elective contributions to a 403(b) plan (unlike a qualified plan) can continue after the individual ceases to receive current compensation from the employer.[162]

Under a qualified defined contribution plan, and subject to an exception[163] for certain disabled employees, the employer may not continue to contribute to the plan for years after an employee has severed from employment.[164]

In the preamble to the proposed regulations, the Treasury and IRS requested comments on whether they have the authority to

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[155] §§ 414(s), 415(c).

[156] § 403(b)(3); Treas. Reg. § 1.403(b)-2(b)(11) (as amended in 2007); *see infra* Part III.S. (discussing the computation of years of service under section 403(b)).

[157] I.R.C. § 403(b)(3) (2006).

[158] Treas. Reg. § 1.403(b)-2(b)(11) (as amended in 2007).

[159] I.R.C. §§ 415(c)(3)(E), 403(b)(3) (2006). There is a special rule for ministers. *See* I.R.C. § 414(e)(5)(B)(i) (2006).

[160] § 403(b)(3).

[161] Treas. Reg. § 1.403(b)-4(d)(1) (as amended in 2007).

[162] *See* Treas. Reg. § 1.403(b)-4(d)(2) (as amended in 2007) (showing two examples).

[163] I.R.C. § 415(c)(3)(C) (2006).

[164] I.R.C. § 415(c) limits the "annual additions" (including both employer and employee contributions) to a participant's accounts under the plan to the lesser of (i) the dollar limit ($49,000 for 2009 and 2010), which is subject to annual cost of living increases, or (ii) 100% of the participant's compensation from the employer for the year. I.R.C. § 415(c) (2006). Accordingly, if the compensation is zero, the limit is zero.

permit 403(b) plans to use compensation, as defined in section 415(c)(3) without regard to section 415(c)(3)(E), in lieu of the definition of includible compensation under section 403(b)(3) and, if so, whether this should be done.[165]

The regulations under section 415 generally provide that amounts received following severance from employment are not considered to be compensation for purposes of section 415,[166] but provide exceptions for certain payments made within two and a half months following severance from employment.[167] These exceptions apply to (1) payments (such as regular compensation, and payments for overtime, commissions, and bonuses) that would have been payable if employment had not terminated, and (2) payments with respect to leave that would have been available if employment had not terminated.[168] Other post-severance payments (such as severance pay, unfunded nonqualified deferred compensation, or parachute payments within the meaning of section 280G(b)(2)) are not compensation, even if paid within two and a half months following severance from employment.[169] The regulations include corresponding changes to the regulations under sections 401(k), 403(b), and 457, providing that amounts received after severance from employment can only be deferred if they meet these conditions.[170]

D. Dollar Limit on Elective Salary Reduction Contributions

1. General Rule

Like salary reduction contributions under a 401(k) plan, elective salary reduction contributions under a 403(b) arrangement are subject to a calendar year dollar limit, which is adjusted annually for cost of living increases.[171] The general limit is the greater of

[165] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 69 Fed. Reg. 67,075, 67,084 (proposed Nov. 16, 2004) (to be codified at Treas. Reg. pts. 1 and 31) (preamble to proposed regulations for Dep't of Treasury).

[166] Treas. Reg. § 1.415(c)-2(e)(1)(ii) (as amended in 2007). This rule generally does not apply to payments to an individual in qualified military service (as that term is used in section 414(u)(1)) to the extent that the payments do not exceed the amounts the individual would have received if the individual had continued to perform services for the employer rather than entering qualified military service. Treas. Reg. § 1.415(c)-2(e)(4) (as amended in 2007).

[167] § 1.415(c)-2(e)(3)(i) (as amended in 2007).

[168] § 1.415(c)-2(e)(3)(ii).

[169] § 1.415(c)-2(e)(3)(iv).

[170] *Id.*

[171] I.R.C. §§ 402(g)(1), (4)–(5) (2006).

$9,500 or the indexed dollar limit for 401(k) plans, which for 2009 and 2010 is $16,500.[172]

The limit on salary reduction contributions applies to the participant, not to each plan separately.[173] Accordingly, if the employee participates in two or more 403(b) plans during the same calendar year, or in both a 403(b) arrangement and a 401(k) plan or a salary reduction simplified employee pension plan ("SEP"), the dollar limit applies to all elective deferrals made to all such plans for that year, even if the plans are maintained by different employers.[174] Elective deferrals in excess of the dollar limit therefore are included in the employee's gross income.[175]

A 403(b) plan will lose 403(b) status if the plan document does not, by its terms, preclude excess salary reduction contributions.[176] For this purpose, salary reduction contributions do not include contributions made pursuant to a one time irrevocable election that is made by the employee at the time of initial eligibility to participate or pursuant to a similar arrangement.[177] If a participant has the right or ability to terminate or modify an election, the contributions *are* salary reduction contributions, even if the participant never exercises this right.[178]

2. Higher Limit for Certain Employees

Under a 403(b) plan, but not a 401(k) plan, a higher dollar limit applies to an employee who has completed at least fifteen years of

[172] I.R.S. News Release IR-2009-94 (Oct. 15, 2009), 2009 WL 3303735.

[173] I.R.C. § 402(g)(3) (2006).

[174] § 402(g)(1)(B).

[175] § 402(g)(1)(A).

[176] I.R.C. §§ 403(b)(1)(E), 401(a)(30) (2006) (requiring that the plan provide that deferrals will not be made in excess of section 402(g)(1) limitations). Section 403(b) status will not be lost if either (1) the excess deferrals are made to a plan created and controlled by an unrelated employer, or (2) the excess is distributed (with income allocable thereto) by April 15 of the following year. I.R.C. § 402(g)(2). The plan must permit the distribution, and the employee is normally required to make a request for the distribution. Treas. Reg. § 1.402(g)-1(e)(4) (as amended in 2007). In certain circumstances, the individual may be deemed to have requested a distribution. Treas. Reg. §§ 1.402(g)-1(e)(2)(i), 1.402-1(e)(3)(i)(A). If both requirements are satisfied, the distribution may be made notwithstanding any other provision of law. I.R.C. § 402(g)(2). For example, an in-service distribution, to an employee under the age of fifty-nine and a half, of his or her salary reduction contributions made to a custodial account would normally be prohibited by section 403(b)(7). I.R.C. § 403(b)(7). Such a distribution, however, may be made to correct an excess salary reduction contribution. I.R.C. § 402(g)(2)(A). If excess deferrals are not distributed timely, then the excess is taxed both in the year contributed and again when distributed. Treas. Reg. § 1.402(g)-1(e)(8)(iii).

[177] I.R.C. §§ 402(g)(3), 403(b)(12)(A); I.R.S. Ann. 95-33, 1995-19 I.R.B. 14.

[178] I.R.S. Ann. 95-33, 1995-19 I.R.B. 14.

service with a "qualified organization."[179] Under this rule, the normal dollar limit may be increased by the least of the following amounts: (1) $3,000; or (2) $15,000, reduced by the total amount excluded from income for prior years by reason of the special rule; or (3) the excess of (a) $5,000 multiplied by the employee's years of service with the organization[180] over (b) the sum of the total elective deferrals by the employee for prior taxable years.[181] Accordingly, for an employee who qualifies for the special rule, the salary reduction contribution for 2009 or 2010 may be as much as $19,500 ($16,500 plus $3,000).[182]

The regulations clarify which employers may offer the special 403(b) catch-up under section 402(g)(7), including a definition of "health and welfare service agency."[183] The proposed regulations defined a health and welfare service agency as either an organization whose primary activity is to provide medical care as defined in section 213(d)(1) (such as a hospice), or a section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals or which provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that provides meals to needy individuals).[184] The final regulations expand this definition to include an adoption agency and an agency that provides either

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[179] I.R.C. § 402(g)(7)(A); Treas. Reg. § 1.403(b)-4(c)(3)(iii). A qualified organization is an "educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches," or a tax-exempt organization controlled by or associated with a church, or a convention or association of churches. I.R.C. § 402(g)(7)(B); Treas. Reg. § 1.403(b)-4(c)(3)(ii).

[180] For purposes of the rule, years of service are determined in accordance with section 403(b). I.R.C. §§ 402(g)(7)(D), 403(b)(4). The legislative history to TAMRA of 1988 states:

> The Act does not specify how years of service are to be determined for purposes of the catch-up rule. The bill provides that, for this purpose, years of service are defined as in section 403(b). This definition will provide consistency with the way years of service are generally calculated under the rules relating to tax-sheltered annuities.
>
> It is recognized that it may be difficult for employers to calculate whether an individual's lifetime elective deferrals exceed the individual's lifetime limit for purposes of the catch-up rule because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals. Accordingly, under the bill, for purposes of calculating an individual's lifetime elective deferrals under the catch-up rule, elective deferrals for prior years are to be determined in the manner prescribed by the Secretary. Under this provision, it is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

S. REP. NO. 100-445, at 4668 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4668. To date, the Secretary has not accepted the invitation to provide "administrable methods" for employers.

[181] I.R.C. § 402(g)(7)(A).

[182] § 402(g)(7)(A); I.R.S. News Release IR-2009-94 (Oct. 15, 2009), 2009 WL 3303735.

[183] Treas. Reg. § 1.403(b)-4(c)(3)(ii).

[184] Prop. Treas. Reg. § 1.403(b)-4(c)(3)(ii)(C), 69 Fed. Reg. 67,075, 67,088 (Nov. 16, 2004).

home health services or assistance to individuals with substance abuse problems, or that provides help to the disabled.[185]

There is a second "catch-up" rule that applies, not only to 403(b) plans but also to qualified plans,[186] and allows a person who is (or will be by year end) at least fifty years old, to contribute an additional $5,500 (for 2009 or 2010) over the normal limit.[187] Accordingly, the normal deferral limit for a fifty-year-old participant under a 401(k) or 403(b) plan is increased from $16,500 to $22,000 for 2009 and 2010.

Under the regulations, any catch-up contribution for an employee who is eligible for both an age fifty catch-up and the special 403(b) catch-up is treated first as a section 403(b) catch-up, to the extent permitted, and then as an age fifty catch-up (to the extent the age fifty catch-up amount exceeds the 403(b) catch-up).[188] The Joint Committee on Taxation provides the following example:

> assume a participant is eligible to make both types of contributions and that the maximum additional deferral which the participant may make for 2005 under the special *section 403(b)* rule is $ 3,000. Under the proposed regulation, the maximum total elective deferral contribution that the participant may make for 2005 is $ 21,000. This is the sum of the basic limit on elective deferrals, $ 14,000 (for 2005), plus the $ 3,000 additional deferral under the special *section 403(b)* rule, plus a catch-up contribution of $ 4,000 (for 2005).[189]

The effect is to reduce the amount of the special 403(b) catch-up that is available in future years, and the rule has been criticized for that reason:

> [W]ithout considering the special 403(b) catch-up, *section 402(g)(1) of the Code* permits an employee age 50 or older to contribute to a 403(b) plan up to $ 18,000 and $ 20,000 in 2004 and 2005, respectively.
>
> *Section 402(g)(7)* states that the limit under *section 402(g)(1)* "shall be increased" by the amount of the special catch-up limit. Notably, *section 402(g)(7)* expressly applies

[185] Treas. Reg. § 1.403(b)-4(c)(3)(ii)(C).

[186] I.R.C. § 414(v).

[187] § 414(v).

[188] Treas. Reg. § 1.403(b)-4(c)(3)(iv); *see also* Prop. Treas. Reg. § 1.403(b)-4(c)(4), 69 Fed. Reg. 67,075, 67,089 (Nov. 16, 2004), Examples 3, 4, 11 and 12.

[189] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, TAX NOTES TODAY, Jan. 28, 2005, 2005 TNT 18-18 (LEXIS).

> to the limit determined under *section 402(g)(1)*, not just the applicable dollar limit (which is under subparagraph (B) of *section 402(g)(1)*).
>
> Therefore, under *section 402(g)(7)*, catch-up contributions are treated as special 403(b) catch-up amounts only if an employee contributes more than the combined limit of the applicable dollar amount and the age 50 catch-up. For example, if an employee contributes more than $ 18,000 in 2005, only the excess amounts are special 403(b) catch-up contributions; and, if he or she contributes $ 18,000 or less, there are no special 403(b) catch-up contributions.
>
> By contrast, under the proposed coordination rule, catch-up contributions are treated as age 50 catch-up amounts only if an employee contributes more than the combined limit of the applicable dollar amount and the special 403(b) catch-up. For example, if an employee contributes more than $ 14,000 in 2005, the excess is treated as special 403(b) catch-up contributions to the extent those contributions are permitted.

Thus, the proposed coordination rule appears to squarely conflict with the plain meaning of *section 402(g)(7) of the Code.*[190]

3. Coordination with Other Plans

For both 403(b) and 401(k) plans, the dollar maximum is reduced by the amount of any elective deferrals made by the employee for the same calendar year under another 401(k) plan, another 403(b) arrangement, or a SEP.[191] If the employee also participates in a section 457 plan, the maximum deferral under the 403(b) or 401(k) plan is *not* reduced by the amount of the elective deferrals under the

[190] Constance M. Hiatt, *Attorney Comments on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Feb. 28, 2005, 2005 TNT 38-50 (LEXIS); *see also* David W. Powell & Louis T. Mazawey, Comments on Behalf of the Groom Law Group, *Attorneys Comment on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Feb. 28, 2005, 2005 TNT 38-57 (LEXIS) ("[A]n amount should count against the 15-year catch-up limit only if the employee decides to use that special catch-up. That is because the 15-year catch-up has a $ 15,000 aggregate lifetime limit under *section 402(g)(7)(A)(ii)*. . . . We believe that if the employee does not affirmatively elect to use the 15-year catch-up limit in a year, it should not be a limit they must exceed before permitting them to use the age 50 catch-up.").

[191] I.R.C. § 402(g)(3); Treas. Reg. § 1.402(g)-1(d)(1)–(2). Under the regulations, this rule also applies to elective deferrals for section 501(c)(18) trusts; however, these arrangements are rare. Treas. Reg. § 1.402(g)-1(b)(4). The rules for SEPs are set out in I.R.C. § 408(k).

457 plan.[192] Because the dollar limit applies at the employee level, rather than the employer level (unlike the section 415 limitations), it is irrelevant whether the plans are maintained by related or unrelated employers.[193]

E. Funding[194]

A plan which qualifies under section 401(a) is subject to few limitations on the investment of plan assets. First, except as permitted by the DOL regulations, a plan may not invest in any asset where the indicia of ownership are located outside the jurisdiction of the United States district courts.[195] Second, if a defined contribution plan allows individual participants to direct how their accounts are invested and an individually directed account invests in any "collectible," the amount so invested is immediately taxable.[196] Third, under ERISA, plan fiduciaries are required to act with reasonable prudence and to diversify the investment of plan assets to reduce the risk of large losses, "unless under the circumstances it is clearly prudent not to do so."[197] Finally, various related party investments, and other transactions involving actual or potential conflicts of interest, are outlawed by the prohibited transaction rules of Code section 4975 and ERISA sections 406 through 408.[198] Similarly, a wide range of investments

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[192] I.R.C. § 457(b)(2)–(3), (c). Generally, the maximum deferral under a section 457 plan will be the lesser of $16,500 or 100% of compensation. I.R.C. § 457(b)(2).

[193] I.R.C. § 402(g)(3).

[194] Treas. Reg. § 1.403(b)-8.

[195] ERISA § 404(b), 29 U.S.C. § 1104(b) (2006). This restriction only applies if the plan is subject to ERISA, as are almost all qualified plans with the exception of governmental plans and non-electing church plans. ERISA § 4, 29 U.S.C. § 1003 (2006). The regulations set forth various exceptions. *See* 29 C.F.R. § 2550.404b-1 (2009).

[196] I.R.C. § 408(m)(1). This rule also applies to IRAs, but not to 403(b) arrangements. *Id.* In practice, the only type of 403(b) funding vehicle which could hold collectibles is a retirement income account. The term "collectible" is defined to include any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property specified in the regulations. I.R.C. § 408(m)(2). Proposed regulations, issued by the IRS in 1984 but not yet finalized, add musical instruments and historical objects (documents, clothes, etc.) to the list of collectibles. Prop. Treas. Reg. § 1.408-10, 9 Fed. Reg. 2,794 (Jan. 23, 1984).

[197] ERISA § 404(a)(1)(B)-(C), 29 U.S.C. § 1104(a)(1)(B)-(C) (2006). This restriction only applies if the plan is subject to ERISA. *See* ERISA 4, 29 U.S.C. § 1003 (2006) (providing that most qualified plans, other than governmental and non-electing church plans, are subject to ERISA).

[198] *See* ERISA §§ 406–408, 29 U.S.C. §§ 1106–1108 (2006) (prohibiting transactions between plans and parties in interest, plan and plan fiduciaries, and restricting transfers of property to a plan by a party in interest and setting limits on the acquisition and holding of employer securities and employer real property); I.R.C. § 4975(c)(1) (prohibiting certain property transactions, loans, the furnishing of goods, services, or facilities, the transfer or use

is available to IRAs.[199]

When section 403(b) was originally enacted, the only available form of investment was the annuity contract. The available funding vehicles for a 403(b) arrangement are still limited to annuity contracts, custodial accounts holding regulated investment company stock, and, in the case of a church employer, retirement income accounts.[200] The annuity contract may be individual or group, fixed or variable.[201] A 403(b) contract may be owned by the individual (this would not be possible under a qualified plan) or by the employer. One major advantage of an individually-owned annuity contract is its portability.[202] Under the rules in effect before the effective date of the new 403(b) regulations, if the funding vehicle is an individual annuity contract owned by the employee, when he or she changes jobs, the new employer can simply continue to contribute to the existing contract, and a contract acquired outside a 403(b) arrangement could serve as a funding vehicle.[203]

In order for there to be an annuity contract, the insurer must be contractually obligated to provide annuity benefits. Prior to the actual purchase of the contract from the insurer, there is no annuity contract for 403(b) purposes.[204] The annuity contract must be purchased from an insurance company, subject to an exception for certain arrangements that were in effect before May 17, 1982.[205] A

of plan income or assets, and the receipt of consideration from any party dealing with the plan, from occurring between the plan and any disqualified person). The ERISA restrictions also apply to a 403(b) arrangement which is subject to ERISA. *See infra* part II.F (discussing which 403(b) arrangements are subject to ERISA). The prohibited transaction rules of section 4975 do not apply to 403(b) arrangements. I.R.C. § 4975(d)-(e)(1).

[199] I.R.C. § 408.

[200] I.R.C. §§ 403(b)(1), (7), (9). Custodial accounts and retirement income accounts are treated as annuity contracts under sections 403(b)(7) and 403(b)(9)(A)(i). The term annuity contract, therefore, includes all three types of funding vehicle unless otherwise indicated. I.R.C. §§ 403(b)(7), (9)(A)(i).

[201] *See* Rev. Rul. 82-55, 1982-1 C.B. 12 (discussing annuity contracts that are to be treated as mutual fund shares for federal income tax purposes); Rev. Rul. 68-488, 1968-2 C.B. 188 (discussing a group annuity contract); Rev. Rul. 68-116, 1968-1 C.B. 177 (defining a variable annuity contract; holding that it is an annuity contract for section 403(b) purposes).

[202] *See* Pratt, 1996 Article, *supra* note 3, at 1219.

[203] Rev. Rul. 68-33, 1968-1 C.B. 175 (discussing how a new annuity contract is considered to be purchased when a new employer pays the first premium of an employee's existing annuity contract); Rev. Rul. 66-254, 1966-2 C.B. 125 (discussing how an employer can pay premiums on an annuity contract originally purchased by the employee or the employee's former employer).

[204] Rev. Rul. 68-488, 1968-2 C.B. 188 (finding that there must be a purchase and that payments made to the bank can be contributions to that purchase); Rev. Rul. 68-487, 1968-2 C.B. 187 (noting that 403(b) requires "the direct purchase of an annuity contract for the employee").

[205] Rev. Rul. 67-387, 1967-2 C.B. 153 (holding that a certain purchase arrangement constituted an annuity contract under 403(b)); Rev. Rul. 67-361, 1967-2 C.B. 153 (holding that

face amount certificate may also be treated as an annuity under section 401(g), if it is nontransferable.[206]

In 1974, ERISA added Code section 403(b)(7), which allows 403(b) assets to be invested in a custodial account that holds regulated investment company stock (normally mutual fund shares).[207] It is essential that a custodial account be created. A "regulated investment company" is an issuer of securities that is registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940.[208] In 1976, the law was further amended to permit investment in closed-end investment companies, which are regulated investment companies that issue nonredeemable shares, as well as mutual funds.[209]

The custodian must be a bank or a person approved by the Commissioner pursuant to section 401(f).[210] Assets of a 403(b) custodial account must be invested exclusively in regulated investment company stock, but a custodial account may permit loans to participants.[211]

In 1982, section 251(b) of TEFRA added a third alternative, a retirement income account, for certain church employers.[212] A

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the organization will have purchased annuity contracts for its employees if the requirements of section 403(b) are entirely met). Both of these rulings were revoked prospectively. Rev. Rul. 82-102, 1982-1 C.B. 62; *see also* Corbin v. United States, 760 F.2d 234, 235 (8th Cir. 1985) (upholding the validity of Rev. Rul. 82-102 and applying it prospectively); Acord v. United States, 532 F. Supp. 22, 24 (E.D. Mo. 1981) ("[I]t is not clear that insurance companies are the sole entities which are authorized to issue annuities under 26 U.S.C. § 403(b)(1)."); Rev. Rul. 70-582, 1970-2 C.B. 95 (ruling that salary reduction agreements are excludable from an employee's income).

[206] I.R.C. § 401(g) (2006) (defining annuity to include face-amount certificates); *see also* Investment Company Act of 1940, ch. 686, sec. 2(a)(15), 54 Stat. 789, 792–93 (codified at 15 U.S.C. § 80a-2(a)(15) (2006) (defining a face-amount certificate)).

[207] The legislative history states: "The committee believes that it would be desirable to provide more flexibility in this area, and, accordingly, the committee bill provides that these contributions may also be placed in qualified custodial accounts if those funds are to be invested in mutual funds." H.R. REP. NO. 93-807, at 151 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4827. "Custodial account" is defined in Treas. Reg. § 1.403(b)-8(d)(2) (2007).

[208] I.R.C. § 851(a).

[209] TRA 76, Pub. L. No. 94-455, §1504(a), 90 Stat. 1520, 1738 (codified as amended at I.R.C. § 403(b)(7)(C) (2006)).

[210] I.R.C. § 401(f)(2) (stating that assets are to be held by a bank); I.R.C. § 403(b)(7)(A) (defining what amounts can be considered as contributions in custodial accounts); I.R.C. § 408(n) (defining the term bank); Treas. Reg. §1.401-(12)(c)(3) (as amended in 1995) (suggesting possible nonbank trustees). A nonbank custodian must demonstrate, to the satisfaction of the Secretary of the Treasury, that the manner in which he or she will hold the assets will be consistent with the requirements of section 401(f). I.R.C. §401(f)(2) (2008); Treas. Reg. §§ 1.401(f)-1(b)(1)(ii), 1.408-2(e) (as amended in 1995 and 2007, respectively).

[211] I.R.C. § 72 (p)(1)(A) (2006).

[212] TEFRA, Pub. L. No. 97-248, § 251(b), 96 Stat. 324, 530 (codified as amended at I.R.C. § 403(b)(9)). Section 403(b) contains several special rules for church employers and employees,

retirement income account is a defined contribution program established or maintained to provide benefits under section 403(b).[213] A retirement income account may offer section 403(b)(1) annuity contracts, section 403(b)(7) custodial accounts, or any other investment. A retirement income account need not be held by any particular type of custodian or invested in any particular way.[214] A retirement income account may be commingled for investment purposes with other retirement income accounts, qualified plan assets, or other church funds.[215]

To be eligible to maintain a retirement income account, the employer must be a church or a convention or association of churches, including an organization (described in section 414(e)(3)(A)) the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits and/or welfare benefits for the employees of a church or a convention or association of churches, if the organization is controlled by or associated with a church or a convention or association of churches.[216]

Section 403(b) assets have traditionally been kept separate from qualified plan assets. The IRS has ruled, however, that a single allocated group annuity contract could be used to fund benefits

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and uses different definitions, of what constitutes a church, for different purposes. § 403(b)(9), (b)(12)(B).

[213] Section 251(e)(5) of TEFRA also allows certain defined benefit plans in existence on September 3, 1982 to be treated as defined contribution plans for this purpose. TEFRA § 251(e)(5), I.R.C. § 403(b)(9).

[214] *See* I.R.S. Priv. Ltr. Rul. 91-22-081 (May 31, 1991) (allowing a number of investment programs and contribution plans as long as they comply with section 403(b)(9)).

[215] H.R. REP. NO. 97-760 (1982) (Conf. Rep.), *reprinted in* 1982 U.S.C.C.A.N. 1190, at 1408–09 ("The conferees intend that the assets of a retirement income account for the benefit of an employee or his beneficiaries may be commingled in a common fund made up of such accounts. However, that part of the common fund which equitably belongs to any account must be separately accounted for (i.e., it must be possible at all times to determine the account's interest in the fund), and cannot be used for, or diverted to, any purposes other than the exclusive benefit of such employee and beneficiaries. Provided those requirements are met, the assets of a retirement income account also may be commingled with the assets of a tax-qualified plan without adversely affecting the status of the account or the qualification of the plan. The conferees also intend that the assets of a church plan (sec. 414(e)) may be commingled in a common fund with other amounts devoted exclusively to church purposes (for example, a fund maintained by a church pension board) if that part of the fund which equitably belongs to the plan is separately accounted for and cannot be used for or diverted to purposes other than for the exclusive benefit of employees and their beneficiaries. Of course, the reasonable costs of administering a retirement income account (including an account which is a part of a common fund) may be charged against the account. Such costs include the reasonable costs of administering a retirement income program of which the account is a part, including costs associated with informing employees and employers of the availability of the program.").

[216] I.R.C. § 403(b)(9).

under both a qualified plan and a 403(b) arrangement.[217]

The regulations require that contributions be transferred to the funding vehicle "within a period that is not longer than is reasonable for the proper administration of the plan,"[218] such as transferring elective deferrals "within 15 business days following the month in which these amounts would otherwise have been paid to the participant.[219] If the plan is subject to ERISA, then a more stringent standard (the same standard as applies to 401(k) plans) would govern.[220]

Under the regulations, custodial accounts and retirement income accounts are subject to an exclusive benefit requirement similar to the requirement applicable to qualified plans.[221] To the extent permitted by the Commissioner in the future, assets held under a custodial account or a retirement income account may be pooled with trust assets held under a qualified plan or IRA.[222]

The final regulations, like the proposed regulations, include a number of special rules for church plans.[223] A life annuity can generally only be provided from an individual account by the purchase of an insurance annuity contract.[224] The final regulations, like the proposed regulations, however, permit a life annuity to be paid from a retirement income account if certain conditions are satisfied.[225]

F. Applicability of ERISA

1. In General

A 403(b) or 401(k) plan is an "employee pension benefit plan,"[226] and is thus subject to ERISA unless it qualifies for an exemption. A

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[217] I.R.S. Priv. Ltr. Rul. 95-40-061 (Oct. 6, 1995) (discussing Rev. Rul. 81-100, and ruling that "trusts which are parts of qualified retirement plans and individual retirement accounts may pool their assets in a group trust without affecting the exempt status of the separate trusts"); *see also* Priv. Ltr. Rul. 94-22-053 (June 3, 1994) (ruling that pooling accounts will not affect exempt status).

[218] Treas. Reg. § 1.403(b)-8(b) (as amended in 2007).

[219] *Id.*

[220] *See infra* text accompanying notes 223–230.

[221] Treas. Reg. § 1.403(b)-8(d)(2)(iii) (discussing custodial accounts); Treas. Reg. § 1.403(b)-9(a)(2)(C) (discussing retirement income accounts).

[222] Treas. Reg. § 1.403(b)-8(f).

[223] § 1.403(b)-9 (setting forth special rules required for church plans).

[224] § 1.403(b)-8(c)(1).

[225] § 1.403(b)-9(a)(5).

[226] ERISA § 3(2), 29 U.S.C. § 1002(3) (2006).

governmental plan[227] is completely exempt.[228] This excludes from ERISA coverage one of the three classes of 403(b) eligible employers, public educational institutions.[229] It also excludes public institutions which are eligible because they are analogous to 501(c)(3) organizations.[230]

A church plan[231] is also completely exempt,[232] unless (as is highly unlikely) it has made an election under section 410(d) of the Code. This excludes from ERISA coverage most 403(b) and 401(k) plans maintained by a church.[233]

Accordingly, after these statutory exemptions are applied, the 403(b) plans subject to ERISA are those maintained by private sector organizations (other than churches) which are tax-exempt under section 501(c)(3).[234] The 401(k) plans subject to ERISA are those maintained by private sector employers (other than churches).[235]

Two additional ERISA exemptions are contained in the Department of Labor regulations. The first, which applies to 401(k) plans but not to 403(b) plans, provides that if the plan has only ever covered owners of the employer (and their spouses), then the plan is not an "employee benefit plan" and thus is not subject to ERISA.[236]

The second, which applies to 403(b) plans but not to 401(k) plans,[237] provides that, if the employer does not contribute to the

[227] This term is defined in ERISA § 3(32), 29 U.S.C. § 1002(32) (2006).

[228] ERISA § 4(B)(1), 29 U.S.C. § 1003(b)(1) (2006). Two recent cases discuss whether an employee organization (in each case, a teachers' union) may establish a 403(b) plan: Montoya v ING Life Insurance & Annuity Co., No. 07 Civ. 2574, 2009 WL 2850748, at *5 (S.D.N.Y. August 31, 2009) and Daniels-Hall v. Nat'l Educ. Ass'n, No. C07-5339RBL, 2008 WL 2179530, at *4 (W.D. Wash. May 23, 2008); *see also DOL Files Amicus Brief Supporting Position That NEA Didn't Create Section 403(b) Plan*, *supra* note 5, at 2115.

[229] I.R.C. § 403(b)(1)(A)(ii) (2006).

[230] *See, e.g.*, 80 Op. Dep't of Labor 19A (1980), 1980 ERISA LEXIS 58, at *5 (opining that a hospital established by state law is a governmental unit); 75 Op. Dep't of Labor 33 (1975), 1975 ERISA LEXIS 4, at *2 (opining that a public library district is a governmental unit); *see also* Richard A. Turner, *Are Public Schools and Other 403(B) Plan Sponsors Fiduciaries?*, SP021 ALI-ABA Course of Study: Retirement, Deferred Compensation, and Welfare Plans of Tax-Exempt and Governmental Employers 419 (2008), SP021 ALI-ABA 409 (Westlaw).

[231] This term is defined in ERISA § 3(33), 29 U.S.C. § 1002(3) (2006).

[232] ERISA § 4(b)(2), 29 U.S.C. § 1003(b)(2) (2006).

[233] For this purpose, the term "church" is defined in § 3(33) of ERISA. Essentially, a church plan is one maintained by a church, or a convention or association of churches for its employees and employees of certain controlled or associated organizations. ERISA § 3(33), 29 U.S.C. § 1002(33) (2006). A plan is not a church plan if it covers primarily persons employed in connection with unrelated trades or businesses. ERISA § 3(33)(B)(I), 29 U.S.C. § 1002(33)(B)(i) (2006).

[234] ERISA § 4(b)(1), 29 U.S.C. § 1003(b)(1) (2006).

[235] *Id.*

[236] 29 C.F.R. § 2510.3-3(b), (c) (2009).

[237] § 2510.3-2(f).

403(b) arrangement from its own funds (i.e., the only contributions are salary reduction contributions by participants), the plan will be exempt if the employer's involvement is limited.[238] In order to be exempt, all of the following requirements must be satisfied:

> (1) Participation [in the 403(b) arrangement] is completely voluntary for employees;
>
> (2) All rights under the annuity contract or custodial account are enforceable solely by the employee, by a beneficiary of such employee, or by any authorized representative of such employee or beneficiary;
>
> (3) The sole involvement of the employer . . . is limited to any of the following [set forth in (i)–(vii)]; and
>
> (4) The employer receives no direct or indirect consideration or compensation in cash or otherwise other than reasonable compensation to cover expenses properly and actually incurred by such employer in the performance of the employer's duties pursuant to the salary reduction agreements.[239]

The actions an employer may take under section 3 are relatively few. The employer may allow annuity contractors (including agents or brokers) to publicize their products to employees.[240] The employer may request "information concerning proposed funding media, products or annuity contractors,"[241] and may summarize or compile the information provided, "in order to facilitate review and analysis by the employees."[242] The employer may collect salary reduction contributions, remit them to annuity contractors, and

[238] § 2510.3-2(f)(3).

[239] § 2510.3-2(f). The preamble to the regulation states that "this regulation does not preclude the possibility that section 403(b) programs which do not fully conform with the provisions of the regulation may nevertheless not be 'established or maintained' by an employer for purposes of Title I of the Act." Definitions and Coverage Under the Employee Retirement Security Act of 1974; Tax Sheltered Annuity Programs, 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979) (codified as amended at 29 C.F.R. pt. 2510.3-2(f)) (preamble to final Dep't of Labor regulations concerning ERISA treatment of 403(b) plans). The DOL has interpreted this exemption narrowly. *See, e.g.*, 94 Op. Dep't of Labor 30A (1994), 1994 ERISA LEXIS 34, at **6–7 (concluding that the DOL could not construe the described plan to be exempt from Title I of ERISA because the employer had to make a judgment concerning an employee's financial hardship to withdraw funds prematurely from the plan; the employer's exercise of judgment was considered outside the scope of regulation 29 C.F.R. § 2510.3-2(f)); 83 Op. Dep't of Labor 23A (1983), 1983 ERISA LEXIS 35, at **7–8 (concluding that the described 403(b) arrangement was designed by the employer and the employer's ability to close accounts or approve brokerage firms exceeded the limitations on the employer's involvement as described in regulation 29 C.F.R. § 2510.3-2(f)(3)).

[240] 29 C.F.R. § 2510.3-2(f)(3)(i).

[241] § 2510.3-2(f)(3)(ii) (as amended in 1982).

[242] § 2510.3-2(f)(3)(iii).

maintain records of such amounts.[243] The employer may hold in its name group annuity contracts covering its employees.[244]

The rules relating to the employer's choice of funding vehicles were modified. "Before February 7, 1978, [the employer could limit] the funding media or products available to employees, or the annuity contractors who could approach employees, to those which, in the judgment of the employer, afforded employees appropriate investment opportunities."[245] In contrast, "[a]fter February 6, 1978, the [employer may limit the funding of media or products available to employees, or the annuity contractors who may approach employees, to a number and selection which is designed to afford employees a reasonable choice in light of all relevant circumstances."[246]

2. Consequences of ERISA Coverage

If the plan is subject to ERISA, there are major consequences. First, ERISA limits the employee eligibility requirements that may be imposed and prohibits the cessation or reduction of benefit accruals because of age.[247]

Second, the arrangement must comply with ERISA's reporting and disclosure requirements. This requires that an annual report (in the 5500 series) be filed with DOL, as well as distributing to the participants and beneficiaries a summary plan description, a summary of any material modifications to the plan, and a summary

[243] § 2510.3-2(f)(3)(iv).

[244] § 2510.3-2(f)(3)(v).

[245] § 2510.3-2(f)(3)(vi).

[246] § 2510.3-2(f)(3)(vii) (as amended in 1982) ("Relevant circumstances may include, but would not necessarily be limited to: [t]he number of employees affected, [t]he number of contractors who have indicated interest in approaching employees, the variety of available products, [t]he terms of the available arrangements, [t]he administrative burdens and costs to the employer, and [t]he possible interference with employee performance resulting from direct solicitation by contractors."). The preamble states that "[i]t may be that in some circumstances it would be reasonable for the employer to limit to one the number of contractors who may deal with employees under the section 403(b) program." Definitions and Coverage Under the Employee Retirement Security Act of 1974; Tax Sheltered Annuity Programs, 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979) (codified as amended at 29 C.F.R. pt. 2510.3-2(f)) (preamble to final DOL regulations concerning ERISA treatment of 403(b) plans). Examples would include a broker who represents numerous vendors; a mutual fund company with numerous funds with different investment objectives; and an insurer which offers numerous investment alternatives under a variable annuity contract. Because of the inherently factual nature of the issue, the DOL ordinarily will not rule on whether a particular employer has afforded employees a reasonable choice in a specific situation. *See* 76 Op. Off. Employee Ben. Plans 1, 41 Fed. Reg. 36,281, 36,282 (Aug. 27, 1976) (Section 5.01).

[247] ERISA §§ 202(2), 204(b)(1)(G), 29 U.S.C. §§ 1052(a)(2), 1054(b)(1)(G) (2006).

annual report.[248]

Third, the arrangement must "be established and maintained pursuant to a written instrument,"[249] which includes the items required by ERISA section 402, namely, the identity of the named fiduciaries of the plan, the "procedure for establishing and carrying out" the plan's funding policy and method, and the procedure for amending the plan.[250]

Fourth, the ERISA fiduciary responsibility rules[251] apply so that, for instance, the fiduciaries must act prudently in investing plan assets or in selecting investment options to be made available to participants. The employer is a fiduciary because it normally has the power to amend the plan and is ultimately responsible for its administration.[252] Any other person having or exercising control over the investment or disposition of plan assets will also be a fiduciary.[253] This could include employees of the employer, an insurance company offering variable annuities, or the custodian of a custodial account.[254] In addition, ERISA section 403(a) requires assets of a covered plan be held in trust.[255] There are two relevant exceptions: the trust requirement does not apply "to any plan assets which consist of insurance contracts or policies (e.g., annuity contracts) issued by an insurance company qualified to do business in a state,"[256] or to assets held in a custodial account pursuant to section 403(b)(7).[257] There is no specific statutory or regulatory exemption for retirement income accounts; such accounts were first available in 1982, eight years after ERISA was enacted, and ERISA has not been amended to reflect their availability.

Further, if the 403(b) arrangement is subject to ERISA, the DOL regulations require employee contributions—which include salary reduction contributions—to be paid over to the funding vehicle as soon as they "can reasonably be segregated from the employer's general assets," but in no event later than the fifteenth business

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[248] Form 5500 contains information about the plan, and is required to be filed with DOL, who forwards the information to the IRS. *See* 29 C.F.R. §§ 2520.103-1, 2520.104a-5, 2520.102-2–3, 2520.104a-2, 2520.104b-2, 2520.104b-10 (2009).

[249] ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1) (2006).

[250] ERISA § 402(a)–(b)(3), 29 U.S.C. §§ 1102(a)–(b)(3) (2006).

[251] ERISA § 404, 29 U.S.C. § 1104 (2006); ERISA § 3(21), 29 U.S.C. § 1002(21) (2006) (defining "fiduciary" broadly).

[252] Treas. Reg. § 1.403(b)-8(b) (2007).

[253] ERISA § 3(21), 29 U.S.C. § 1102(21) (2006).

[254] Treas. Reg. § 1.403(b)-8 (2007).

[255] ERISA § 403(a), 29 U.S.C. § 1103(a) (2006).

[256] ERISA § 403(b)(1), 29 U.S.C. § 1103(b)(1) (2006).

[257] ERISA § 403(b)(5), 29 U.S.C. § 1103(b)(5) (2006).

day of the following month.[258]

Fifth, if the plan is structured as a money purchase pension plan, the minimum funding rules of ERISA apply.[259] If the arrangement is structured as a discretionary contribution plan, the funding rules are not applicable.[260] It is not always easy to classify 403(b) arrangements and, unlike qualified plans that are required to identify their type,[261] the documents establishing a 403(b) arrangement are not required to do so.[262] If the plan is subject to the funding rules, then the joint and survivor annuity rules also apply.[263] These annuity rules also apply to discretionary contribution arrangements unless certain requirements are satisfied.[264]

Sixth, the prohibited transaction rules of ERISA sections 406–408 apply.[265] The prohibited transaction rules and penalties under section 4975, however, do not apply to 403(b) arrangements.[266]

Seventh, the ERISA bonding rules apply.[267]

Eighth, the plan must comply with the ERISA rules governing claims and claims procedures.[268]

Ninth, the plan must comply with recently promulgated DOL rules relating to investment advice, fee disclosures to participants, and service providers.[269]

Finally, a plan may not be amended to reduce the rate of future benefit accruals unless, after the amendment is adopted and at least fifteen days before its effective date, notice of the amendment is provided to each participant and beneficiary.[270] This would apply to any plan which is subject to the minimum funding rules.[271]

ERISA 403(b) plans have been subject to limited Form 5500 filing

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[258] 29 C.F.R. § 2510.3-102(b) (2009). The maximum time period is extended by ten business days for an employer who satisfies the requirements of 29 C.F.R. § 2510.3-102(d) (2009).

[259] ERISA § 301(a)(8), 29 U.S.C. §1081(a)(8) (2006).

[260] ERISA § 302(a)(1), 29 U.S.C. §1082(a)(2)(B) (2006).

[261] I.R.C. § 401(a)(27)(B) (2006).

[262] *See generally* I.R.C. § 403(b) (stating that the statutory requirements do not include a plan type requirement).

[263] ERISA § 205, 29 U.S.C. § 1055 (2006).

[264] ERISA § 205(b)(1)(C), (b)(2), 29 U.S.C. §§ 1055(b)(1)(C), (b)(2) (2006).

[265] ERISA §§ 406–408, 29 U.S.C. §§ 1106–1108 (2006).

[266] The definition of "plan" for purposes of § 4975 includes qualified plans, section 403(a) plans, and IRAs, but does not include section 403(b) arrangements. I.R.C. § 4975(e)(1) (2006).

[267] ERISA § 412, 29 U.S.C. § 1112 (2006).

[268] ERISA § 503, 29 U.S.C. § 1133 (2006).

[269] 29 C.F.R. § 2550.408g-1 (2009).

[270] ERISA § 204(h), 29 U.S.C. § 1054(h) (2006 & Supp. I 2007).

[271] ERISA §§ 301–304, 29 U.S.C. §§ 1081–1084 (2006).

requirements: they completed only certain parts of the Form 5500, and were exempted from completing the many schedules required for qualified plan filings.[272] On November 16, 2007, DOL, IRS, and the Pension Benefit Guaranty Corporation ("PBGC") published final regulations that remove the limited filing exemption.[273] Effective for plan years beginning on or after January 1, 2009, ERISA 403(b) plans will generally be subject to the standard Form 5500 filing requirements.[274] In addition, sponsors of plans with one-hundred or more eligible participants generally will need to have their plans audited by an independent qualified public accountant.[275]

A 403(b) plan or 401(k) plan is generally subject to the QDRO requirements of Code section 414(p), regardless of whether the plan is subject to ERISA.[276]

There are several significant advantages of being subject to ERISA, including a "clear legal framework for defining [the employer's] obligations and duties"; more control over plan assets; "more control over the design and administration of the plan"; and preemption of state law.[277] ERISA will preempt most state laws that would otherwise affect the plan,[278] though it preserves state laws regulating insurance, banking, or securities.[279] If state law is preempted, then any cause of action must generally be brought under ERISA's enforcement provisions.[280] This in turn,

> eliminates the possibility of punitive damages, consequential

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[272] 29 C.F.R. § 2520.104-44(b)(3) (2009).

[273] Annual Reporting and Disclosure, 72 Fed. Reg. 64,710 (Nov. 16, 2007) (to be codified at 29 C.F.R. pt. 2520) (preamble to final DOL rules relating to annual reporting and disclosure requirements under ERISA).

[274] *Id.* at 64,715.

[275] *Id.* DOL granted some relief in Field Assistance Bulletin 2009-02. U.S. Dep't of Labor, Field Assistance Bulletin No. 2009-02, (July 20, 2007), *available at* http://www.dol.gov/ebsa/regs/fab2009-2.html.

[276] I.R.C. § 414(p)(9) (2006). Any qualified plan which is a governmental plan or a non-electing church plan is not subject to the QDRO rules, because such plans are not subject to the requirements of section 401(a)(13) of the I.R.C. *Id.*; *see also* Treas. Reg. § 1.401(a)-13(a) (as amended in 1988). Section 414(p)(9) provides that "[f]or purposes of this title, except as provided in regulations, any distribution from an annuity contract under section 403(b) pursuant to a qualified domestic relations order shall be treated in the same manner as a distribution from a plan to which section 401(a)(13) applies." I.R.C. § 414(p)(9). For the advantages and disadvantages of ERISA coverage, see Greg K. Hitchcock et al., 403(b) Plans: Covered by ERISA or Exempt? (July 9, 2008), http://www.dwt.com/LearningCenter/Advisories?find=21203.

[277] *See* Hitchock et al., *supra* note 276, at 2.

[278] ERISA § 514(a), 29 U.S.C. § 1144(a) (2006) (providing that ERISA "shall supersede any and all State laws" which relate to an employee benefit plan covered by ERISA, subject to certain exceptions).

[279] ERISA § 514(b)(2), 29 U.S.C. § 1144(b)(2).

[280] ERISA § 502, 29 U.S.C. § 1132 (2006).

> damages and a jury trial, and generally limits reliance on oral statements that conflict with plan terms. Additionally, in the event of a conflict with an employee regarding the terms of a plan, employers under ERISA are given the benefit of the doubt in interpreting the plan, and usually any reasonable and consistent interpretation is upheld by courts.[281]

3. The Impact of the New 403(b) Regulations

The enhanced employer responsibilities under the new 403(b) regulations, particularly the "written plan" requirement, have led many to question whether compliance with the regulations would cause employers to lose the benefit of the regulatory exemption for employee-funded 403(b) plans.[282]

DOL has addressed this question in a recent Field Assistance Bulletin ("FAB").[283] Generally, the FAB addresses what kind of activities a private sector 403(b) plan sponsor can engage in that may make the entity a fiduciary under Title I of ERISA.[284] The FAB states that certain discretionary activities *will* make the plan sponsor a fiduciary for the 403(b) plan: "[e]xamples of such discretionary determinations are authorizing plan-to-plan transfers, processing distributions, satisfying applicable qualified joint and survivor annuity requirements, and making determinations regarding hardship distributions, qualified domestic relations orders, and eligibility for or enforcement of loans."[285] The FAB does not apply to public sector entities.[286]

The new written plan requirement will not necessarily make a 403(b) plan sponsor ineligible for the regulatory ERISA exemption for plans funded solely by employee contributions. [287] The preamble to the regulations states that DOL has advised the Treasury and IRS that "an employer may undertake responsibilities" that would

[281] Hitchcock et al., *supra* note 276, at 2.
[282] 29 C.F.R. § 2510.3-2(f) (2009).
[283] U.S. Dep't of Labor, FAB No. 2007-02, (July 24, 2007), *available at* http://www.dol.gov/ebsa/pdf/fab2007-2/pdf [hereinafter FAB 2007-02].
[284] *Id.* at 2.
[285] *Id.* at 4.
[286] *Id.* at 2 n.1; *see also* Nat'l Ass'n of Gov't Defined Contribution Adm'rs (NAGDCA), *403(b) Plans Frequently Asked Questions* (Apr. 2008), http://www.nagdca.org/documents/NAGDCA-403bFAQ.pdf [hereinafter NAGDCA].
[287] 29 C.F.R. § 2510.3-2(f). DOL provided additional guidance on the scope of involvement by tax-exempt organizations that will cause a plan to be subject to ERISA in an advisory opinion. 94 Op. Dep't of Labor 30 (1994), 1994 ERISA LEXIS 34, at *1.

"constitute establishing and maintaining an ERISA-covered plan."[288] DOL stated that this "must be analyzed on a case-by-case basis, applying the criteria set forth in 29 C.F.R. § 2510.3-2(f)," including the employer's involvement as contemplated by the plan documents and in operation.[289] On July 24, 2007, DOL discussed ERISA coverage of section 403(b) programs in FAB 2007-02.[290] The FAB states in part:

> An employer, by adopting such a written plan, does not automatically establish a Title I plan. Compiling the benefit terms of the contracts and the responsibilities of the employer, annuity providers and participants is a function similar to the information collection and compilation activities expressly permitted under the Department's TSA safe harbor. Indeed, the preamble to the final Treasury regulations makes clear that the "plan" required to satisfy the Code does not have to be a single document, but may incorporate by reference other documents, including insurance policies and custodial account agreements and other documents governing the contracts and accounts prepared by the annuity providers. 26 C.F.R. § 1.403(b)-3(b)(3).
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> The Department of Labor expects that the written plan for a TSA program that complies with the safe harbor would consist largely of the separate contracts and related documents supplied by the annuity providers and account

[288] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,136–41,137 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[289] *Id.* ("Comments submitted on the proposal supported the continued availability of non-Title I section 403(b) programs to employees of tax-exempt employers and asked for additional guidance for employers who offer their employees access to such programs. According to the Department of Labor, review of the final section 403(b) regulations has not led the Department of Labor to change its view on the principles that apply in determining whether any given section 403(b) program is covered by Title I of ERISA. Even though the differences between the tax rules for section 403(b) programs and those governing other ERISA-covered pension plans may have diminished as a result of the final section 403(b) regulations, the Department of Labor continues to be of the view that tax-exempt employers can comply with the requirements in the section 403(b) regulations and remain within the Department of Labor's safe harbor for tax-sheltered annuity programs funded solely by salary deferrals. The Department of Labor notes, however, that the new section 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement. The question of whether any particular employer, in complying with the section 403(b) regulations, has established or maintained a plan covered under Title I of ERISA must be analyzed on a case-by-case basis applying the criteria set forth in 29 CFR § 2510.3-2(f) and section 3(2) of ERISA.").

[290] FAB 2007-02, *supra* note 283, at 1–2.

> trustees or custodians. An employer's development and adoption of a single document to coordinate administration among different issuers, and to address tax matters that apply, such as the universal availability requirement in Code section 403(b)(12)(A)(ii), without reference to a particular contract or account, would not put the TSA program out of compliance with the safe harbor.[291]

The Treasury and IRS requested comments on the extent that the regulations raise questions "concerning the scope and application" of the ERISA exemption.[292] The obvious comment is that the new plan document requirement makes it even more important than formerly that DOL clarify the regulatory exemption, which is intolerably imprecise.[293] The facts and circumstances standard set out in the FAB is difficult to apply in practice.[294]

G. The "Written Plan" Requirement

A section 401(a) qualified plan must have a plan document that specifically incorporates numerous qualification requirements under section 401(a) and the regulations.[295] By contrast, there have

[291] *Id.* at 4.

[292] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 69 Fed. Reg. 67,075, 67,081 (proposed Nov. 16, 2004) (to be codified at Treas. Reg. pts. 1 and 31) (preamble to proposed regulations for Dep't of Treasury).

[293] *See* Lincoln Financial Group Addresses Proposed Regs on Retirement Annuity Contracts, TAX NOTES TODAY, Feb. 18, 2005, 2005 TNT 33-31 (LEXIS) ("With the publication of the Proposed Regulations, the matter only became more opaque. The Proposed Regulations address this matter in the preamble under the heading 'Interaction between Title I of ERISA and Section 403(b) of the Code' where it describes the consultation of the Treasury and the Service with the DOL. We think that the result of that consultation can be fairly summarized as compliance with the requirements in the Proposed Regulations does not necessarily mean that a 403(b) plan of a 501(c)(3) organization will be governed by ERISA, but it might. Quite frankly, that is simply not good enough."); *see also* ASPPA Comments on Proposed Regs on Retirement Annuity Contracts, TAX NOTES TODAY, Mar. 25, 2005, 2005 TNT 57-15 (LEXIS) ("The plan document requirement discussed above, and other duties placed on employers under the Proposed Regulations, makes it essential for the DOL to provide specific guidance about what types and degree of employer involvement will subject a plan to Title I of ERISA.").

[294] *See, e.g.*, Posting of Bob Toth to Benefits Biz Blog, The New 403(b) Plan Documents and ERISA, http://www.benefitsbizblog.com/2008/08/the-new-403b-plan-documents-an.html (Aug. 29, 2008, 11:07 EST) ("So a word of caution to plan drafters, employers and service providers: inadvertently putting 'standard' 401(a) language (which assumes a plan administrator's control over a plan) into a 403(b) document or a service provider agreement can be an expensive proposition. Doing it improperly can cause ERISA liability. But it really raises the question as to whether or not a 501(c)(3) organization can now ever avoid ERISA status for its 403(b) plan, because of the new regs.").

[295] I.R.C. § 401(a) (2006); Treas. Reg. § 1.401-1 (as amended in 1976).

been few documentation requirements for a 403(b) arrangement.[296] Often, there has not been a single 403(b) document: the plan has been evidenced by a collection of documents, including salary reduction agreements, annuity contracts, custodial agreements, summary plan descriptions, and additional information distributed to employees.

If a 403(b) plan is subject to ERISA, then a plan document is required by ERISA,[297] but there is no plan document requirement in Code section 403(b) itself. In a major change, the new 403(b) regulations[298] require that a 403(b) arrangement be maintained pursuant to a written plan:

> The existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan. Without such a central document for a comprehensive summary of responsibilities, there is a risk that many of the important responsibilities required under the statute and final regulations may not be allocated to any party. While a section 403(b) contract issued to an employee can provide for the issuer to perform many of these functions by itself, the contract cannot satisfy the function of setting forth the eligibility criteria for other employees, nor can the issuer by itself coordinate those Code requirements that depend on other contracts, such as the loan limitations under section

[296] ERISA section 402(a)(1) requires every employee benefit plan to be "established and maintained pursuant to a written instrument" which must "provide for one or more named fiduciaries who jointly or severally . . . have authority to control and manage the operation and administration of the plan." ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1) (2006). ERISA section 402(b) requires every plan to (1) "provide a procedure for establishing and carrying out a funding policy and method," (2) "describe any procedure under the plan for the allocation of [administrative] responsibilities," (3) "provide a procedure for amending such plan and for identifying the persons who have authority to amend the plan," and (4) "specify the basis on which payments are made to and from the plan." ERISA § 402(b), 29 U.S.C. § 1102(b) (2006). Section 402(c) lists additional optional plan provisions. ERISA § 402(c), 29 U.S.C. § 1102(c) (2006). ERISA section 402 generally applies to all employee benefit plans described in ERISA section 4(a) which are not exempt under ERISA section 4(b). Thus, it applies to most qualified plans (other than governmental plans, certain church plans, and plans covering only owners of the plan sponsor) and also to 403(b) arrangements which are subject to ERISA. In addition, regardless of whether it is subject to ERISA, a 403(b) arrangement must (1) limit elective deferrals to the dollar amount specified in section 402(g) (generally $ 16,500 for 2009 and 2010); (2) permit the direct transfer of eligible rollover distributions; and (3) incorporate restrictions on when distributions may be made. I.R.C. § 401(a)(30)–(31) (2006) (requiring that elective deferrals be subject to 402(g) limitations); I.R.C. § 403(b)(1)(E), (7)(A)(ii), (10)–(11) (2006) (incorporating restrictions on when distributions may be made).

[297] ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1) (2006).

[298] Treas. Reg. § 1.403(b)-3(b)(3) (as amended in 2007).

> 72(p). The issuer must rely on information or representations provided by either the employer or the employee for employment-based information that is essential for compliance with section 403(b) provisions, such as the limitations on elective deferrals in section 402(g) and the requirements of section 72(p)(2) for a plan loan that is not a taxable deemed distribution. In addition . . . the maintenance of a written plan also benefits participants by providing a central document setting forth their rights and enables government agencies to determine whether the arrangements satisfy applicable law and, in particular, for determining which employees are eligible to participate in the plan.
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> . . . .
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> Additional comments recommended that certain responsibilities be permitted to be allocated to employees. The IRS and Treasury Department have concluded that it is generally inappropriate to allocate these responsibilities to employees for a number of reasons. First, employees often lack the expertise to systematically meet these responsibilities and may not recognize the importance of performing these actions (including not fully appreciating the tax consequences of failing to perform the responsibility). Second, an individual employee may have a self-interest in a particular transaction. In addition, while there are various factors that will often cause an employer or issuer to have an interest in procedures that ensure that the requirements of section 403(b) are satisfied (including income tax withholding requirements), an employee generally bears the income tax exposure and other risks of failing to comply with rules set forth in the plan. The IRS and Treasury Department believe it is important to prevent failures in advance so as to minimize the cases in which the adverse effects of a failure fall on the employee.[299]

The written plan must include all of the material provisions regarding "eligibility, benefits, applicable limitations" as well as "contracts available under the plan, and the time and form under

[299] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,130 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

which benefit distributions would be made."[300]

Further, the final regulations addressed some of the concerns raised by some of the comments that "the written plan requirement would impose additional administrative burdens."[301]

> [T]he final regulations make a number of clarifications, including that the plan is permitted to allocate to the employer or another person the responsibility for performing functions to administer the plan, including functions to comply with section 403(b). Any such allocation must identify who is responsible for compliance with the requirements of the Code that apply based on the aggregated contracts issued to a participant, including loans under section 72(p) and the requirements for obtaining a hardship withdrawal under §1.403(b)-6 of these regulations.[302]

The rule applies to contributions by a church only if the funding vehicle is part of a retirement income account.[303]

The rule does not require that there be a single plan document.[304] The final regulations specifically permit the plan to "incorporate by reference other documents [including [an] insurance policy or custodial account], which [would thus] become part of the plan."[305]

Therefore, with respect to 403(b) plan document requirements

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[300] Treas. Reg. § 1.403(b)-3(b)(3).

[301] Revised Regulations Concerning 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,130 (discussing in the preamble comments raised with respect to the written plan requirement that were addressed following notice of the prior proposed regulations).

[302] *Id.*

[303] Treas. Reg. § 1.403(b)-3(b)(3)(iii).

[304] *See* Fred Stokeld, *Guidance Imminent on Hardship Distributions from Deferred Comp Plans for Katrina Victims*, TAX NOTES TODAY, Sep. 9, 2005, 2005 TNT 174-3 (LEXIS) ("We're not talking about a plan document in a 401(a) sense. We're talking about a plan document that someone can [use] to reference what the terms of the plan are." (quoting Thomas Reeder, Associate Benefits Tax Counsel, Speech at ALI-ABA sponsored conference in Wash. (Sept. 8, 2005))); *see also* James D. Kemper et al., Comments on Behalf of IceMiller, IceMiller Seeks Changes in Proposed Regs on Retirement Annuity Contracts, TAX NOTES TODAY, March 4, 2005, 2005 TNT 42-56 (LEXIS) ("In our experience, most employers sponsoring 403(b) plans incorporate the details relating to the various forms of permissible distributions into the 403(b) plan document by reference to the 403(b) contracts. This is because the terms and conditions relating to various distributions, and even the types of distributions available, may vary significantly from vendor to vendor and with respect to the actual investment options selected by the participant. Since the written plan document can be satisfied through the use of more than one document, we request that the Service clarify in Proposed Treasury Regulation section 1.403(b)-3(b)(3) that reference to specific terms in underlying annuity contracts (for example) will satisfy the written plan document requirement. Such a clarification would also be helpful in the governmental plan area. In some cases, the terms of a governmental 403(b) plan may be found in state statute and state administrative rules, as well as potentially other documents, e.g. annuity contracts. In such a case, we would envision 'declaring' the relevant documents as the plan documents.").

[305] Treas. Reg. § 1.403(b)-3(b)(3)(ii).

under the new regulations, the rules state that:

> [A] plan may include a wide variety of documents, but it is important for the employer that adopts the plan to ensure that there is no conflict with other documents that are incorporated by reference. If a plan does incorporate other documents by reference, then, in the event of a conflict with another document, except in rare and unusual cases, the plan would govern. In the case of a plan that is funded through multiple issuers, it is expected that an employer would adopt a single plan document to coordinate administration among the issuers, rather than having a separate document for each issuer.[306]

The Treasury notes further that "section 403(b) applies only if the contract is purchased under a plan that includes the elective deferral limits under section 402(g), including aggregation of all plans, contracts, or arrangements of the employer that are subject to the limits of section 402(g)."[307] Like the proposed regulations, "the final regulations require the written section 403(b) [plan] to include this limit. . . . [T]he term 'elective deferral' includes a designated Roth contribution as well as a pre-tax elective contribution. These rules are generally the same as the rules . . . under section 401(k)."[308]

The plan may also contain optional features, such as hardship distributions, loans, plan-to-plan or annuity contract to annuity contract transfers, and acceptance of rollovers to the plan.[309] "However, if a plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 403(b) [and the regulations.]"[310]

Several commentators requested that the plan document requirement not become effective until IRS issues model plan language,[311] or a model form,[312] and/or opened an approval process

[306] Revised Regulations Concerning 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,130 (discussing in the preamble written plan requirements under the final regulations).

[307] *Id.* at 41,132.

[308] *Id.*

[309] Treas. Reg. § 1.403(b)-3(b)(3)(i).

[310] *Id.*

[311] S*ee*, *e.g.*, Powell & Mazawey, *supra* note 190 (stating that in the absence of model plan language, employers must go through the expensive process of seeking a private letter ruling to determine if a 403(b) plan satisfies the requirements of the Code).

[312] *See* Kathy Ireland, Comments on Behalf of the Investment Company Institute, Unofficial Transcript of IRS Hearing on Tax-Sheltered Annuity Contracts is Available, TAX NOTES TODAY, Mar. 11, 2005, 2005 TNT 47-19 (LEXIS) (providing an unofficial transcript of testimony in behalf of the Investment Company Institute before an IRS hearing on proposed

for 403(b) plans similar to the determination letter process for qualified plans. Some, however, suggested that such an approval process would be too cumbersome and/or expensive.[313]

Other commentators simply requested more time before the plan document requirement becomes effective:

> Many of the largest governmental 403(b) plans and arrangements are maintained pursuant to state or local statutes that will need to be amended in one or more ways to conform to the final rules. The process of securing the necessary state legislation may well take several years, depending on how frequently the legislature meets, other matters on the agenda, the number and complexity of the regulation changes, etc.
>
> We respectfully submit that ample time should be permitted to accommodate all of the above situations. In light of the fact that the proposed rules would change decades of law, we do not think it is unreasonable to allow a minimum of three full years after final rules are published for the tasks described above to occur. In the interim, we believe that reasonable good faith efforts to achieve operational compliance with any earlier general effective date for the regulations should be permitted.[314]

The IRS has published model plan provisions that may be used by public schools.[315] The model language can, to some extent, be used as a guide by other employers.[316] The Service has also issued a draft of a preapproved plan document program for 403(b) plans.[317]

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regulations under section 403(b): "[f]orm 5305-SEP is used widely by employers to establish simplified employee pension arrangements, and includes only a limited number of provisions. The underlying IRA accounts contain the majority of the required provisions, and are maintained in the names of the individual employees. A new model form for 403(b) plans could be similarly streamlined, because as we've discussed earlier, the underlying annuity contracts and custodial agreements already include many of the requirements of section 403(b). Thus, the plan document could consist of the executed model form wrapped around, if you will, the existing provisions of the individual annuity contracts and custodial agreements").

[313] *See* Powell & Mazawey, *supra* note 190 ("We do not request a determination letter process similar to 401(a) plans because we believe that process would be too cumbersome and expensive for many of the small tax exempt organizations and schools that sponsor 403(b) plans.").

[314] *Id.*

[315] Rev. Proc. 2007-71, 2007-2 C.B. 1184.

[316] *Id.*

[317] I.R.S. Ann. 2009-34, 2009-1 C.B. 91; *see also Commenters Ask for Significant Expansion of Section 403(b) Prototype Plan Program*, 36 Pens. & Ben. Rep. (BNA) 1341 (June 9, 2009); *IRS Review of Vesting Schedules Could Alter Draft 403(b) Prototype Plan*, 36 Pens. & Ben. Rep. (BNA) 2086 (Sep. 15, 2009); Florence Olsen, *Section 403(b) Plans: IRS Officials*

A determination letter program for individually designed plans may follow.[318]

Because the written plan requirement was not going into effect until 2009, employers were expected to adopt a written plan (including applicable amendments) by the effective date of the regulations, generally January 1, 2009 for this purpose.[319] On December 12, 2008, however, the IRS issued Notice 2009-3,[320] which provided with respect to § 403(b) plans that:

> The Service will not treat a §403(b) plan as failing to satisfy the requirements of §403(b) and the final regulations during the 2009 calendar year, provided that: (1) on or before December 31, 2009, the sponsor of the plan has adopted a written §403(b) plan that is intended to satisfy the requirements of §403(b) (including the final regulations) effective as of January 1, 2009; (2) during 2009, the sponsor operates the plan in accordance with a reasonable interpretation of §403(b), taking into account the final regulations; and (3) before the end of 2009, the sponsor makes its best efforts to retroactively correct any operational failure during the 2009 calendar year to conform to the terms of the written §403(b) plan, with such correction to be based on the general principles of correction set forth in [EPCRS].
>
> The relief under this notice applies solely with respect to the 2009 calendar year, and may not be relied on with respect to the operation of the plan or correction of operational defects in any prior or subsequent year.[321]

H. Special Section 415 Rules for 403(b) Arrangements

Unlike the rules for qualified plans, an excess annual addition under a 403(b) arrangement does not disqualify the entire arrangement: the sanction is that the excess (if vested) is currently

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Considering Vesting Schedules in Draft Preapproved Program Under 403(b), BNA Pens. & Ben. Daily (July 9, 2009); I.R.S. Ann. 2009-89, 2009-52 I.R.B. 1.

[318] *See* Sam Young, IRS Says Employee Plan Oversight Continuing to Evolve, TAX NOTES WEEKLY, May 19, 2008, 119 Tax Notes 701 (LEXIS); *see also* Officials Warn Practitioners of Pitfalls to Avoid Under New 403(b) Regulations, 35 Pens.& Ben. Rep. (BNA) 2037 (Sep. 9, 2008).

[319] *See* Young, *supra* note 318.

[320] I.R.S. Notice 2009-3, 2009-2 IRB 250.

[321] *Id.*; *see also* Rev. Proc. 2008-50, 2008-2 C.B. 464 (setting forth "correction principles and rules of general applicability" for 403(b) written plans).

taxable.[322] Under the regulations, this liberal rule applies only if, for the year of the excess and each year thereafter, the issuer of the contract maintains *separate* accounts for (1) the excess and (2) the amount not in excess of the section 415 limitations.[323] Several comments on the proposed regulations suggest that this new separate contract requirement is not consistent with the statute:

> The regulations . . . restrict this treatment to a contract that maintains a separate account for the excess, which would generally not be the case where excess annual additions are made. This construction of the statute effectively provides that an excess annual addition would taint the entire contract. As a result, the Proposed Regulations clearly fail to reflect Congressional intent and we request that final regulations provide that, so long as separate accounting is done within a reasonable period of time after such contribution is discovered, the excess will not cause a failure.[324]

The regulations under section 415 clarify the aggregation rules that apply to 403(b) plans, other plans of the employer, and plans of related employers.[325] Generally, a 403(b) plan is not aggregated with other plans that are maintained by the participant's employer, because the 403(b) plan is deemed to be maintained by the participant, not by the employer, for purposes of section 415.[326] If a participant in a 403(b) plan "is in control of *any* employer for a limitation year,"[327] however, the 403(b) plan is then "treated as a

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[322] Treas. Reg. § 1.403(b)-3(b)(2) (as amended in 2007); *see also* I.R.C. § 415(a)(2) (2006).

[323] Treas. Reg. § 1.403(b)-3(b)(2) ("In accordance with the last sentence of [Code] section 415(a)(2), if an excess annual addition is made to a contract that otherwise satisfies the requirements of [section 403(b)], then the portion of the contract that includes such excess annual addition fails to be a section 403(b) contract [and instead will be a contract to which section 403(c) applies] and the remaining portion of the contract [that includes the contribution that is not in excess of the § 415 limitations] is a section 403(b) contract. This paragraph (b)(2) is not satisfied unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts [for the portion that includes the excess and for the § 403(b) portion].").

[324] Joseph McKeever & Barbara Seymon-Hirsch, on behalf of the Committee of Annuity Insurers, *Attorneys Comment on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Feb. 4, 2005, 2005 TNT 23–13 (LEXIS); *see also* Richard Skillman, *Attorney Urges Changes to Proposed Regs on Qualified Plan Limitations*, TAX NOTES TODAY, Aug. 30, 2005, 2005 TNT 167-30 (LEXIS) ("This provision is demonstrably inconsistent with the intended and settled meaning of the relevant statutory provisions. . . . As applied to *section 403(b)* contributions, *section 415(c)* is a limitation on the amount excludable from gross income under section *403(b)(1)*, no more, no less.").

[325] Treas. Reg. § 1.415(f)-1 (aggregating plans).

[326] § 1.415(f)-1(f)(1).

[327] § 1.415(f)-1(f)(2) (emphasis added).

defined contribution plan maintained by both the controlled employer and the participant for that limitation year . . . [and thus, the 403(b) plan] is aggregated with all other defined contribution plans maintained by that employer."[328]

In general, a section 403(b) arrangement is treated as being maintained by the participant for whom the contract is purchased, rather than by the employer that makes the plan available.[329] If that participant also controls either that employer or another employer, then the 403(b) arrangement is treated as being maintained by both the participant and the employer that he or she controls.[330] For determining control, ownership attribution rules

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[328] *Id.* The regulations include the following examples:

Example 6. (i) Facts. N is employed by a hospital, which purchases an annuity contract described in section 403(b) on N's behalf for the current limitation year. N is in control of the hospital within the meaning of section 414(b) or (c), as modified by section 415(h). The hospital also maintains a qualified defined contribution plan during the current limitation year in which N participates.

(ii) Conclusion. Under section 415(k)(4), the hospital, as well as N, is considered to maintain the annuity contract. Accordingly, for N the sum of the annual additions under the qualified defined contribution plan and the annuity contract must satisfy the limitations of section 415(c) and § 1.415(c)-1.

Example 7. (i) *Facts.* The facts are the same as in *Example 6,* except that instead of being in control of the hospital, N is the 100 percent owner of a professional corporation P, which maintains a qualified defined contribution plan in which N participates.

(ii) *Conclusion.* Under section 415(k)(4), the professional corporation, as well as N, is considered to maintain the annuity contract. Accordingly, the sum of the annual additions under the qualified defined contribution plan maintained by professional corporation P and the annuity contract must satisfy the limitations of section 415(c) and § 1.415(c)-1.

Treas. Reg. § 1.415(f)-1(j), Examples 6 & 7 (citations omitted) (emphasis added).

[329] I.R.C. § 415(k)(4) (2006); Treas. Reg. § 1.415(f)-1(f)(1) (2007).

[330] Treas. Reg. § 1.415(f)-1(f)(2); *see also* Treas. Reg. § 1.415(f)-1(f)(2)(i) ("Where a participant on whose behalf a section 403(b) annuity contract is purchased is in control of any employer for a limitation year as defined in paragraph (f)(2)(ii) of this section (regardless of whether the employer controlled by the participant is the employer maintaining the section 403(b) annuity contract), the annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year. Accordingly, where a participant on whose behalf a section 403(b) annuity contract is purchased is in control of any employer for a limitation year, the section 403(b) annuity contract is aggregated with all other defined contribution plans maintained by that employer. In addition, in such a case, the section 403(b) annuity contract is aggregated with all other defined contribution plans maintained by the employee or any other employer that is controlled by the employee. Thus, for example, if a doctor is employed by a non-profit hospital to which section 501(c)(3) applies and which provides him with a section 403(b) annuity contract, and the doctor also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, then any qualified defined contribution plan of the professional corporation must be aggregated with the section 403(b) annuity contract for purposes of applying the limitations of section 415(c) and § 1.415(c)-1. For purposes of this paragraph (f)(2), it is immaterial whether the section 403(b) annuity contract is purchased as a result of a salary reduction agreement between the employer and the participant.").

apply.[331] For this purpose:

> a participant is in control of an employer . . . if . . . a plan maintained by that employer would have to be aggregated with a plan maintained by an employer that is 100 percent owned by the participant. Thus, for example, if a participant owns 60 percent of the common stock of a corporation, the participant is considered to be in control of that employer . . . ."[332]

The regulations further provide that:

> If a [403(b) plan] is aggregated with a qualified plan of a controlled employer . . . the plans must satisfy the limitations of section 415(c) both separately and on an aggregate basis. In applying separately the limitations of section 415 to the qualified plan and to the section 403(b) annuity contract, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity contract (that is, without regard to § 1.415(c)-2(g)(3)).[333]

If the total annual addition exceeds the section 415 limitation, the excess is treated as a disqualified contribution to the 403(b) arrangement, and therefore includible in the employee's income, before any qualified plan is disqualified.[334] The employee need not

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[331] I.R.C. §§ 1563(d)-(e).

[332] Treas. Reg. § 1.415(f)-1(f)(2)(ii) (as amended in 2007).

[333] § 1.415(f)-1(f)(3).

[334] § 1.415(g)-1(b)(3)(iv)(C)(2) (2007). The regulations include the following example under subsections (C)(2)(i)–(iii) illustrating the application of paragraph (b)(3)(iv)(C). The example assumes that the dollar limitation under section 415(c)(1)(A) that applies for all relevant limitation years is $45,000.

> Example. (i) N is employed by a hospital which purchases an annuity contract described in section 403(b) on N's behalf for the current limitation year. N is also the 100 percent owner of a professional corporation P that maintains a qualified defined contribution plan during the current limitation year in which N participates. (The facts of this example are the same as in § 1.415(f)-1(j) Example 7.) N's compensation (within the meaning of §1.415(c)-2) from the hospital for the current limitation year is $150,000. For the current limitation year, the hospital contributes $30,000 for the section 403(b) annuity contract on N's behalf, which is within the limitations applicable to N under the annuity contract (specifically, the limit under the annuity contract is $45,000)). Professional corporation P also contributes $20,000 to the qualified defined contribution plan on N's behalf for the current limitation year (which represents the only annual additions allocated to N's account under the plan for such year), which is within the $45,000 limitation of section 415(c)(1) applicable to N under the plan.
>
> (ii) Under section 415(k)(4), the professional corporation, as well as N, is considered to maintain the annuity contract. Accordingly, the sum of the annual additions under the qualified defined contribution plan maintained by professional corporation P and the annuity contract must satisfy the limitations of section 415(c) and §1.415(c)-1.
>
> (iii) Because the total aggregate contributions ($50,000) exceed the section 415(c)

aggregate contributions to the 403(b) arrangement with other plans of the employer that sponsors the arrangement, unless he or she controls that employer.[335]

I. Former Employees

Section 403(b)(3) allows an employer to treat an employee as having compensation for up to five years after he or she severs from employment.[336] The preamble to the proposed regulations noted that the regulations did not address contributions for former employees other than under this five-year rule (e.g., accumulated sick pay that is actually paid after severance from employment).[337] "The Treasury Department and IRS expect to issue separate guidance on this issue, potentially addressing this question with respect to not only section 403(b), but also sections 401(k), 457(b) (for eligible governmental plans), and 415(c)."[338] This issue is now covered by the section 415 regulations: employees can make deferrals from certain amounts that are actually paid after severance from employment.[339]

Under the final regulations, there are two ways in which contributions can be made to a former participant's 403(b) account after he or she has terminated service with the employer. First, only three types of compensation received after termination of service can be included as compensation for plan purposes: regular pay, accrued but unused vacation, and accrued but unused sick pay.[340] From any of those three items, they may make elective deferrals, after they have terminated employment, by the later of (1) two-and-one-half months from the date of severance or (2) the end of the calendar year of severance.[341]

Second, employer non-elective contributions can be made for five

> limitation applicable to N ($45,000), $5,000 of the $ 30,000 contributed to the section 403(b) annuity contract is considered an excess contribution and therefore currently includable in N's gross income. The contract continues to be a section 403(b) annuity contract only if, for the current limitation year and all years thereafter, the issuer of the contract maintains separate accounts for each portion attributable to such excess contributions.

Id. (citation omitted).

[335] § 1.415(f)-1(f)(1).

[336] § 1.403(b)-4(d).

[337] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 69 Fed. Reg. 67,075, 67,080 (proposed Nov. 16, 2004) (to be codified at Treas. Reg. pts. 1 and 31).

[338] *Id.*

[339] Treas. Reg. §§ 1.415(c)-2(e)(3) (2007), 1.403(b)-3(b)(4)(ii) (as amended in 2007).

[340] § 1.415(c)-2(e)(3) (2007).

[341] § 1.403(b)-3(b)(4)(ii) (as amended in 2007).

years after the date of severance.[342] This applies *only* to non-elective contributions by the employer, not to contributions pursuant to a salary reduction agreement.[343] There cannot be contributions after the individual dies.[344] Non-governmental employers must ensure that these contributions do not discriminate in favor of highly compensated participants.[345]

Under a qualified defined contribution plan, and subject to an exception[346] for certain disabled employees, the employer may not continue to contribute to the plan for years after an employee has severed from employment.[347] Code section 403(b)(3) allows an employer to treat an employee as having compensation for up to five years after he or she severs from employment.[348] Accordingly, the employer can continue to contribute to a 403(b) plan, on behalf of a former employee, for up to five years after the employee severs from employment.

J. Nondiscrimination[349]

In the retirement plan context, "nondiscrimination" has a specialized meaning. Retirement plans are generally subject to the well-known employment discrimination rules (e.g., age discrimination, sex discrimination), but they must also comply with additional rules designed to ensure that the amount of contributions or benefits under the plan does not unduly discriminate in favor of "highly compensated employees" ("HCEs") when compared to the contributions or benefits for non-highly compensated employees

[342] § 1.403(b)-4(d).

[343] § 1.410(b)-2(d) (as amended in 1994).

[344] § 1.403(b)-4(d) (noting, as evidenced by Example 3, that contributions cannot be made after an individual dies).

[345] *See infra* notes 349–50 and accompanying text.

[346] I.R.C. § 415(c)(3)(C) (2006).

[347] I.R.C. § 415(c)(1) (2006) limits the "annual addition" (including both employer and employee contributions) to a participant's accounts under the plan to the lesser of (i) the dollar limit ($49,000 for 2009 and 2010), which is subject to annual cost of living increases, or (ii) 100% of the participant's compensation from the employer for the year. Accordingly, if the compensation is zero, the limit is zero.

[348] In comments to the IRS on the proposed regulations, the National Tax-Sheltered Accounts Association requested guidance on this provision. "The Service has introduced, in public forums, several 'concerns' that it has with respect to these post-employment contributions without providing acceptable solutions to the problems raised." Kristi Cook & Ellie Lowder, Comments on Behalf of the Nat'l Tax-Sheltered Accounts Ass'n, *Group Offers Input on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Mar. 4, 2005, 2005 TNT 42-57 (LEXIS).

[349] Treas. Reg. § 1.403(b)-5 (2007).

("NCHEs").[350]

Before 1986, there were no nondiscrimination rules for 403(b) arrangements. TRA 86 enacted new nondiscrimination requirements,[351] which do not apply to 403(b) arrangements maintained by a church or a qualified church-controlled organization.[352] This includes elementary and secondary schools controlled, operated, or supported by churches, but may exclude organizations that sell goods or services to the public, such as hospitals and universities.[353]

Breach of the nondiscrimination requirements results in the loss of 403(b) status.[354]

1. Elective Deferrals

Under a 401(k) plan, elective deferrals by employees are tested separately for discrimination under the actual deferral percentage ("ADP") test.[355] In order to qualify, either (1) the average rate of deferrals, as a percentage of compensation, by the group of HCEs must not exceed the average rate of deferrals, as a percentage of compensation, by the group of NCHEs by more than a permitted margin, or (2) the employer must make "safe harbor" contributions for the NCHEs.[356]

Under a 403(b) plan, salary reduction contributions are tested

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[350] *See* I.R.C. §§ 401(a)(4), 403(b)(12), 410(b)(5)(B); *see also* I.R.C. § 414(q) (defining the term "highly compensated employee" as "any employee who—(A) was a 5-percent owner at any time during the year or the preceding year, or (B) for the proceeding year—(i) had compensation from the employer in excess of $80,000, and (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year."). The $80,000 threshold is indexed for inflation and is $110,000 for 2009 and 2010.

[351] TRA 86, Pub. L. No. 99-514, § 1120, 100 Stat. 2085, 2643 (codified as amended at I.R.C. § 403(b)(10) (2006)). The legislative history states:

> The committee believes that it is not appropriate to exempt tax-sheltered annuity programs from all coverage and nondiscrimination rules. The committee does not believe these programs should be granted significant tax advantages while covering relatively small numbers of employees or provide disproportionately large benefits to the highly compensated employees. Accordingly, the committee concludes it is appropriate to apply tests similar to the present-law coverage and nondiscrimination rules to tax-sheltered annuity programs.

H.R. REP. NO. 99-426, at 712 (1985).

[352] I.R.C. § 403(b)(1)(D). For this purpose, the I.R.C. §§ 3121(w)(3)(A)-(B) definition of "church" is used, rather than I.R.C. § 414(e) definition that is used for most purposes under I.R.C. § 403(b). *See* I.R.C. §§ 403(b)(1)(D), 414(e), 3121(w)(3)(A)-(B).

[353] *See* I.R.S. Priv. Ltr. Rul. 93-07-029 (Nov. 25, 1992).

[354] Treas. Reg. § 1.403(b)-3(d)(ii) (as amended in 2007).

[355] I.R.C. § 401(k)(3).

[356] I.R.C. § 401(k)(3)(E), (11), (12).

separately for nondiscrimination.[357] A 403(b) arrangement is not required to allow employees to make salary reduction contributions, but if the 403(b) arrangement allows any employee to elect to do so, then all employees (subject to the limited exceptions described below) must be allowed to make such contributions.[358] Unlike 401(k) plans, the focus is on eligibility (universal availability) rather than actual contributions, and so the requirement can be satisfied even if (1) no NCHE contributes anything to the 403(b) plan and/or (2) the employer makes no contribution for any NCHE.[359] Accordingly, the only detriment to the employer, resulting from the enactment of this provision, is the additional administrative burden of identifying all employees to whom the election must be made available, and affording them the opportunity to make an election. The employer may require a minimum contribution, not exceeding $200 per year.[360] The employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions.[361]

If a salary reduction contribution is "made pursuant to a [one] time irrevocable election made by the employee at the time of initial eligibility to participate in the [arrangement,]" then it is treated and tested as a non-salary reduction contribution.[362] In addition, future regulations may describe other one time irrevocable elections, which cause contributions to be non-salary reduction contributions.[363]

In applying the nondiscrimination rule for salary reduction contributions, the employer may *not* exclude employees who have not met minimum age and service requirements.[364] The employer may, however, generally exclude any employee who: (1) is not an employee of the entity that sponsors the plan (i.e., no employer aggregation rules apply for this purpose);[365] (2) is a participant in a

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[357] I.R.C. § 403(b)(12)(A)(ii).
[358] *Id.*
[359] Treas. Reg. § 1.403(b)-5(b)(1) (2007).
[360] § 1.403(b)-5(b)(3).
[361] § 1.403(b)-5(b)(1).
[362] I.R.C. § 403(b)(12)(A).
[363] I.R.S. Ann. 95-33, 1995-19 I.R.B. 14.
[364] I.R.C. § 403(b)(12)(A)(ii).
[365] The legislative history states:

> As under present law, the new coverage and nondiscrimination rules generally apply with respect to the "employer" as defined in section 414(b), (c), (m) and (o). In addition, the present-law rules relating to leased employees continue to apply (sec. 414(n)). However, the rules relating to elective deferrals will apply, pursuant to Treasury regulations, with respect to the entity of the employer sponsoring the tax-sheltered annuity program. For example, in determining whether a tax-sheltered annuity program offered by a State university permits all employees the opportunity to make

section 457 eligible deferred compensation plan, or a 401(k) plan, or another 403(b) arrangement of the employer, which allows salary reduction contributions; (3) is a nonresident alien described in Code section 410(b)(3)(C); (4) is a student performing services described in section 3121(b)(10), if the conditions of section 410(b)(4) are satisfied; or (5) normally works less than twenty hours per week.[366] If any employee within any category (4) or (5) is eligible to contribute, however, all employees in the same category must be eligible.[367]

An employer which has historically treated geographically distinct units as separate organizations for employee benefit purposes may treat each unit as a separate employer for this purpose, provided that the units are operated independently on a day-to-day basis.[368] Units located within the same standard metropolitan statistical area are not geographically distinct.[369]

The regulations generally provide that the universal availability requirement applies separately to each common law entity, i.e., to each section 501(c)(3) organization, or, in the case of a section 403(b) plan that covers the employees of more than one state entity, to each entity that is not part of a common payroll.[370]

Comments were requested on whether plans that exclude any of the following additional categories of employees (as was permitted under IRS Notice 89-23) should be permitted to continue to exclude these types of employees for at least some period of time:

> (i) Employees who make a one-time election to participate in a governmental plan described in section 414(d) [instead of a section 403(b) plan];
> (ii) Professors who are providing services on a temporary basis to another [public school] for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original [public school];
> (iii) Employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their

elective deferrals, the relevant workforce includes all employees of the State university, not all employees of the State.

H.R. REP. NO. 99-426, at 715 (1985).

366 I.R.C. § 403(b)(12)(A).

367 Treas. Reg. § 1.403(b)-5(b)(4)(i) (2007).

368 § 1.403(b)-5(b)(3)(ii).

369 *Id.*

370 § 1.403(b)-5(b)(3)(i).

> retirement . . . .
> (iv) [And certain] employees who are covered by a collective bargaining agreement . . . .[371]

The final regulations do not include any of these additional exceptions.

> The comments submitted in response to the request generally requested to have these exclusions continue to be allowed. However, after consideration of the comments received, the IRS and Treasury Department have concluded that these exclusions are inconsistent with the statute and, accordingly, they are not permitted under these regulations. Nonetheless, as described further in the following paragraphs, other rules may provide relief with respect to individuals who are under a vow of poverty and to certain university professors affected.[372]

As several comments pointed out, the failure to provide an exception for employees covered by a collective bargaining unit is particularly problematic.

> The Committee requests that final regulations provide that collectively bargained employees may be treated as excludable employees. The universal availability requirement is fundamentally a nondiscrimination requirement and collectively bargained employees are generally exempt from other nondiscrimination requirements. It would be entirely anomalous if collectively bargained employees were taken into account for universal availability, which is generally intended to be a more liberal nondiscrimination requirement. Moreover, the very nature of the collective bargaining process provides assurance that the interests of collectively bargained employees will be adequately protected. Further, any other approach would inappropriately intrude on the collective bargaining process.[373]

[371] § 1.403(b)-11 (as amended in 2007).

[372] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,135 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[373] McKeever & Seymon-Hirsch, *supra* note 324, at 33–34; *see also* Carol H. Jewett & Felicia A. Finston, *Section 403(b) Plans for Tax-Exempt Employers—The Collective Bargaining Dilemma*, BNA Tax & Accounting, *available at* http://www.bnatax.com/tm/insights_jewett2.htm ("[E]ven if the exclusion from 403(b) plan participation is negotiated between the employer and the union . . . [t]his change creates significant labor relations issues that could get overlooked by non-governmental tax-exempt

Under the regulations, a 403(b) plan satisfies the universal availability requirement for elective deferrals only if the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year.[374] "An effective opportunity is *not* considered to 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 section 403(b) contract."[375]

For this purpose, "an employee normally works fewer than 20 hours per week if and only if":[376]

> (1) For the 12-month period beginning on the date the employee's employment commence[s], the employer reasonably expects the employee to work fewer than 1,000 hours of service (as defined in section 410(a)(3)(C)) in such period; and
>
> (2) For each plan year ending after the close of the 12- month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period.[377]

Plans that are subject to Title I of ERISA must comply with

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employers in the course of complying with the 403(b) Regulations. . . . A tax-exempt employer who is a party to a collective bargaining agreement generally cannot simply amend its § 403(b) plan to cover the employees covered by such agreement without running afoul of the provisions of the National Labor Relations Act (NLRA). This is because retirement benefits are a mandatory subject of bargaining between the employer and the union. . . . [Furthermore, a] plan that excluded [collective bargaining] Employees on July 26, 2007 is not subject to the universal availability rule until the later of: (i) the first day of the first taxable year that begins after December 31, 2008; or (ii) the earlier of the date on which the related collective bargaining agreement terminates (determined without regard to any extensions after July 26, 2007) or July 26, 2010.").

[374] According to Bob Architect of the IRS:

> [P]art of universal availability is that participants who have the right to make elective deferrals need to be given a meaningful notice of that right. Something affirmative on behalf of the employer that communicates this information to the participant.
>
> We don't say what type of communication this could be, whether electronic or hard copy, but there must be some form of a meaningful notice. Also, to satisfy universal availability, we deal with the election timing. Individuals have to know and be given the right as to when to enter into a salary reduction agreement and how many times during the year, or when during that year, they can alter that agreement to accommodate, for example, differences in desired reduction of their salary.

I.R.S., *IRC 403(b) Tax-Sheltered Annuity Plans-Ask Bob Architect*, http://www.irs.gov/retirement/article/0,,id=172433,00.hmtl (last visited Dec. 12, 2009).

[375] Treas. Reg. § 1.403(b)-5(b)(2) (2007) (emphasis added).

[376] § 1.403(b)-5(b)(4)(iii)(B).

[377] *Id.*

additional requirements.[378] The IRS has a current project that examines compliance with the universal availability rule by school districts.[379]

2. Other Contributions

Contributions not made pursuant to a salary reduction agreement, including all non-elective and matching contributions, are tested separately and must satisfy nondiscrimination requirements which are generally applicable to qualified plans.[380] These contributions must satisfy (1) the general nondiscrimination rule,[381] (2) the Social Security integration (permitted disparity) requirements,[382] (3) the limitation on compensation which may be

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[378] *See* ERISA § 202(a)(1), 29 U.S.C. § 1052(a)(1) (2006); *see also* Treas. Reg. § 1.410(a)-1(a)–(b). Bob Architect of the IRS cautions that:

> Any organization that is subject to ERISA, and remember, governments are not subject to ERISA. Many churches are not subject to ERISA that sponsor 403(b)s. But, any organization that is subject to ERISA should really look at a section of the regulations that specifically deals with this, because if you're subject to ERISA, a bright line one thousand hour test may well run afoul of some of the ERISA rules.
>
> For this purpose they should see Section 1.403(b)-5(b)(4)(iii)(b)(2) in the regulations, which we have cited to, for this discussion.

I.R.S., *IRC 403(b) Tax-Sheltered Annuity Plans-Ask Bob Architect*, http://www.irs.gov/retirement/article/0,,id=172433,00.tml (last visited Dec. 12, 2009). Treas. Reg. § 1.403(b)-4(e) provides rules for determining years of service for part-time individuals. The work performed is generally determined on the basis of the individual's hours of service (as defined under section 410(a)(3)(C)), except that a plan may use a different measure of work if appropriate under the facts and circumstances. "For example, a plan may provide for a university professor's work to be measured by the number of courses taught during an annual work period in any case in which that individual's work assignment is generally based on a specified number of courses to be taught." NAGDCA, *supra* note 286.

[379] *See* IRS Expands Project to Ensure Eligible Public School Employees Can Participate in Retirement Annuities, TAX NOTES TODAY, June 21, 2007, 2007 TNT 121-15 (LEXIS); *see also* IRS Announces Universal Availability Project: Focus on School District 403(b) Plans, REISH, LUFTMAN, REICHER & COHEN BULLETIN (Reish & Reichter, Attorneys at Law, Los Angeles, CA), June 26, 2007, at 1, available at http://www.reish.com/publications/pdf/universalproj.pdf; Tamara M. Vaughn Middleton, IRS Increases Scrutiny of School District 403(b) Arrangements, ASPPA ASAP PUB. NO. 07-17 (Am. Soc'y of Pen. Prof'ls & Actuaries, Arlington, VA), July 18, 2007, at 1, available at http://www.asppa.org/Main-Menu/Credibility/Publications/ASAPs/ASPPA-asaps-ARCHIVE/2007/07-17-IRS-Increases-Scrutiny-of-School-District-403b-Arrangements.aspx.

[380] I.R.C. § 403(b)(12)(A)(i) (2006). This section lists the section 401(a) requirements that must be satisfied by 403(b) arrangements, other than those sponsored by church employers. I.R.C. § 403(b)(1)(D) (2006). The legislative history states: "[u]nlike [with pensions], the committee intends that the Secretary will take into account the special circumstances faced by educational organizations and tax-exempt organizations (including the compressed salary scales of those organizations and the special needs of certain educational institutions in attracting visiting professors) in applying the rules." H.R. REP. NO. 99-426, at 713 (1985).

[381] I.R.C. § 401(a)(4) (2006).

[382] § 401(a)(1), (5)(C).

taken into account ($200,000 subject to cost of living increases),[383] (4) the minimum participation rule (only if it is a defined benefit plan),[384] (5) the minimum coverage requirements,[385] and (6) the nondiscrimination rule for after-tax employee contributions and employer matching contributions.[386] If a government "picks up" contributions under section 414(h), (i.e., elects to treat employee contributions as employer contributions) such contributions are deemed to be employer contributions rather than salary reduction contributions.[387]

The regulations do not adopt "the good faith reasonable standard [of IRS Notice 89-23] for [purposes of] satisfying the nondiscrimination requirements of section 403(b)(12)(A)(i)."[388]

As noted above, salary reduction contributions "made pursuant to a 1-time irrevocable election made [by the participant] at the time of initial eligibility to participate in the [403(b) arrangement] or is made pursuant to . . . a one-time irrevocable election [described] in [the] regulations," are not treated as salary reduction contributions subject to section 403(b)(12)(A)(ii).[389] Instead, they are subject to section 403(b)(12)(A)(i), and must satisfy the statutory requirements

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[383] § 401(a)(17).

[384] § 401(a)(26)(A).

[385] § 410(b). In the case of a 403(b) arrangement maintained by a governmental employer, or by a church employer which is not exempt from section 403(b)(12), because it is not described in section 3121(w)(3), it would appear that the arrangement should be subject to the lenient pre-ERISA coverage requirements, as would be the case for a qualified plan maintained by such an employer. I.R.C. § 410(c)(1). This approach is supported by the statute, which requires a 403(b) arrangement to satisfy, inter alia, section 410(b) "in the same manner as if such plan were described in section 401(a)." I.R.C. § 403(b)(12)(A)(i). The regulations, however, take the position that such a 403(b) arrangement must satisfy the normal employee coverage rules. *See* Treas. Reg. § 1.410(b)-2(d) (as amended in 2006); *see also* STAFF OF J. COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 678 (Comm. Print 1987). There does not appear to be any policy reason why 403(b) arrangements should be subject to more stringent coverage rules than qualified plans maintained by such employers.

[386] I.R.C. § 401(m). The references to sections 401(a)(17) and 401(m) were added by section 1011(m)(2)(A) and (B) of TAMRA. TAMRA, Pub. L. No. 100-647, sec. 1011(m)(2)(A)–(B), § 1120(b), 102 Stat. 3342, 3471.

[387] I.R.C. § 414(h)(2); I.R.S. Notice 89-23, 1989-1 C.B. 654, 1989; *see, e.g.*, I.R.S. Priv. Ltr. Rul. 90-33-072 (Aug. 17, 1990) (explaining pick-ups and ruling that employee contributions based on worker's compensation benefits are not considered pick-up contributions). Note that, while section 414(h) provides for contributions to qualified plans and section 403(a) plans to be picked up, it does not specifically include contributions to a 403(b) arrangement. I.R.C. § 414(h).

[388] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,134 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[389] I.R.C. § 403(b)(12)(A)(ii).

listed above.[390]

Employer matching contributions and after-tax employee contributions are subject to the ACP test under section 401(m), even though the salary reduction contributions which are matched are not subject to any comparable test.[391] Salary reduction contributions may not be considered in the ACP test. Accordingly, even under a 403(b) arrangement, matching contributions on behalf of highly compensated employees may need to be reduced in order to satisfy section 401(m).[392] If not timely corrected, such excess aggregate contributions are subject to a ten percent excise tax imposed on the employer.[393]

A matching contribution is an employer contribution made on behalf of an employee on account of an after-tax employee contribution, or an elective deferral, made by such employee.[394] As indicated above, certain salary reduction contributions made pursuant to a one time irrevocable election are not treated as salary reduction contributions, but as employer contributions. Accordingly, if such a contribution is matched by the employer, the employer contribution is not a matching contribution, and must satisfy the requirements of sections 401(a)(4), 401(a)(26), and 410(b), rather than the ACP test under section 401(m).[395]

K. Employer Aggregation and Controlled Group Rules

The 403(b) regulation package also included controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a).[396] These new rules are not limited to 403(b) plans, but apply for purposes of any employee benefit plan to which section 414(c) applies.[397]

Under these new rules, the "employer" includes:

> [t]he exempt organization whose employees participate in the plan and any other organization that is under common

[390] § 403(b)(12)(A)(i).
[391] § 401(m).
[392] § 401(m)(6)(B)(ii).
[393] § 4979.
[394] I.R.C. § 401(m)(4)(A) (2008); Treas. Reg. § 1.401(m)-1(a)(2) (as amended in 2009).
[395] I.R.S. Ann. 95-33, 1995-19 I.R.B. 14. (May 8, 1995).
[396] Treas. Reg. § 1.414(c)-5(a) (as amended in 2007).
[397] "These rules apply to plans referenced in section 414(b), (c), (m), (o), and (t), such as plans qualified under section 401(a) or 403(a), as well as section 403(b) plans." Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,130 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

> control with that exempt organization. . . . [based on] 80 percent of the directors or trustees . . . being representatives of, or directly or indirectly controlled by, [an exempt] organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the general power to remove such trustee or director and designate a new trustee or director. [398]

The regulations include an anti-abuse rule,[399] and also allow exempt organizations to choose to be aggregated if they maintain a single plan and the organizations regularly coordinate their exempt activities.[400] The final regulations authorize the IRS to issue guidance permitting other "entities that include [tax-exempt entities] to elect to be treated as under common control for one or more specified purposes."[401] "It is expected that this authority would not be exercised unless the IRS determines that the organizations are so integrated in their operations as to effectively constitute a single coordinated employer for purposes of sections 414(b), (c), (m), and (o), including common employee benefit plans."[402]

These rules are generally relevant for purposes of the nondiscrimination requirements, the section 415 contribution limitations, section 403(b) catch-up contributions, and the minimum distribution rules. The rules generally do not apply to (1) church entities under section 3121(w)(3); (2) a state or local government; or (3) a federal government entity.[403] "Until further guidance is issued, church entities under sections 3121(w)(3)(A) and (B) and State or local government public schools that sponsor section 403(b) plans can continue to rely on the rules in Notice 89-23 for determining the controlled group."[404]

The rules raise the controversial issue of whether the IRS can require aggregation of entities which do not have owners, for

[398] Treas. Reg. § 1.414(c)-5(b).
[399] § 1.414(c)-5(f).
[400] § 1.414(c)-5(c)(1).
[401] § 1.414(c)-5(c)(2).
[402] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,137.
[403] Treas. Reg. § 1.414(c)-5(a).
[404] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,138.

purposes of testing whether their benefit plans qualify for tax-favored treatment. As part of ERISA, Congress enacted sections 414(b) and (c) under which "all employees [of a controlled group of corporations and a group] of trades or businesses (whether or not incorporated) . . . under common control" are generally treated as employed by a single employer.[405] In order for there to be aggregation under section 414(b) or (c), however, there must be common ownership.[406]

Subsequently, Congress enacted section 414(m), providing that "all employees of the members of an affiliated service group [are] treated as employed by a single employer."[407] Again, the existence of an affiliated service group requires common ownership, unless the group consists of (1) an organization whose primary business is providing management services, and (2) the recipient(s) of those services.[408] Finally, section 414(o) directs the Secretary of the Treasury to issue "such regulations . . . as may be necessary to prevent the avoidance of any employee benefit requirement listed in subsection (m)(4) or (n)(3) or any requirement under section 457 through the use of—(1) separate organizations, (2) employee leasing, or (3) other arrangements."[409]

The requirements of sections 414(b), (c), (m) and (o) clearly apply to qualified plans.[410] Given the plain language of the statute's requirement of common ownership, however, there does not appear to be any basis on which the IRS can legitimately argue that organizations without owners can be aggregated.

Even when applied to qualified plans, the position of the IRS appears to have no basis in the statute. The case for employer aggregation in testing 403(b) arrangements is even weaker, as section 403(b) is not listed anywhere as a section to which the aggregation rules apply. It is not even mentioned in section 414.[411] This omission is particularly significant, in that section 414(o) specifically includes a reference to section 457.[412] In enacting TRA 1986, Congress appeared to believe that the aggregation rules do apply to section 403(b),[413] but there is no support for this belief in

405 I.R.C. § 414(c) (2006).
406 § 1563(a) (defining "controlled group" by reference to common ownership).
407 § 414(m)(1).
408 § 414(m)(5).
409 § 414(o).
410 § 414(b), (c), (m)(4), (n)(3), (o).
411 *Id.*
412 § 414(o).
413 H.R. REP. NO. 99-841, at II-373 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N.

the language of the statute.

L. Distributions

1. Minimum Distribution Rules

Any 403(b) arrangement must comply with minimum distribution requirements similar to the rules for qualified plans.[414] These rules generally require distributions to begin by April 1 of the year following the year in which the employee attains age seventy and one-half or retires, and limit the length of time over which payments are made.[415] Except as discussed below, however, this applies only to benefits accruing after 1986.[416] The post-1986 accruals include post-1986 earnings on pre-1987 accruals.[417]

The insurer or custodian is required to identify the pre-1987 accumulation; if it fails to do so, the entire account balance is subject to the new rules.[418] Required distributions reduce the post-1986 balance to the extent that they do not exceed the minimum amount required to be distributed. Any excess permanently reduces the pre-1987 balance.[419]

In applying the minimum distribution rules, a 403(b) arrangement is generally treated as an IRA.[420] If an individual has more than one 403(b) arrangement, the minimum distribution is generally calculated separately for each 403(b) arrangement. After calculating the required minimum distribution from each 403(b) arrangement, however, the total amount may generally be taken

4075, 4661 (1986).

[414] I.R.C. § 403(b)(10); Treas. Reg. § 1.403(b)-6(e) (as amended in 2009).

[415] Treas. Reg. § 1.403(b)-6(e)(3).

[416] Treas. Reg. § 1.403(b)-6(e)(6); I.R.C. § 403 (2008). Before the enactment of TRA 86, minimum distribution rules requiring distributions during the life of the participant applied only to individual retirement arrangements and to certain 5% owners. TRA 86 extended the rules to all qualified plans and 403(b) arrangements. TRA 86, Pub. L. No. 99-514, § 1852(a)(3)(C), 100 Stat. 2085, 2865 (codified as amended at I.R.C. § 403 (2008)); I.R.C. §§ 401(a)(9), 403(b)(10), 408(a)(6) (2006). It is not clear why their application was limited to post-1986 benefit accruals under 403(b) arrangements but extends to all benefits under qualified plans. I.R.C. § 403 (2006). There is no similar exclusion of pre-1987 accruals for purposes of the other penalty taxes enacted by TRA 86, namely the 10% additional tax under section 72(t) and the (now repealed) 15% excise tax under section 4980(a). I.R.C. §§ 72(t), 4980(a) (2006).

[417] Treas. Reg. § 1.403(b)-6(e)(6)(i).

[418] § 1.403(b)-6(e)(6)(ii).

[419] § 1.403(b)-6(e)(6)(iii).

[420] § 1.403(b)-6(e)(2), (7).

from any one of the 403(b) arrangements.[421]

All distributions, regardless of when the amount accrued, must satisfy the minimum distribution incidental benefit ("MDIB") rule.[422] The December 31, 1986 account balance must satisfy the longstanding requirement that the present value of the total payments to be made to the employee must be more than 50% of the present value of all payments to be made.[423] Amounts credited after 1986 are subject to the same rules that apply to qualified plans.[424]

Under the Worker, Retiree, and Employer Recovery Act of 2008, no minimum required distribution ("MRD") is required for calendar year 2009 from IRAs and employer-sponsored defined contribution plans, including governmental 457(b) plans.[425] The next MRD would be *for* calendar year 2010. This relief applies to lifetime distributions to employees and IRA owners and post-death distributions to beneficiaries.[426] Beneficiaries who are taking distributions under the five-year rule are given an extra year to complete payments.[427]

Governmental plans are subject to a less stringent, good faith compliance standard.[428]

2. Salary Reduction Contributions

Distributions attributable to salary reduction contributions (including earnings) may be paid only when the employee attains the age of fifty-nine-and-one-half, severs from employment, dies, becomes disabled (as defined in I.R.C. § 72(m)(7)), or incurs a financial hardship.[429] In the case of hardship, income attributable to such contributions may not be distributed.[430] These restrictions

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[421] § 1.403(b)-6(e)(7).
[422] § 1.403(b)-6(e)(1).
[423] § 1.401(b)(1)(i) (as amended in 1976); Rev. Rul. 73-239, 1973-1 C.B. 201 (citing Rev. Rul. 72-241, 1972-1 C.B. 108); *see* I.R.S. Priv. Ltr. Rul. 91-06-022 (Feb. 8, 1991) (discussing why an amendment to a 403(b) arrangement does not violate the incidental benefit rule of Treasury Regulation section 1.403(b)-1(c)(3) and section 403(b)). In a Private Letter Ruling, the IRS ruled that to commence distribution of the pre-1987 account balance at age seventy-five satisfied the MDIB rule, provided that the distributions were paid over a period which would be permissible under section 401(a)(9). I.R.S. Priv. Ltr. Rul. 93-45-044 (Nov. 12, 1993); I.R.S. Priv. Ltr. Rul. 79-13-129 (Dec. 29, 1978); *see* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976).
[424] I.R.C. § 401(a)(9)(D) (2006); Treas. Reg. § 1.403(b)-6(e)(1) (as amended in 2009).
[425] I.R.C. § 401(a)(9)(H).
[426] *Id.*
[427] *Id.*
[428] § 401 note; Treas. Reg. § 1.401(a)(9)-1, Q&A (A-2)(d) (2009).
[429] I.R.C. § 403(b)(11).
[430] *Id.*

do not apply to: (1) amounts attributable to contributions other than salary reduction contributions, i.e., employer contributions or after-tax employee contributions, or (2) amounts accumulated by the end of the last year beginning before 1989.[431]

The regulations generally define "severance from employment" in the same way as the 401(k) regulations, but provide that a severance from employment also occurs when: (1) the employee ceases to be employed by an eligible employer that maintains the section 403(b) plan, or (2) the employee works "in a capacity that is not employment with an eligible employer."[432]

> Examples of the situations that constitute a severance from employment include: an employee transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization; an employee ceasing to work for a public school, but continuing to be employed by the same State; and an individual employed as a minister for an entity that is neither a State nor a section 501(c)(3) organization ceasing to perform services as a minister, but continuing to be employed by the same entity.[433]

3. Custodial Accounts

In the case of a custodial account, no amount may be distributed before the occurrence of one of the above events, and only salary reduction contributions (and any pre-1989 earnings thereon) may be distributed for hardship.[434]

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[431] § 72 note (Effective Date of 1986 Amendment). There are exceptions for (1) certain benefits in pay status on March 1, 1986, and (2) benefits subject to an election under section 242(b)(2) of TEFRA. *Id.*

[432] Treas. Reg. § 1.403(b)-6(h) (as amended in 2009).

[433] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,132 (July 26, 2007) (to be codified at Treas. Reg. pt. 1, 31, 54 and 602) (preamble to final regulations for Dep't of Treasury).

[434] I.R.C. §§ 72, 403(b)(7)(A)(ii). A hardship distribution has the same meaning, and is subject to the same limitations, as under section 401(k). Treas. Reg. § 1.403(b)-6(d)(2) (as amended in 2007). As originally enacted in 1974, contributions to a custodial account qualified only if they were paid "to provide a retirement benefit" for the employee. S. REP. NO. 95-1263, at 95 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6761, 6858. Proposed Treasury Regulations required that the stock could not be distributed from the custodial account unless (1) the employee attained age sixty-five, died, or became disabled, or (2) the employee separated from service after attaining age fifty-five. In 1978 Congress deleted the "retirement benefit" language and replaced it with distribution restrictions similar to those under current law.

> State law generally requires that the owner of an annuity contract be able to obtain the cash surrender value of the contract if the contract is surrendered before annuity payments begin. Consequently, an employee who owns a tax-sheltered annuity contract

Prior to TRA 86, all amounts held in a custodial account could be distributed upon hardship. TRA 86 added a similar restriction on hardship distributions from 401(k) plans.[435] Accordingly, the distribution rules for custodial accounts are more restrictive than for other 403(b) funding vehicles, as they apply to amounts attributable to employer contributions and after-tax employee contributions.[436]

4. Plan Termination

It is important to note that these statutory distribution restrictions, unlike the 401(k) plan rules,[437] do not include an explicit exception for distributions made as a result of plan termination. Accordingly, prior to the issuance of the new 403(b) regulations, if a plan participant was not yet eligible for a distribution, the only "distribution" option was a transfer under Revenue Ruling 90-24, which had to be initiated by the participant, not the employer. Thus, it was effectively impossible for an employer to terminate a 403(b) plan unless all of the participants agreed to such a transfer.

In a very important change, the regulations allow the plan to provide for plan termination, with a resulting distribution of

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> may be able to surrender the contract before retirement and use the proceeds for purposes other than retirement.
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> . . . .
>
> The committee believes that the more restrictive rule for distributions of stock of a regulated investment company has imposed an undesirable competitive disadvantage on regulated investment companies.
>
> The bill permits stock of a regulated investment company to qualify under the tax-sheltered annuity rules if the stock cannot be distributed before the employee retires, dies, separates from service, becomes disabled, attains age 59 1/2, or encounters financial hardship, such as unusual medical expenses.

Id. Despite this liberalization, the distribution rules for custodial accounts remain more restrictive than those applicable to annuity contracts and retirement income accounts. There does not appear to be any good reason for the discrepancy between these 403(b) funding vehicles. The new withdrawal restrictions under TRA 86 added to, rather than superseded, the prior rules for custodial accounts. One commentator has cited this as a "good example of the emerging legislative principle that, once enacted, no restrictive rule is ever so redundant or vestigial as to warrant its repeal." Richard W. Skillman, *Providing Retirement Income and Deferred Compensation for Employees of Charitable Organizations After the Tax Reform Act of 1986*, 16 N.Y.U. CONF. ON TAX PLAN FOR THE CHARITABLE SECTOR 4-1, 4-12, 4-13 (1988).

[435] I.R.C. § 401(k)(2)(B).

[436] § 403(b)(7)(A).

[437] § 401(k)(2)(B)(i)(II), (k)(10) (stating that amounts attributable to elective deferrals under a qualified cash or deferred arrangement may be distributed on plan termination without the establishment of another defined contribution plan (other than an ESOP)).

accumulated benefits.[438] In order for the plan to be effectively terminated, all accumulated benefits must be distributed, to all participants and beneficiaries, as soon as administratively practicable after termination of the plan.[439] A distribution includes delivery of a fully paid individual insurance annuity contract.[440] Depending on the terms of the annuity contract or custodial account agreement, however, termination may be difficult or impossible to effect in a particular case.[441]

In general, distribution is permitted only if the employer (taking into account the controlled group rules) does not make contributions to another 403(b) arrangement, based generally on 403(b) contributions made during the twelve months before and after the date of plan termination.[442] The regulations *do not* allow the transfer of existing participant balances from a terminated 403(b) arrangement to a qualified plan:

> Some employers who desire to terminate a 403(b) arrangement would rather transfer existing participant balances to their qualified defined contribution plan. In such cases, the transfer would be structured as a plan-to-plan transfer, not as direct or indirect rollovers by individual participants. An employer may consider this approach as a desirable way to avoid "leakage." That is, employees would not have the ability to elect an immediate distribution (in

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[438] Treas. Reg. § 1.403(b)-10(a)(1) (as amended in 2007).

[439] *Id.*

[440] *Id.*; *see also* Posting of Bob Toth to Benefits Biz Blog, Distributing 403(b) Annuities, Part II: The 403(b) Plan Distributed Annuity, http://www.benefitsbizblog.com/2008/04/distributing-403b-annuities-pa.html (Apr. 4, 2008, 15:52 EST).

> We envision this as a particularly useful option in plans which are funded with individually owned annuity contracts, contracts over which the employer has little-if any- control. It gives the employer the ability to relinquish all of its obligations related to these pesky sorts of arrangements without having to actually force the distribution of funds from its terminating 403(b) plan. The regulations are silent, however, on just how these "fully paid individual insurance annuity contracts" should be treated in the absence of an employer . . . .
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> . . . One of the key questions unique to the 403(b) world involves the individual 403(b) custodial account: is it to be treated as a QPDA, even though it is not an annuity contract?

Id.

[441] *See* Fred Stokeld, *Termination of Tax-Deferred Annuity Plans Requires Full Distribution of Assets, IRS Official Says*, TAX NOTES TODAY, July 8, 2009, 2009 TNT 128-3 (LEXIS); 403(b) Plan Termination: Illusion or Reality?, SUNGARD RELIUS TECHNICAL UPDATES, http://www.relius.net/News/TechnicalUpdates.aspx?ID=462 (last visited Dec. 12, 2009).

[442] SUNGARD RELIUS TECHNICAL UPDATES, *supra* note 441.

> lieu of a rollover) and thus be tempted to ignore the benefits of conserving such funds for retirement.[443]

A 403(b) plan sponsor can terminate the 403(b) plan and set up a 401(k) plan within the first twelve months following the termination, as long as there is no new 403(b) plan set up,[444] in the same way as a 401(k) plan sponsor could terminate its plan and set up a new 403(b) plan.

Must employer contributions (other than elective deferrals) be 100% vested upon plan termination? This is not absolutely required by the statutes, because section 411(d)(3) of the Code does not apply to 403(b) plans and it has no ERISA counterpart. The termination procedure allowed by the regulations, however, requires distribution of all accumulated benefits,[445] and it is difficult to see how this could be done without fully vesting all benefits. If the plan is not subject to ERISA, full vesting may be required by state law. Also, inclusion of a vesting schedule will complicate plan administration considerably, and require the maintenance of separate accounts.[446] If the employer wants its contributions to be subject to a vesting schedule, it is probably easier to make those contributions to a separate qualified plan.

A 403(b) plan could be terminated before the 2009 effective date of the regulations. According to the preamble to the regulations:

> For periods following July 26, 2007 and before the applicable date, taxpayers can rely on these regulations, except that (1) such reliance must be on a consistent and reasonable basis and (2) the special rule at § 1.403(b)-10(a) of these regulations permitting accumulated benefits to be distributed on plan termination can be relied upon *only* if all of the contracts issued under the plan at that time satisfy *all* of the applicable requirements of these regulations (*other* than the requirement at § 1.403(b)-3(b)(3)(i) of these regulations that there be a written plan).[447]

A plan could be terminated prior to January 1, 2009 without adopting a plan document, so long as the annuity contracts and/or

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[443] Douglas O. Kant, Comments on Behalf of Fidelity Investments, *Fidelity Comments on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Mar. 4, 2005, 2005 TNT 42-58 (LEXIS).

[444] Treas. Reg. § 1.403(b)-10(a)(1).

[445] § 1.403(b)-10(a)(1).

[446] § 1.403(b)-3(d)(2)(ii).

[447] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,139 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54 and 602) (preamble to final regulations for Dep't of Treasury) (emphasis added).

custodial accounts were in compliance with all of the requirements of the final regulations. To terminate a plan on or after January 1, 2009, the written plan must permit plan termination.[448] Bob Architect, the leading IRS spokesman on 403(b) plans, has expressed concern about compliance with the termination requirements. Architect also expressed concern about the potential for bad terminations of 403(b) plans. A 403(b) plan is not terminated simply because it no longer receives contributions; termination involves the liquidation and distribution of all plan assets. "The problem that I foresee and that I am concerned about is that bad terminations are going to equal bad distributions, which are going to equal bad rollovers," Architect remarked.[449]

State law may limit the ability of a public entity to terminate a 403(b) plan. Also, in some circumstances, the documents governing the annuity contract or custodial account may not give the employer sufficient control to effect a plan termination. If an annuity contract does not provide for distribution upon plan termination, the plan will not be able to terminate. The regulations do not give the employer the authority to force a participant with an individual annuity contract or custodial agreement to receive a complete distribution.[450]

If a plan includes individual custodial accounts, the employer may not satisfy the distribution requirement by informing the participant and vendor that it is treating the custodial account as "distributed." Unlike an individual annuity contract, a participant would have to liquidate the account to effect a distribution.[451]

5. Other Amounts

For the first time, the regulations subject amounts that are not subject to the statutory distribution restrictions to rules similar to the pre-ERISA rules[452] for profit sharing plans. These amounts may be distributed on severance from employment or the occurrence of a stated event, such as after a fixed number of years, attainment

[448] *Id.*

[449] Fred Stokeld, *Effective Date of Regs on Tax-Sheltered Annuity Plans Approaching, Official Notes*, TAX NOTES TODAY. Sept. 5, 2008, 2008 TNT 173–4 (LEXIS).

[450] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,139–50 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54 and 602) (preamble to final regulations for Dep't of Treasury).

[451] *Id.* at 41,156–57.

[452] Treas. Reg. § 1.401-1(b)(1)(ii) (as amended in 1976).

of a stated age, or disability.[453] This new rule has been criticized:

> The Proposed Regulations provide for a limit on distribution of employer non-elective contributions. This fails to recognize the limited exception to the normal federal securities law requirement that variable annuities that are always registered products in the context of 403(b) plans and that are issued jointly by insurers and the insurers' registered separate accounts, must be freely redeemable pursuant to the requirements of The Investment Company Act of 1940. The limited exception is found in a "no-action" letter issued by the staff of the SEC in 1988. That no-action letter is limited to the requirements imposed by Code section 403(b)(11) that, of course, only imposes distribution restrictions on elective deferral contributions.[454]

Other critics question whether the change is permissible under contract law:

> Furthermore, such a provision is problematic in several ways for plans that already permit such distributions. First, for governmental plans, in many jurisdictions, it may not be possible to adopt such a limitation without creating an impermissible "impairment of contract" under local law. Many states restrict or prohibit a governmental employer's ability to adversely change the terms of a retirement plan for any active employee, even as to future accruals. In addition, such a provision, if applied to 403(b) plans subject to ERISA, would cause the plan to fail the anti-cutback rule of ERISA *section 204(g)* as to prior accruals. Finally, the restrictions will add needless administrative burdens and costs with no real benefit to participants. In this regard, to the extent the policy behind this change is to encourage retirement savings, we believe that there is already sufficient incentive not to take such distributions unless necessary in the form of the additional 10% tax on distributions prior to age 59 1/2.[455]

In response to these and other comments, the final regulations

[453] § 1.403(b)-6(b) (as amended in 2009) ("[A] section 403(b) contract is permitted to distribute retirement benefits to the participant no earlier than upon the earlier of the participant's severance from employment or upon the prior occurrence of some event, such as after a fixed number of years, the attainment of a stated age, or disability. *See* § 1.401-1(b)(1)(ii) for additional guidance."). Benefits attributable to after-tax employee contributions, and certain corrective distributions, are not subject to these restrictions. *Id.*

[454] Powell & Mazawey, *supra* note 190.

[455] *See* Kemper et al., *supra* note 304.

provide that the general rule requiring the occurrence of a stated event in order for distributions to commence *does not* apply to insurance contracts issued before January 1, 2009. Also, conforming amendments may be adopted, by plans that are subject to ERISA, without violating the anti-cutback rule.[456] A plan amendment adopted before January 1, 2009 to comply with these rules will not violate ERISA's anti-cutback rules.[457]

6. Exceptions

Distributions to an alternate payee under a QDRO may be made, regardless of these distribution restrictions.[458]

It has generally been assumed that loans to participants were available under the same rules as apply to qualified plans.[459] If the 403(b) arrangement is subject to ERISA, then the prohibited transaction exemption rules for plan loans must be satisfied.[460] With respect to loans to participants, however, the regulations provide that:

> The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from an issuer of a section 403(b) contract to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 403(b) and §§ 1.403(b)-1 through 1.403(b)-5, this section, and §§ 1.403(b)-7

[456] Treas. Reg. § 1.403(b)-11(e) (as amended in 2007).

[457] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,139 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54 and 602) (preamble to final regulations for Dep't of Treasury).

[458] I.R.C. § 414(p)(10) (2006). Treas. Reg. § 1.403(b)–10(c) has been clarified to indicate that, in order to be treated as a permissible distribution under that section, the distribution must be pursuant to a QDRO as described in section 206(d)(3) of ERISA and the Department of Labor's guidance.

[459] I.R.C. § 72(p). Before the 1982 enactment of TEFRA, which specifically included 403(b) arrangements as one type of "qualified employer plan" loan that was subject to the rules of section 72(p), it was not clear that a 403(b) loan would be treated as a valid loan for income tax purposes. I.R.C. § 72(p)(4)(A)(i)(III). *Compare* Minnis v. Comm'r of Internal Revenue, 71 T.C. 1049, 1056 (1979), *nonacq.*, 1979-2 C.B. 2 (holding that a 403(b) loan was valid and therefore, not includible in the employee's gross income), *with* Rev. Rul. 81-126, 1981-1 C.B. 206 (ruling that a 403(b) loan was a taxable distribution).

[460] I.R.C. § 4975(d)(14); *see also* ERISA § 408(b), 29 U.S.C. § 1108(b) (2006); 29 C.F.R. § 722550.408b-1 (2009). Section VIII of the Examination Guidelines covers plan loans. I.R.S. Ann. 95-33, 1995-19 I.R.B. 14.

> through 1.403(b)-11, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to be treated as not being a distribution. However, a plan loan offset is a distribution for purposes of this section.[461]

M. Transfers[462]

Prior to the issuance of the new 403(b) regulations, a plan participant—without employer involvement or consent—could make a tax-free transfer under Revenue Ruling 90-24.[463] Under this ruling, a direct transfer of all or any portion of a participant's 403(b) accumulation, from any type of 403(b) funding vehicle to any other type of 403(b) funding vehicle, was not taxable, provided that the transferee arrangement was subject to any distribution restrictions which applied to the transferor.[464] Section 401(k) participants did not have this right. Revenue Ruling 90-24 has now been revoked.[465]

One important consequence of the rules set forth in the regulations is that they give more control to employers, and less control to employees over decisions relating to transfers.[466]

The final regulations, like the 2004 proposed regulations, provide for three kinds of non-taxable exchanges or transfers of amounts in section 403(b) contracts: (1) a mere change of investment within the same plan (contract exchange);[467] (2) a plan-to-plan transfer, so that there is another employer plan receiving the exchange;[468] or (3) a

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[461] Treas. Reg. § 1.403(b)-6(f) (as amended in 2009).

[462] *See* Treas. Reg. § 1.403(b)-10(b) (as amended in 2007).

[463] Rev. Rul. 90-24, 1990-1 C.B. 97, *repealed by* Rev. Rul. 2009-18, 2009-27 I.R.B. 1; *see infra* note 466 and accompanying text.

[464] Rev. Rul. 90-24, 1990-1 C.B. 97

[465] Rev. Rul. 2009-18, 2009-27 I.R.B. 1 (listing obsolete guidance).

[466] *See* I.R.S., *IRC 403(b) Tax-Sheltered Annuity Plans-Ask Bob Architect*, http://www.irs.gov/retirement/article/0,,id=172433,00.html (last visited Dec. 12, 2009).

> This issue generated the most interest under the proposed regulations. It was felt that this right to transfer was a very important right to participants and they wouldn't be locked into an investment which they were not pleased with. Let me talk for a moment about what happened and how this unabridged right addled both the employer in compliance and the Internal Revenue Service in enforcement of the rules of 403(b).

Id.

[467] Treas. Reg. § 1.403(b)-10(b)(2).

[468] § 1.403(b)-10(b)(3).

transfer to purchase permissive service credit[469] (or a repayment to a defined benefit governmental plan).

> If an exchange or transfer does not constitute a change of investment within the plan, a plan-to-plan transfer, or a purchase of permissive service credit, the exchange or transfer would be treated as a taxable distribution of benefits in the form of property if the exchange occurs after a distributable event (assuming the distribution is not rolled over to an eligible retirement plan) or as a taxable conversion to a section 403(c) nonqualified annuity contract if a distributable event has not occurred. . . . In any case in which a distributable event has occurred, a participant in a section 403(b) plan can always change the investment through a distribution and non-taxable rollover from a section 403(b) contract to an IRA annuity, as long as the distribution is an eligible rollover distribution. Note, however, that an IRA annuity cannot include provisions permitting participant loans. See section 408(e)(3) and (4) and §§ 1.408-1(c)(5) and 1.408-3(c).[470]

Any permitted exchange, transfer, or purchase is *not* treated as a distribution for purposes of the distribution restrictions, and therefore may be made before severance from employment or another distribution event.[471]

> The 2004 proposed regulations would have imposed additional restrictions on contract exchanges by limiting tax-free contract exchanges to situations in which the new contract is provided under the plan. The proposal was intended to improve compliance with the Code requirements that apply on an aggregated basis because, without coordination, it is difficult, if not impossible, for a plan to comply with those tax requirements. . . . In addition, these changes make it easier for employers to respond to an IRS inquiry or audit. For example, where assets have been transferred to an insurance carrier or mutual fund that has no subsequent connection to the plan or the employer, IRS audits and related investigations have revealed that employers encounter substantial difficulty in demonstrating

[469] § 1.403(b)-10(b)(4).

[470] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,131 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54 and 602) (preamble to final regulations for Dep't of Treasury).

[471] *Id.*

> compliance with hardship withdrawal and loan rules. These problems are particularly acute when an individual's benefits are held by numerous carriers.[472]

Commentators objected to the proposal to limit exchanges. The final regulations include changes and transition rules to reflect these comments. "The regulations allow contract exchanges with certain characteristics associated with Rev. Rul. 90-24, but under rules that are generally similar to those applicable to qualified plans."[473]

> Unlike the 2004 proposed regulations, [the final] regulations permit an exchange of one contract for another to constitute a mere change of investment within the same plan, but only if certain conditions are satisfied in order to facilitate compliance with tax requirements. Specifically, the other contract must include distribution restrictions that are not less stringent than those imposed on the contract being exchanged and the employer must enter into an agreement with the issuer of the other contract under which the employer and the issuer will from time to time in the future provide each other with certain information. This includes information concerning the participant's employment and information that takes into account other section 403(b) contracts or qualified employer plans, such as whether a severance from employment has occurred for purposes of the distribution restrictions and whether the hardship withdrawal rules in the regulations are satisfied. Additional information that is required is information necessary for the resulting contract or any other contract to which contributions have been made by the employer to satisfy other tax requirements, such as whether a plan loan constitutes a deemed distribution under section 72(p).[474]

The regulations also authorize the IRS to issue guidance allowing exchanges in other cases, where the resulting contract has procedures reasonably designed to ensure compliance with tax requirements that depend on (1) information concerning the participant's employment, or (2) information that takes into account other section 403(b) contracts or qualified employer plans.[475]

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[472] *Id.*
[473] *Id.*
[474] *Id.*
[475] Treas. Reg. § 1.403(b)-10(b)(2)(iii) (as amended in 2007).

> [P]rocedures that rely on an employee certification, such as whether a severance from employment has occurred or whether the participant has other outstanding loans, would generally not be adequate to meet this standard, because such a certification is not disinterested, and also because of the lack of employer oversight in the certification process to ensure accuracy.[476]

Plan-to-plan transfers are permitted, provided that:

(1) The employee/beneficiary is an employee or former employee of the employer (or business of the employer) that maintains the receiving plan,

(2) The transferor plan provides for such transfers,

(3) The receiving plan provides for the receipt of transfers,

(4) The benefit immediately after the transfer is at least equal to the benefit immediately before the transfer, and

(5) The receiving plan imposes restrictions on distributions of transferred assets that are not less stringent than those of the transferor plan.[477]

For any exchange, the benefit must be as great after the transfer as it was before the transfer. Does this mean that vendors may not assess surrender charges under the contract?

> Both the Treasury official and the IRS staffer engaging in Q&A discussions with the NTSAA and other groups have indicated, this *does not mean that surrender charges or other regular product charges cannot be assessed.* It does mean that the participant's account cannot be charged a transactional fee for the exchange. For example, product providers cannot assess a transfer paperwork fee or transfer origin fee. Regular fees normally charged to contract holders are permitted.[478]

Additional plan-to-plan transfer rules may apply to ERISA 403(b) plans.[479]

The new rules relating to contract exchanges do not apply to contracts received in an exchange that occurred on or before

[476] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,132 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[477] Treas. Reg. § 1.403(b)-10(b)(3)(i)(A)–(F).

[478] Ellie Lowder, *Tax-Free Transfers Under the Final Regulations*, http://www.ntsaa.org/staticcontent/Images/Bulletin_on_90-24_Transfers.pdf (last visited Dec. 12, 2009).

[479] Treas. Reg. § 1.403(b)-10(b)(ii).

September 24, 2007, assuming that the exchange (including the contract received in the exchange) satisfied pre-existing legal requirements (including Revenue Ruling 90-24).[480]

> According to Treasury and the IRS in informal discussions, that means that the paperwork for the tax-free transfer must be fully in place by September 24. This means that the receiving company has forwarded the necessary documentation to the transferring company, and the transferring company has agreed to the transfer. The actual tendering of the check need not take place by September 24 to meet the current rules, so long as the legal obligation to transfer exists on that date.[481]

Transfers after September 24, 2007 and before January 1, 2009 can only be made to providers that have entered into a written agreement with the employer sponsoring the 403(b) plan to share certain information for compliance purposes. The employer has until January 1, 2009, however, to actually establish the agreement with the receiving companies and until December 31, 2009 to adopt a written plan that permits such exchanges.[482]

It seems that "orphan" 403(b) contracts and custodial accounts—those that have no current connection to an employer-sponsored program—must be converted to IRAs by January 1, 2009, the effective date of the regulations, in order to retain their tax-favored status. Contracts received in a valid, prior law transfer on or before September 24, 2007 are grandfathered. [483]

The new regulations distinguish between post-September 24,

[480] § 1.403(b)-11(g).

[481] Lowder, *supra* note 478.

[482] *See* Treas. Reg. § 1.403(b)-11 (as amended in 2007); I.R.S. Notice 2009-3, 2009-1 C.B. 250; *see also* Lowder, *supra* note 478.

[483] *See* Treas. Reg. § 1.403(b)-3(b)(3); *see also* Sutherland, Asbill & Brennan LLP, Legal Alert: Intended Operation of New 403(b) Transfer Rules Requires Immediate Attention, Aug. 3, 2007, http://www.sutherland.com (go to "Alerts & Publications; search keyword "403(b)" and scroll down the list) (suggesting that three types of product required attention before January 1, 2009: (1) orphan products exchanged after September 24, 2007; (2) products that are not orphans at the time of a post-September 24, 2007 exchange, but become orphans before January 1, 2009; and (3) orphan products never involved in an exchange); Steptoe & Johnson LLP, Memorandum, Frequently Asked Questions: New Section 403(b) Annuity Regulations, Aug. 14, 2007, http://www.naifa.org/advocacy/documents/403bFAQ.pdf ("It appears that the requirement that a 403(b) contract must be maintained pursuant to a plan applies to all plans unless specifically exempted, such as a church plan. There are certain plans that would be exempt if they are transferred on or before September 24, 2007, but otherwise existing 403(b) arrangements will have to meet these new requirements. This may be hard to do where the employer has ceased to exist or no longer sponsors a 403(b) plan. The IRS seems to think that the financial institutions offering the plans will maintain the plans and meet these requirements, but that may be unrealistic.").

2007 transfers that preserve the qualified status of the participant's section 403(b) account and transfers that could cause the participant's entire account balance to become taxable on January 1, 2009. A "compliant" post-September 24, 2007 transfer is one made to a vendor who will either (1) be eligible to receive future plan contributions, or (2) have entered into an information sharing agreement with the employer by January 1, 2009.[484] A "non-compliant" post- September 24, 2007 transfer is one made to any other vendor.[485] In Revenue Procedure 2007-71,[486] however, the IRS provides a self-correction mechanism for any participant who makes a non-compliant transfer between September 25, 2007 and January 1, 2009.[487] "The participant can preserve the tax-deferred status of his or her account by re-exchanging the contract for one issued by a vendor" described above.[488] The re-exchange must be completed by July 1, 2009.[489]

Any other vendor that received a transfer after September 24, 2007 is treated as holding a transitional contract. "A vendor with a 'transition[al]' contract must make a reasonable, good faith effort to obtain information from the employer prior to making a loan or distribution to the participant."[490]

A grandfathered contract is one that ceased receiving contributions before 2005.[491] Under the Revenue Procedure, the final regulations do not apply to these contracts, and the rules in existence prior to the issuance of the final regulations will continue to apply to them.[492] There is no requirement for the employer to enter into an Information Sharing Agreement ("ISA") with a grandfathered vendor.[493]

An orphan contract is one that ceased receiving contributions from the employer between 2005 and December 31, 2008. ISAs do not apply to these contracts.[494] Under the Revenue Procedure, "[t]hese 'orphan' contracts are subject to a reasonable, good faith standard rule for sharing information necessary to determine the

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[484] Treas. Reg. § 1.403(b)-10(b)(2)(i)(C)(1)–(2) (as amended in 2007).
[485] *Id.*
[486] Rev. Proc. 2007–71, 2007–2 C.B. 1184.
[487] NAGDCA, *supra* note 286.
[488] *Id.*
[489] *Id.*
[490] *Id.* at 3.
[491] *Id.*
[492] *Id.* at 4.
[493] *Id.*
[494] *Id.* at 3.

participant's right to request a loan or a distribution."[495]

If, as of January 1, 2009, a vendor with an orphan contract holds account balances, the vendor must make a reasonable good faith effort to obtain loan and distribution information from the employer. If the employer is out of business, the vendor may rely on the participant's self-certification unless it is unreasonable to do so.[496] "An employee with an orphan contract may transfer his or her account balance into the contract of [an approved vendor] under the plan (subject to the terms of the orphan contract), but is not required to do so."[497]

If a participant transfers funds from one 403(b) plan to another 403(b) plan, "both the receiving employer's and transferring employer's plans must have written provisions allowing the transfer to take place. The receiving employer's plan must impose the withdrawal restrictions at least as stringent as the restrictions in the prior employer's plan."[498] Therefore, the Regulations (as did the Proposed Regulations) present the crucial issue of the

> imposition of an employer consent requirement for transfers to section 403(b) contracts. Under the Proposed Regulations, a participant may freely transfer amounts from one section 403(b) contract to another only if the transferee contract is one designated as part of the plan by the employer. Any other transfer is prohibited except in extremely narrow circumstances. The effect is to create an employer consent requirement for transfers, i.e., the employer must agree that the transferee contract is part of the plan.[499]
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> . . . .
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> It is also critical to note that the change suggested by the Proposed Regulations is highly problematic with respect to outstanding contracts because the Proposed Regulations would retroactively take away an individual's contractual right to transfer with respect to existing amounts under his or her individually-owned section 403(b) contract, and, as indicated above, many state insurance laws impose anti-cutback-type rules that prohibit an insurer from unilaterally eliminating existing contractual rights. This issue is presented by the vast majority of outstanding contracts, yet

[495] *Id.* at 4.
[496] *Id.*
[497] *Id.* at 7.
[498] *Id.* at 6.
[499] McKeever & Seymon-Hirsch, *supra* note 324.

> the Proposed Regulations ignore this problem. An entirely separate issue is presented by amounts that already have been transferred pursuant to Revenue Ruling 90-24. The Proposed Regulations also ignore the ongoing status of these existing transfers and the status of the contracts to which the amounts were transferred.[500]

For example:

> A tax-exempt client with a 403(b) plan that adopts a 401(k) plan would often like to merge the plans. In PLR 200317022, IRS ruled that a transfer (not a rollover initiated by the employee, but a transfer initiated by the employer) from a 403(b) plan to a 401(k) plan would result in taxation of the 403(b) proceeds. In PLR 200242047, IRS ruled that a 403(b) plan is not disqualified despite pooling of assets with 401(a) assets ("The arrangement herein described is analogous to the facts as described in Revenue Ruling 81-100, wherein individual trusts were combined into a group trust.").[501]

N. Defined Benefit Programs[502]

It has been possible for a 403(b) arrangement to be a defined benefit program, though these are rare (and difficult to administer). The regulations generally require a 403(b) plan to be a defined contribution plan.[503] This requirement does not apply to certain pre-TEFRA church plans. Any other existing defined benefit plan that has taken the position, based on a reasonable interpretation of the statute, that it satisfies section 403(b) would be grandfathered for pre-effective date accruals, and, according to the preamble to the proposed regulations, "might seek to take the position that it satisfies the section 401 qualified plan rules for subsequent accruals (assuming it satisfies those rules with respect to those accruals)."[504]

"The Code does not define section 403(b) in terms of it being limited to defined contribution plans," and several commentators objected to this change on that basis.[505] The preamble does not offer

[500] *Id.*

[501] Theresa Lensander & David Pratt, *Workshop 52: Contemporary Plan Design for Tax Exempt Organizations—How to Connect with 403(b), 457 and 409A* (2006), *available at* http://aspavps.securesites.net/archive/conf/2006/annualoutlines/Workshop%2052-Pratt.pdf.

[502] *See* Treas. Reg. § 1.403(b)-10(f) (as amended in 2007).

[503] *Id.*

[504] Prop. Treas. Reg. § 1.403(b), 69 Fed. Reg. 67,075, 67,083 (Nov. 16, 2004).

[505] Randolph M. Goodman & Terrill A. Hyde, *Attorneys Criticize Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, March 11, 2005, 2005 TNT 47-17 (LEXIS);

any reason for the change. The change also appears to be inconsistent with a recent statutory provision affecting 401(k) plans. Prior to enactment of the PPA 2006, it was not possible for a "qualified cash or deferred arrangement" to be part of a defined benefit plan.[506] Section 903 of the PPA provides for a new type of hybrid plan, a combination of a defined benefit plan and a 401(k) plan, provided that certain conditions are satisfied, generally effective for plan years beginning after 2006.[507]

O. Insurance

Previously, a 403(b) plan, like a qualified plan, could provide life insurance protection as well as retirement benefits.[508] The regulations provide that incidental insurance, unless grandfathered, may not be part of a 403(b) plan.[509] This new prohibition applies to contracts issued on or after February 14, 2005.[510]

P. Nonforfeitability

Section 403(b) applies to the purchase of an annuity contract (or other funding vehicle) where "the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums."[511] The nonforfeitability requirement was presumably included because contributions to purchase a forfeitable contract would not have been taxable even in the absence of section 403(b). Despite the language of the statute, some 403(b) plans include vesting schedules for employer contributions. Under the new regulations, a forfeitable contract is treated as being subject to section 403(c) rather than 403(b).[512] Comments on the proposed

see also Kemper et al., *supra* note 304.

[506] I.R.C. § 401(k)(1) (2006).

[507] PPA 2006 § 903, I.R.C. § 414(x) (2006).

[508] Treas. Reg. § 1.403(b)-1(c)(3), *amended by* T.D. 9340, 1965-1 C.B. 180.

[509] Treas. Reg. § 1.403(b)-8(c)(2) (as amended in 2007).

[510] *See* Powell & Mazawey, *supra* note 190; *see also* Cook & Lowder, *supra* note 348.

[511] I.R.C. § 403(b)(1)(C).

[512] Treas. Reg. § 1.403(b)-3(d)(2) provides as follows:

> (2) Failure to satisfy nonforfeitability requirement—(i) Treatment before contract becomes nonforfeitable. If an annuity contract issued by an insurance company would qualify as a section 403(b) contract but for the failure to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section, then the contract is treated as a contract to which section 403(c) applies. *See* § 1.403(b)-8(d)(4) for a rule under which a custodial account that fails to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section is treated as a section 401(a) qualified plan for certain purposes.
>
> (ii) Treatment when contract becomes nonforfeitable—(A) In general. Notwithstanding paragraph (d)(2)(i) of this section, on or after the date on which the

regulations objected to this change:

> For over 40 years, 403(b) programs have accepted nonvested contributions and treated such amounts as subject to all of the rules applicable to 403(b) programs. Creating a requirement for a separate 403(c) contract unnecessarily complicates the administration of vested plans and fails to recognize the inherent problems when trying to apply this requirement to individually owned 403 (b) contracts.[513]
>
> Proposed Treasury Regulation section 1.403(b)-3(c)(2) states that if an "annuity contract issued by an insurance company would qualify as a *section 403(b)* contract but for the failure to satisfy the nonforfeitability requirement of Proposed Treasury Regulation section 1.403(b)-3(a)(2), then the 403(b) contract is treated as a contract to which Code *section 403(c)* applies.
>
> . . . Proposed Treasury Regulation section 1.403(b)-3(c)(2) addresses only how to treat an "annuity contract issued by

participant's interest in a contract described in paragraph (d)(2)(i) of this section becomes nonforfeitable, the contract may be treated as a section 403(b) contract if no election has been made under section 83(b) with respect to the contract, the participant's interest in the contract has been subject to a substantial risk of forfeiture (as defined in section 83) before becoming nonforfeitable, each contribution under the contract that is subject to a different vesting schedule is maintained in a separate account, and the contract has at all times satisfied the requirements of paragraph (a) of this section other than the nonforfeitability requirement of paragraph (a)(2) of this section. Thus, for example, for the current year and each prior year, no contribution can have been made to the contract that would cause the contract to fail to be a section 403(b) contract as a result of contributions exceeding the limitations of section 415 (except to the extent permitted under paragraph (b)(2) of this section) or to fail to satisfy the nondiscrimination rules described in § 1.403(b)-5. See also § 1.403(b)-10(a)(1) for a special rule in connection with termination of a section 403(b) plan.

(B) Partial vesting. For purposes of applying this paragraph (d), if only a portion of a participant's interest in a contract becomes nonforfeitable in a year, then the portion that is nonforfeitable and the portion that fails to be nonforfeitable are each treated as separate contracts. In addition, for purposes of applying this paragraph (d), if a contribution is made to an annuity contract in excess of the limitations of section 415(c) and the excess is maintained in a separate account, then the portion of the contract that includes the excess contributions account and the remainder are each treated as separate contracts. Thus, if an annuity contract that includes an excess contributions account changes from forfeitable to nonforfeitable during a year, then the portion that is not attributable to the excess contributions account constitutes a section 403(b) contract (assuming it otherwise satisfies the requirements to be a section 403(b) contract) and is not included in gross income, and the portion that is attributable to the excess contributions account is included in gross income in accordance with section 403(c). *See* § 1.403(b)-4(f) for additional rules.

Treas. Reg. § 1.403(b)-3(d)(2).

[513] Cook & Lowder, *supra* note 348.

> an insurance company" that has a vesting schedule. We are not aware of any statutory or policy reason why vesting schedules should not be permitted with respect to custodial or retirement income accounts as well as to annuity contracts.[514]

In its comments, the American Society of Pension Professionals and Actuaries ("ASPPA") expressed concern that the requirement to hold non-vested contributions in I.R.C. section 403(c) contracts/accounts could: (1) "[s]ubject non-vested contributions to IRC section 409A, resulting in potential adverse tax consequences to participants or additional reporting requirements"; (2) "[a]dd additional administrative complexity between individual deferral plans and plans with vesting schedules making IRC section 403(b) compliance efforts more difficult"; (3) "[c]onflict with various insurance and security laws"; and (4) "[i]ncrease costs that will ultimately be passed on to participants."[515]

ASPPA recommended that the vesting rules be modified to "require insurers and custodians to account for non-vested amounts in a separate notational account within the 403(b) contracts and custodial accounts, without actually segregating these amounts into separate contracts or accounts or subjecting them to IRC section 403(c)."[516]

Q. Years of Service [517]

Section 403(b) was enacted sixteen years before ERISA, and includes a special definition of "year of service" that differs significantly from the ERISA definition used by most qualified plans.[518] The section 403(b) definition was originally a key element of the exclusion allowance calculation:[519] since the repeal of the exclusion allowance limitation, its most important applications are in calculating the "includible compensation" used in applying the section 415 limitations, determining employer contributions for former employees, and determining whether an individual has

[514] Kemper et al., *supra* note 304.

[515] Brian H. Graff et al., Comments on Behalf of the ASPPA, *ASPPA Comments on Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, Mar. 25, 2005, 2005 TNT 57-15 (LEXIS).

[516] *Id.*

[517] *See* Prop. Treas. Reg. § 1.403(b)-4(e), 72 Fed. Reg. 41,128, 41,147–48 (July 26, 2007).

[518] *Id.*

[519] I.R.C. § 403(b)(2), *repealed by* EGTRRA 2001, Pub. L. No. 107-16, §632(a)(2)(B), 115 Stat. 38, 113.

fifteen years of service, so as to qualify for the section 403(b) catch-up contribution.[520]

Under the ERISA definition, an individual generally must be credited with one year of service for each twelve month computation period in which he or she has at least 1,000 hours of service.[521] An individual must generally be credited with one hour of service for each paid hour, including paid non-working hours.[522] By contrast, in determining the number of years of service under section 403(b), one includes:

> (1) One year for each full year during which the individual has been a full time employee of the employer. In determining whether an individual is employed full-time, the amount of work which he or she must perform is compared with the amount of work normally required of individuals holding the same position with the same employer who generally derive the major portion of their personal service income from the position; and
> (2) A fraction of a year for each full year during which the employee has been a part-time employee, and for each partial year during which the individual was either a full-time or a part-time employee of the employer.[523]

The employer's annual employment year, not the employee's taxable year, is the computation period for determining years of service. Only service for the employer while it is eligible to sponsor a 403(b) arrangement is taken into account. Service need not be continuous. It is possible to "tack" employment with predecessor and successor employers.[524]

There are special rules for calculating the length of service of ministers and lay employees of a church, a convention or association of churches, or a tax-exempt organization which is controlled by, or associated with, a church or convention or association of churches. Such an employee counts, as years of service, all his or her employment with all employers related to a particular church.[525]

As appears from reading the regulation, determining the number of years of service is no easy task, and demands accurate recordkeeping back to the employee's original date of hire.

[520] Prop. Treas. Reg. § 1.403(b)-4(e); 72 Fed. Reg. 41,128 (July 26, 2007).
[521] ERISA § 202(a)(3)(A), 29 U.S.C. § 1052(b) (2006).
[522] 29 C.F.R. § 2530.200b-2(a)(2) (2009).
[523] Prop. Treas. Reg. § 1.403(b)-4(e), 72 Fed. Reg. 41,128, 41,148 (July 26, 2007).
[524] *Id.*
[525] *Id.*

In the case of a part-time employee, or a full-time employee who is employed for only part of the year, the employee's most recent periods of service are aggregated to determine his or her most recent one-year period of service.

> In such a case, there is first taken into account his or her service during the annual work period for which the last year of service's includible compensation is being determined; then there is taken into account his or her service during his next preceding annual work period based on whole months; and so forth, until the employee's service equals, in the aggregate, one year of service.[526]

If, at the close of a taxable year, an employee has some portion of one year of service (but has accumulated less than one year of service), the employee is deemed to have one year of service. Otherwise, fractional years of service are not rounded up.

R. The Anti-Conditioning Rule

The regulations include (without explicit statutory authority) a rule similar to the anti-conditioning rule of Code section 401(k)(4)(A):[527]

> [U]nlike with respect to Code *section 401(k)*, the statutory language of Code *section 403(b)* does not contain an anti-conditioning rule. Moreover, while an anti-conditioning rule serves a purpose with respect to Code *section 401(k)* plans in order to ensure that employers do not attempt to evade the non-discrimination rules applicable to employee salary deferrals under the ADP test, Code *section 403(b)* elective deferrals are not subject to similar discrimination testing. Rather, employers sponsoring 403(b) plans have to make elective deferrals available to a non-discriminatory group of employees.[528]
>
> For example, one current plan design pairs a 403(b) plan with a money purchase pension plan or a profit sharing plan (for convenience, a profit sharing plan). The plan design provides that if an employee contributes a certain percentage of pay (e.g., three percent (3%)) to the 403(b) plan, the

[526] *Id.*
[527] Prop. Treas. Reg. § 1.403(b)-5(b)(2), 72 Fed. Reg. 41,128, 41,150 (July 26, 2007).
[528] Kemper et al., *supra* note 304.

employee will receive an employer contribution under the profit sharing plan (e.g., a five percent (5%) employer contribution).[529]

S. Automatic Enrollment

A 403(b) or 457 plan may provide for automatic enrollment.[530] Some states have laws that require written authorization by an employee of all payroll deductions. It is not clear whether these laws are preempted by ERISA, and DOL has not yet responded to ruling requests on this issue. In a 1994 ruling, DOL did rule that the New York statute[531] would be preempted to the extent that it is interpreted to limit, prohibit or regulate the funding of ERISA plans.[532] State law would, however, apply to plans that are not subject to ERISA, such as governmental plans and non-electing church plans.

Section 902 of the PPA includes provisions to encourage automatic enrollment programs, generally effective for plan years beginning *after* December 31, 2007. The Act provides specific plan design rules in order to qualify for favorable treatment.[533]

T. 403(b) Final Regulations: Effective Date and Transition Rules[534]

The regulations are generally applicable for taxable years beginning after December 31, 2008.[535] "Thus, because individuals will almost uniformly be on a calendar taxable year, these regulations will generally apply on January 1, 2009."[536] The regulations include several transition rules. First, for a 403(b) plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on July 26, 2007, the regulations do not apply until the earlier of (1) "The date on which the last such collective bargaining agreement terminates

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[529] Timothy D. S. Goodman, *Attorney Seeks Clarification of Proposed Regs on Retirement Annuity Contracts*, TAX NOTES TODAY, May 20, 2005, 2005 TNT 97-17 (LEXIS).
[530] Rev. Rul. 2000-35, 2000-2 C.B. 138; Rev. Rul. 2000-33, 2000-2 C.B. 142.
[531] N.Y. Labor Law § 193 (McKinney 2009).
[532] 94 Op. Dep't of Labor 27A (1994), *available at* 1994 ERISA LEXIS 30, at *5; 96 Op. Dep't of Labor 01A (1996), *available at* 1996 ERISA LEXIS 1, at *5.
[533] PPA 2006 § 902, I.R.C. § 414(x) (2006).
[534] Treas. Reg. § 1.403(b)-11 (as amended in 2007).
[535] § 1.403(b)-11(a).
[536] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,138 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

(determined without regard to any extension after July 26, 2007)" or (2) July 26, 2010.[537] Second, for a "plan maintained by a church-related organization for which the authority to amend the plan is held by a church convention (within the meaning of section 414(e))," the regulations do not apply before the beginning of the first plan year following December 31, 2009.[538]

Special rules apply to plans which included certain exclusions ((1) employees who make a one-time election to participate in a governmental plan instead of a section 403(b) plan, (2) visiting professors, and (3) employees who are affiliated with a religious order who have taken a vow of poverty) that Notice 89-23 permitted for the universal availability rule, but which are no longer permitted under the regulations. If a plan excluded any of these three classes of employees from eligibility to make elective deferrals on July 26, 2007, the plan may continue that exclusion until taxable years beginning on or after January 1, 2010.[539] "In the case of a governmental plan for which the authority to amend the plan is held by a legislative body that meets in legislative session," the plan may continue the exclusion until the earlier of (i) "The close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009; or (ii) January 1, 2011."[540]

The rule that a section 403(b) contract may not distribute retirement benefits earlier than the participant's severance from employment or the occurrence of some event does not apply to contracts issued before January 1, 2009. In order to permit plans to comply with the rules relating to in-service distributions for contracts issued before January 1, 2009, the regulations provide that an amendment adopted before January 1, 2009, to comply with these rules, does not violate the anti-cutback rules.[541]

The regulations do not permit a life insurance contract, an endowment contract, a health or accident insurance contract, or a property, casualty, or liability insurance contract to constitute an annuity contract for purposes of section 403(b). This rule does not apply to contracts issued before September 24, 2007.[542]

The specific new rules relating to contract exchanges that were

[537] Treas. Reg. § 1.403(b)-11(b).
[538] § 1.403(b)-11(c)(1).
[539] § 1.403(b)-11(d)(1).
[540] § 1.403(b)-11(d)(3).
[541] § 1.403(b)-11(e).
[542] § 1.403(b)-11(f).

permitted under Revenue Ruling 90-24 do not apply to contracts received in an exchange that occurred on or before September 24, 2007, assuming that the exchange (including the contract received in the exchange) satisfies pre-existing legal requirements (including Revenue Ruling 90-24).[543]

The regulations include special applicability date rules to coordinate with recently issued regulations under sections 402A and 415.[544]

From July 26, 2007 to the applicable date, taxpayers can rely on the regulations, except that (1) reliance must be on a consistent and reasonable basis, and (2) the rule permitting accumulated benefits to be distributed on plan termination can be relied upon *only* if all of the contracts issued under the plan at that time satisfy all of the applicable requirements of the regulations (other than the requirement that there be a written plan).[545]

Bob Architect, the leading IRS spokesman on the regulations, has noted that the controlled group rules under section 414(c) also go into effect on January 1, 2009.[546] "[T]he IRS is working on a prototype preapproved program. . . . The fact that the preapproved program will not be open on January 1[, 2009] does not mean the effective date of the 403(b) [regulations] will be pushed back."[547]

Revenue Procedure 2008-50, which updates the Employee Plans Compliance Resolution System ("EPCRS"), does not specifically address anticipated common defects under the 403(b) regulations. "[T]he IRS expects to add the defects and the appropriate corrections in the coming months."[548]

> Architect mentioned several potential pitfalls the IRS is anticipating. One would be the failure of 403(b) programs with required written plan documents to adopt the plans formally. "What good is [the written plan document] going to be if you don't memorialize the formal adoption of that plan?" Architect said. "Be careful and make sure [your] clients or whoever is doing this formally adopt their plans" by January 1, he said.[549]

[543] § 1.403(b)-11(g).

[544] § 1.403(b)-11(h), (i).

[545] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,139 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury) (emphasis added).

[546] Stokeld, *Effective Date of Regs*, *supra* note 449.

[547] *Id.*

[548] *Id.*

[549] *Id.*

U. Effect of Failure to Satisfy the Section 403(b) Requirements[550]

All contracts purchased for an employee by an employer are treated as a single contract for purposes of section 403(b).[551] "Thus, if a contract fails to satisfy any of the section 403(b) requirements, then not only that contract but also any other contract purchased for that individual by that employer would fail to be a contract that qualifies for tax-deferral under section 403(b)."[552] Under the regulations, as under the proposed regulations, if a contract includes any amount that fails to satisfy the requirements of the regulations, then (subject to special rules relating to vesting conditions[553] and excess contributions, under section 415 or section 402(g)),[554] "that contract and any other contract purchased for that individual by that employer does *not* constitute a section 403(b) contract."[555] Also, if a contract is not established pursuant to a written plan, then the contract does not satisfy section 403(b). [556]

> [I]f an employer is not an eligible employer for purposes of section 403(b), none of the contracts purchased by that employer is a section 403(b) contract. If a plan fails to satisfy the nondiscrimination rules (including a failure to operate the plan in accordance with its coverage provisions or a failure to operate the plan in a manner that satisfies the nondiscrimination rules), none of the contracts issued under the plan would be section 403(b) contracts.[557]

Under the regulations, any operational failure within a specific contract, other than those described above,

> generally will not adversely affect the contracts issued to other employees that qualify in form and operation with section 403(b). Thus, for example, if an employee's elective deferrals under a contract, when aggregated with any other contract, plan, or arrangement of the employer for that

[550] Treas. Reg. § 1.403(b)-3(d) (as amended in 2007).
[551] I.R.C. § 403(b)(5) (2006).
[552] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,136 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).
[553] Treas. Reg. §§ 1.403(b)-3(d)(2)(A), (B).
[554] § 1.403(b)-3(d)(1)(i), 4(f).
[555] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,136 (emphasis added); Treas. Reg. § 1.403(b)-3(d)(1)(i).
[556] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,136; Treas. Reg. § 1.403(b)-3(d)(1)(ii) (as amended in 2007).
[557] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. at 41,136.

> employee during a calendar year, exceed the maximum deferral amount permitted under section 402(g)(1)(A) (as made applicable by section 403(b)(1)(E)), the failure would adversely affect the contracts issued to the employee by that employer, but would not adversely affect any other employee's contracts.[558]

In most cases, it should be possible to correct the problem under the EPCRS, but often this will involve significant cost to the employer.[559]

The regulations provide that, if the requirements of section 403(b) fail to be satisfied with respect to an employer contribution, then the contribution is subject either to the rules under section 403(c) (relating to nonqualified annuities) if the contribution is for an annuity contract issued by an insurance company, or the rules under sections 61, 83, or 402(b) if the contribution is to a custodial account or retirement income account that (in either case) fails to satisfy the requirements of section 403(b).[560]

Section 403(c) provides that the value of a nonqualified contract is included in gross income under the rules of section 83, which generally does not occur before the employee's rights in the contract become substantially vested.[561] Under the regulations, on the date on which the employee's interest in that contract becomes nonforfeitable, the contract may be treated as a section 403(b) contract if the contract has at all prior times satisfied the requirements of section 403(b) other than the nonforfeitability requirement.[562] Solely for this purpose, if a participant's interest in a contract is only partially nonforfeitable in a year, then the portion that is nonforfeitable and the portion that is forfeitable are bifurcated.[563]

These provisions raise issues under Code sections 409A and 457: 403(c) arrangements, unlike 403(b) plans, are not exempted from compliance with either section.

Under the final regulations, like the proposed regulations, a separate account is necessary in several situations:

> [A] separate bookkeeping account is required for any contract in which only a portion of the employee's interest is

[558] *Id.*
[559] *Id.* at 41,138.
[560] Treas. Reg. § 1.403(b)-3(d)(1)(iii).
[561] I.R.C. § 403(c) (2006).
[562] Treas. Reg. § 1.403(b)-3(d)(2)(ii)(A).
[563] § 1.403(b)-3(d)(2)(ii)(B).

> vested . . . . [I]f the section 403(b) plan fails to establish a separate account for contributions in excess of the section 415(c) limitation . . . so that such excess contributions are commingled in a single insurance contract with contributions intended to qualify under section 403(b) without maintaining a separate account for each amount, then none of the amounts held under the insurance contract qualify for tax deferral under section 403(b). Any such separate account must be established by the time the excess contribution is made to the plan. The separate account for excess contributions under section 415(c) is necessary to effectuate differences in the tax treatment of distributions (for example, because of the need to properly allocate basis under section 72 and separately identify amounts that can be rolled over). . . . [A] separate account is required for elective deferrals to be treated as held in a designated Roth account . . . ."[564]

V. EPCRS

Section 1101 of the PPA clarifies that the IRS has the authority to (1) establish and improve the EPCRS, and (2) to waive income, excise, or other taxes to ensure that such penalties bear a reasonable relationship to the failure.[565] The IRS has recently updated EPCRS.[566]

In May, 2008, Bob Architect said that the IRS will definitely provide corrective measures for 403(b) plans in the next version of EPCRS. The defects to be addressed will focus on the written plan requirement.[567]

W. The Excise Tax

If the amount (other than rollover contributions) contributed to a 403(b)(7) custodial account exceeds the limit under section 415, the employee is subject to a cumulative 6% excise tax on the excess.[568]

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[564] Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 Fed. Reg. 41,128, 41,136 (July 26, 2007) (to be codified at Treas. Reg. pts. 1, 31, 54, and 602) (preamble to final regulations for Dep't of Treasury).

[565] PPA 2006, § 1101.

[566] Rev. Proc. 2008-50, 2008-35 I.R.B. 464.

[567] IRS Updating Guidance to Provide Corrective Measures for 403(b) Plans, Official Says, CCH PENSION AND BENEFITS NEWS (June 11, 2008), *available at* http://hr.cch.com/news/pension/061108a.asp.

[568] I.R.C. § 4973(a)(3) (2006).

There is no excise tax on excess contributions to an annuity contract or a retirement income account. This is an illogical difference.

IV. Proposed Changes

A. Eligible Employers

Is there any valid policy reason for continuing to allow a type of retirement plan that is only available to certain tax-exempt and educational organizations? It is not clear that these organizations, as a class, are so distinct from other types of employers as to merit special treatment. In its employee benefit activities, Harvard University has more in common with a *Fortune* 500 company than with a neighborhood charity.

The legislative history of the various statutes which have created and amended section 403(b) does not provide any empirical evidence supporting special treatment. Indeed, the fact that Congress extended certain qualified plan rules to 403(b) arrangements suggests that it does not view eligible employers as being different from other employers, or at least that it views them as being less different than they might once have been. There is a need to do empirical research into whether different types of retirement programs are needed for employees of tax-exempt organizations and, if so, whether this applies to all tax-exempt organizations or only to some, and, if the latter, what the distinguishing characteristics of the tax-exempt organizations which require special treatment are. If different types of retirement programs are deemed to be necessary, then such programs should be subject to a single, coherent set of rules, and should not be subjected to rules designed for different types of employers. If not, then section 403(b) should be repealed and the current eligible employers should be limited to the same types of plan as are available to other employers.

There also does not appear to be a valid policy reason for limiting the availability of retirement arrangements to which employees can contribute on a pre-tax, salary deferral basis, particularly in view of concerns as to the long-term financial solvency of Social Security and Medicare. Accordingly, section 401(k)(4)(B), which prohibits most state and local government employers from sponsoring 401(k) plans, should be repealed.[569]

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[569] Although it is beyond the scope of this paper, the same argument supports repeal of the

The following sections assume that 403(b) plans continue to be available, and recommend specific changes in the law. In many cases, appropriate grandfather or transition rules would be needed, in order to preserve employees' contractual rights under existing arrangements and to allow employers time to bring their plans into compliance.

B. Compensation

The definition of "includible compensation" under section 403(b)[570] differs from the definition of "compensation" used for most qualified plan purposes[571] in two major respects. First, includible compensation is determined for the most recent period which can be counted as one year of service, under the section 403(b) rules.[572] This can be a complex procedure: for a part-time or part-year employee, it involves aggregating amounts earned over two or more years, and for an employee who has had a break in service it may require reviewing several years of past records. One questions how many 403(b) plan sponsors are doing the calculation correctly. It does have the advantage of annualizing the pay actually earned by part-time and part-year employees, and thus potentially allowing larger contributions for them, but there is no reason why this should be allowed under a 403(b) plan but not a 401(k) plan.

Second, an employee is deemed to have includible compensation from the employer for a five-year period after the cessation of actual compensation payments,[573] thus allowing employer 403(b) plan contributions to continue for a five-year period after termination of employment. Again, there is no reason why this should be allowed under section 403(b) but not under 401(k).

In each case, the current 403(b) rule should be revised to conform to the 401(k) rule.

C. The Special 403(b) Catch-Up

Section 402(g)(8) allows an additional elective deferral, which can be as much as $3,000 (to a lifetime limit of $15,000).[574] This is

special rules limiting the availability of nonqualified deferred compensation arrangements for employees of governmental and tax-exempt employers. I.R.C. § 457.

[570] § 403(b)(3).

[571] § 415(c)(3)(A).

[572] *See supra* Part III.S.

[573] I.R.C. § 403(b)(3).

[574] § 402(g)(8).

available only (1) under a 403(b) plan, (2) to an employee who has at least fifteen years of service (determined under the 403(b) rules, and (3) if the employer is a "qualified organization."[575] If there is a need to allow additional elective deferrals by long service employees, in addition to the age fifty catch-up under section 414(v),[576] then why is its availability so limited? The empirical evidence shows that very few eligible employees make the maximum regular deferral ($16,500 for 2009 and 2010),[577] let alone additional catch-up contributions. Since they cannot afford to do so, it seems likely that this benefits only relatively affluent participants. The rule should be repealed.

D. Funding

The recent seismic tremors in the stock market have reminded us again of the vulnerability of those who rely solely on defined contribution plans for their future retirement income. In view of this, there is no valid policy reason for limiting the permissible investments for 403(b) arrangements more narrowly than for 401(k) plans. Almost all 403(b) arrangements are defined contribution programs, rather than defined benefit programs, so there is no level of benefits guaranteed by the employer. Instead, the ultimate benefit is the sum of all contributions made to the employee's account, plus investment earnings. Over an employee's working lifetime, the majority of the accumulation is attributable to investment earnings, rather than contributions, and even a 1% difference in the average annual rate of return can have a significant effect on the eventual accumulation.

A 2008 Spectrem Group report finds that lower savings rates, fewer employer matching contributions, and conservative investing habits could account for a lower accumulation of retirement savings for 403(b) plan participants than their 401(k) counterparts.[578] "Only 38% of participants in 403(b) plans contribute 6% or more of their salaries to their retirement plans, compared with 48% of private-sector 401(k) participants."[579] Also, "participants in 403(b) plans are slightly more conservative investors than 401(k)

[575] § 402(g)(7)(B).
[576] § 402(g)(1)(C).
[577] I.R.S. Pub. 571, at 2 (Jan. 2009), *available at* 2009 WL 179948.
[578] Spectrem Group, *403(b) Participants Accumulate Less Retirement Savings than 401(k) Participants*, Plansponsor.com, Aug. 27, 2008, http://www.plansponsor.com/pi_typeII/?RECORD_ID=42812.
[579] *Id.*

participants. Overall, 52% of 403(b) participants describe their plan investment strategy as very or somewhat conservative compared to 43% of 401(k) participants," based on the survey of 205 participants in 401(k) plans and 196 participants in 403(b) plans.[580] Only "57% of 403(b) participants receive employer match[ing] contributions [ ] fewer than the 74% of 401(k) participants who do."[581]

When 403(b) was originally enacted, it allowed investments only in annuity contracts, not because Congress had decided that this was the only appropriate investment, but because the purpose of the legislation was to limit tax-deferred contributions to annuity contracts.[582] The addition of mutual funds in 1974 resulted in much needed additional flexibility, but the investment environment has changed dramatically since 1974, and many employees and plan sponsors would benefit from having access to the same broad range of investments as are available to qualified plans.[583]

If this change was adopted, then church employers described in section 403(b)(9) would then receive the same treatment allowed all other eligible employers. Otherwise, there is no valid policy reason, and the legislative history of TEFRA provides none, why church employers should have more flexibility than other eligible employers.

The ability to commingle retirement income accounts with other church funds is also troubling. If a 403(b) arrangement is subject to ERISA, then all plan assets are required to be held in trust, separate from the employer's assets and exempt from the claims of its creditors, subject to narrowly defined exceptions.[584] From a policy perspective, it would seem preferable that all retirement funds, including funds accumulated under governmental plans, church plans, and other non-ERISA plans should be kept separate from the employer's assets; first, to minimize the risk of conversion

[580] *Id.*

[581] *Id.*

[582] TAA 58, Pub. L. No. 85-866, § 23(a), 72 Stat. 1606, 1620 (codified as amended at I.R.C. § 403(b) (2006)).

[583] For instance, mutual funds tend to have higher expenses than individually managed accounts, which reduces the rate of return. The typical annual fee for a $25 million balanced mutual fund investing in stocks and bonds would be 1.28% ($320,000), against 0.5% ($125,000) for an individually managed fund of the same size. *See* Janie S. Kass, *DC Investments: Should They Be the Same as Your DB Investments?*, 3 J. PENSION BENEFITS 51 (1995). Assume that the annual rate of return for the employee described in note 147 is 11% before investment management fees. A 1.28% annual expense would reduce her net return to 9.72%, and her eventual accumulation from $683,179 to $508,315. If the management fee were only 0.5%, her annual return would be 10.5%, and her eventual accumulation would be $608,318, a difference of $100,003.

[584] ERISA § 403, 29 U.S.C. § 1103 (2006).

by the employer, and second, to protect the funds from claims by the employer's creditors.

The availability of retirement income accounts is only one of many ways in which the rules governing retirement plans favor church and church-related employers.[585] One can understand the reluctance of the federal government to enact legislation that could impair the practice of religion, but it is difficult to see how requiring church employer retirement plans to follow the same rules as other plans could possibly have this effect. Of the two largest hospitals in Albany, New York, one has a religious affiliation, but the second does not. The retirement plans maintained by the former are "church plans," and thus are exempt from ERISA and many of the substantive qualification rules under the Code. The plans of the second hospital are required to comply with all of these rules. This makes no sense.

E. Applicability of ERISA

As a general rule, all non-governmental, non-church retirement plans are subject to ERISA.[586] Certain 403(b) plans that are funded exclusively by employee deferrals, however, enjoy a regulatory exemption.[587] This exemption is not available to 401(k) plans. Apart from the fact that the scope of the exemption is far from clear, this distinction is irrational and unfair. The exemption should be repealed.

F. The Written Plan Requirement

An employer that attempts to maintain a program as complex as today's 403(b) plan without an adequate document setting out the plan terms is foolhardy. Documentation is important, for the reasons set out by the IRS in the preamble to the regulations.[588] IRS spokespersons have, in discussing the new written plan requirement, been at pains to stress that assembling a 403(b) written plan is not as onerous as preparing a document for a

[585] For example, church plans are generally exempted from complying with (1) the requirements of ERISA, ERISA § 4(b)(2), 29 U.S.C. § 1003(b)(2) (2006); (2) the qualified plan vesting rules and certain other qualification requirements, I.R.C. §§ 401(a), 411(e)(1)(B); (3) the qualified plan coverage and nondiscrimination rules, I.R.C. § 410(c)(1)(B); and (4) the nondiscrimination rules for 403(b) plans, I.R.C. § 403(b)(1)(D).

[586] *See supra* Part III.F.

[587] *See supra* text accompanying notes 190–91.

[588] *See supra* note 298 and accompanying text.

qualified plan. The IRS should issue additional model language for use by 403(b) plan sponsors,[589] and should also finalize and expand its draft program, for approving 403(b) documents.[590] Once this has been done, the documentation requirements for 403(b) plans should be similar to the requirements for qualified plans, and the exemption for church plans (other than those funded through a retirement income account) should be eliminated.

G. Section 415

The rules of section 415, as modified in their application to 403(b) arrangements, are a trap for the unwary. Even as applied to qualified plans, in their unmodified form, they are among the hardest of all the qualification rules from a compliance standpoint. The special 403(b) modifications are not well known, even by experienced pension practitioners.[591] Consider the following scenarios:

1. X is employed by a Hospital that is eligible to sponsor a 403(b) arrangement. He does not control the Hospital. The Hospital maintains a 401(k) plan and another defined contribution plan, both of which are qualified. X makes a $5,000 elective deferral, and receives a $2,500 Hospital matching contribution, under the 401(k) plan. X also receives a $3,000 Hospital contribution under the other defined contribution plan. The two plans are aggregated for 415 purposes.[592]
2. The facts are as in 1, but Hospital sponsors a 403(b) arrangement rather than a 401(k) plan. The plans are not aggregated for 415 purposes.[593]
3. In addition to the employment described above, X is employed by his wholly-owned corporation. He is covered by the plans described in 1, and also by the corporation's profit sharing plan. Hospital's plans and the corporation's plan are not aggregated, because Hospital and the corporation are unrelated employers.[594]
4. In addition to the employment described above, X is

[589] *See supra* notes 315–16 and accompanying text.
[590] *See supra* notes 317–18 and accompanying text.
[591] I.R.C. § 415(g) (2006).
[592] *Id.*
[593] *Id.*
[594] *Id.*

> employed by his wholly-owned corporation. He is covered by the plans described in 2, and also by the corporation's profit sharing plan. Hospital's qualified plan and the corporation's plan are not aggregated, because Hospital and the corporation are unrelated employers. The 403(b) arrangement and the corporation's plan are aggregated, however, because X controls the corporation.[595]

A large part of the complexity derives from the general rule that, for section 415 purposes, a 403(b) plan is deemed to be maintained by the individual participant, not by the employer.[596] This is totally at odds with reality: the plan is, and has to be, maintained by an eligible employer.

Thus, 403(b) arrangements should be subject to the same section 415 rules as any qualified defined contribution plan.

H. Nondiscrimination

As many comments have pointed out,[597] the nondiscrimination rules for qualified plans are a complex mess that does not achieve their stated purpose. There is no good reason, however, to have different rules for elective deferrals under 401(k) plans and 403(b) plans. First, if it is appropriate to test actual contributions under a 401(k) plan, then it is also appropriate to do so under a 403(b) plan, rather than merely requiring universal availability. Second, the nondiscrimination rules for elective deferrals under a 403(b) plan should include a collective bargaining exception, as does every other retirement plan nondiscrimination rule. Third, the 401(k) rules,[598] unlike the universal availability rule, allow an employer to require an employee to complete one year of service before being allowed to make elective deferrals. Here, the 403(b) rule is preferable, and the 401(k) rule should be modified.

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[595] *Id.*

[596] Treas. Reg. § 1.415(f)-1(f)(1) (as amended in 2007).

[597] *See, e.g.*, Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435, 435 (1987); Michael J. Collins, *Reviving Defined Benefit Plans: Analysis and Suggestions for Reform*, 20 VA. TAX REV. 599, 599 (2001); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47, 67 (1991); David A. Pratt, *Pension Simplification*, 35 J. MARSHALL L. REV. 565, 565 (2002); Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984); Daniel I. Halperin & Alicia H. Munnell, *How the Pension System Should Be Reformed*, BROOKINGS INSTITUTION CONFERENCE ON ERISA AFTER 25 YEARS: A FRAMEWORK FOR EVALUATING PENSION REFORM 5 (Sept. 17, 1999), *available at* http://www.brook.edu/es/events/erisa/99papers/erisa10.pdf.

[598] I.R.C. § 401(k)(3)(F).

I. Distributions

The 403(b) minimum distribution rules should be conformed to the qualified plan rules by (1) eliminating the exclusion of pre-1987 accumulations, and (2) treating 403(b) plans as employer plans rather than IRAs.

The distribution restrictions for salary reduction contributions and other contributions should be identical to the corresponding 401(k) rules, and the additional restrictions relating to custodial accounts should be repealed. The statute should provide that loans to participants are available on the same terms as loans from qualified plans. Finally, the statute should specifically permit, and allow distributions upon, termination of a 403(b) plan.

J. Transfers

The transfer rules under the new regulations remove many of the discrepancies that existed under the prior law between participants' rights under a 403(b) plan and their rights under a 401(k) plan. The new rules, however, are very complex. This is likely to lead to significant problems with compliance, particularly in the near future. The Treasury and IRS should consider simplifying the rules.

K. Insurance

Under the new regulations, a 403(b) plan generally may not provide life insurance protection; whereas a 401(k) plan may do so. Here, the 403(b) rule is preferable; the qualified plan rules would be simplified by the prohibition of future insurance purchases.

L. Nonforfeitability

There are good reasons for requiring that all benefits under all tax-favored retirement plans be fully vested and nonforfeitable at all times. Until this happens, qualified plans and 403(b) plans should be governed by the same rules. The Code should be amended to specifically permit graduated vesting under 403(b) plans.

M. The Excise Tax

The six percent excise tax on excess contributions to a custodial account[599] should either be repealed or extended to annuity contracts and retirement income accounts.

V. CONCLUSION

The United States tax system relies heavily on voluntary compliance by taxpayers. In addition, if employers and employees are properly to take advantage of tax-favored retirement arrangements, they must be able to understand the applicable rules.

The present rules for 403(b) plans are too complex and confusing. In addition to the numerous changes to the I.R.C. since section 403(b) was enacted in 1958, plan sponsors must now also consider the applicability of ERISA, an entirely separate, highly complex statute, and the voluminous regulations under it.

It is time to rethink, from the beginning, whether tax-exempt employers, as a class, are sufficiently different from taxable employers so that there is a need for a separate retirement arrangement available only to tax-exempt employers. If not, then tax-exempt employers should have full access to all types of retirement arrangements, qualified or nonqualified, available to taxable employers. If so, then specific rules should be crafted that deal with the special characteristics of tax-exempt employers.

The objectives of TRA 86 were stated to be simplicity, fairness, and economic growth. It is time to reinstate at least the first two of these goals in designing retirement programs for tax-exempt employers.

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[599] I.R.C. § 4973(a).