# Ready or not: Clarifications, frustrations, and operations of the final 403(b) regulations

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January 1, 2009, has come and gone. Information-sharing agreements have been completed, plan documents are being drafted, third-party administrators have been hired, and employers are weighing the pros and cons of having an ERISA plan over a non-ERISA plan and vice versa. The final 403(b) regulations, published in July 2007, required all organizations with a 403(b) plan, whether ERISA or non-ERISA, to take a good look at their plans and determine any required changes to the plan itself or the administration. The regulations outlined the specific changes that plans have to undergo, but left many questions unanswered for employers, administrators, and vendors alike.

## WRITTEN PLAN DOCUMENT

With the requirement for a written plan document now in place, the IRS is expecting the 403(b) world to follow what many consider to be limited guidance. The IRS will provide additional updates and guidance. Most recently, the IRS issued *Notice 2009-3*, which outlines the relief during 2009 for plan sponsors of 403(b) plans required to have a written document in place by January 1, 2009. The notice states that a 403(b) plan will not be treated as failing to satisfy the 403(b) requirements and the final regulations in the 2009 calendar year, as long as:

- on or before December 31, 2009, the plan sponsor adopts a written plan that is intended to satisfy the 403(b) requirements effective as of January 1, 2009
- during 2009, the plan sponsor operates the plan in accordance with the 403(b) final regulations
- before the end of 2009, the plan sponsor makes its best effort to retroactively correct any operational failure in the 2009 calendar year in order to conform to the written 403(b) plan

A senior IRS representative, speaking in a webcast in February, reportedly expressed the view that the written 403(b) plan does not have to be effective as of January 1, 2009, nor do operational corrections have to be made back to January 1, 2009. Plan sponsors can adopt a plan document with an effective date other than January 1, 2009, without being penalized by the IRS. In addition, they should correct operational failures back to the effective date of the plan document.

The IRS has to date not provided sample plan language, except for school districts; this language cannot be fully relied upon by other tax-exempt organizations. In addition, there is no preapproved or determination letter program for 403(b) plans. This has many sponsors concerned that once their plan documents are written, they will be operating without the approval of the IRS. To alleviate this concern, the IRS in April issued *Announcement 2009-34*, stating its intent to establish a preapproval program for prototype plans. The Announcement included a draft revenue procedure for issuing opinion letters for 403(b) prototype plans. In addition, the IRS issued draft sample plan language and is requesting comments from the public on both subjects. The revenue procedure will provide instruction to practitioners on how to submit a prototype plan for IRS approval. The approval will be in the form of an opinion letter stating that the form of the document meets the 403(b) requirements and final regulations.

Similar to a 401(k) prototype plan document, the 403(b) prototype plan document has two parts: the basic plan document and the adoption agreement. The employer is not allowed to modify the provisions listed in the basic plan document, but may revise the adoption agreement. The employer chooses the options that best fit the desired plan design and then signs the adoption agreement. The signed plan adoption agreement means that the employer has a written plan in place.

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The Announcement states that the goal of the IRS is to provide a 403(b) prototype plan that would be "broadly suitable for the majority of eligible employers." This does not mean that employers have to use the prototype plan. In fact, if employers currently have a plan document in place or have drafted a document, then switching over to the prototype plan might not be cost-effective or efficient. In addition, employers need to consider the existing plan design with regard to vesting. The prototype plan does not support graduated vesting schedules. Remember, the written plan document can be a single document or a combination of multiple documents, as long as those documents accurately reflect the requirements of the tax code.

### INFORMATION-SHARING AGREEMENTS (ISA)

The plan document has not been the only area of confusion and concern for employers. The information-sharing agreements (ISA) have proven to be a challenge both to understand and to explain to employers. An ISA is an agreement between the employer and the vendor to share information about a participant, including such things as employment status, contract information, and loan and hardship distribution eligibility. When the final regulations were first issued and vendors and practitioners began trying to understand how the 403(b) landscape would change, the belief was that an employer needed to have an ISA with any vendor that was currently receiving money, or may have received money in the past. This is not true and the IRS has clarified its position. The ISA is required only if the employer permits a plan participant to transfer all or a portion of his or her accrued benefits from an approved vendor to a vendor that is not on the approved list.

Many vendors are requiring an employer to complete an ISA even if they are currently considered an approved vendor of the employer. Technically, an employer's plan will not be out of compliance if the employer does not sign the ISA with the approved vendor, but the plan would be out of compliance if the employer chose not to share information with all of the approved vendors in the plan. If employers find information sharing cumbersome and time consuming, they should turn to a third-party administrator (TPA) for help.

If an employer has stopped sending contributions to a vendor as of December 31, 2008, and the employer's plan does not allow for transfers but the vendor still holds the accrued benefits accumulated before that date, the employer is not required to have an ISA in place with that vendor. In this instance, to ensure that the information necessary to complete a transaction is shared by all, both the employer and the vendor need to know who to contact on both sides in case a participant would like to take a loan or distribution. Neither the employer nor the vendor can rely on the information provided by the participant.

### CONTRACT EXCHANGES

Employers and practitioners should keep in mind that contract exchanges that took place after September 24, 2007, are not grandfathered. These exchanges must meet the ISA requirement. This means that if an employee made a contract exchange between September 24, 2007, and January 1, 2009, to a vendor that was not receiving contributions from the employer or did not have an ISA, then an ISA should have been signed by January 1, 2009. Without this ISA, the contract exchange is not considered part of the employer's plan, making this a potential taxable distribution for the participant. IRS's *Revenue Procedure 2007-71* provides an additional six months for a participant to self-correct for the post-September 24, 2007, exchange. To correct this exchange, the participant should re-exchange the contract to a vendor that is approved or to a vendor that has an ISA. However, this must be done by July 1, 2009.

### ORPHAN CONTRACTS

So what about contracts that are grandfathered or are with vendors no longer approved? The Revenue Procedure says that if a contract was issued after December 31, 2004, but before January 1, 2009, by a vendor no longer receiving contributions from the plan in a year after the contract was issued, the contract will still satisfy tax code section 403(b) even if not part of the written plan. The IRS expects both the employer and the vendor to make a reasonable, good-faith effort to include the contract as part of the plan by gathering information about the contract and identifying contacts from the employer and vendor to properly address plan administration issues, such as loans and distributions. If a vendor contract stopped receiving participant contributions prior to January 1, 2005, there is no good-faith effort requirement for the vendor or the employer.

The Revenue Procedure also addresses vendor contracts that were in place, with account balances, prior to January 1, 2009, and not receiving contributions for *former employees and beneficiaries*. If the former participant or beneficiary requests a loan or a distribution, the vendor must make a reasonable effort to see if a loan is outstanding or a distribution has been taken. In this instance, the vendor would contact the employer. However, the Revenue Procedure also allows the vendor to rely on information provided by the employee, as long as the employee is a former employee as of January 1, 2009. According to the Revenue Procedure, the employee can self-certify his or her current status with the employer, "assuming that reliance on that information is not unreasonable under the facts and circumstances."

### FIDUCIARY RESPONSIBILITY

Over the past year, employers have been concerned that signing a plan document or an ISA or that providing participant communications could subject the plan to ERISA. This is simply not true. These actions are just a way of pulling the plan administration together, something that many employers recognize has been missing, but were also required by the final regulations.

The final regulations clarify that these and other administrative changes are necessary but they do not subject a non-ERISA arrangement to the ERISA requirements. This is especially true in the case of public school districts. However, the public entity non-ERISA arrangements are not completely off the hook. Plan sponsors need to be aware of what their state law says about fiduciary requirements and how that may affect their current arrangements. These requirements are believed to be similar to what is required under ERISA. Plans currently subject to ERISA have already had to comply with much of what is required in the final regulations.

### PLAN OPERATIONS

If employers are worried about documents, ISAs, and ERISA, are they taking the time to make sure they are operating their plans correctly? Although the document tells employers what they can do, who is eligible, and how to do it, is the plan operationally compliant?

Will revisions be necessary to the current draft document? This may be a consideration for employers if they recognize that they are currently unable to follow the terms of the document. They may want to use this one-year reprieve to *test-drive* the document before it is finalized.

The chart below highlights aspects of the final regulations that may be challenging for employer operations.

### IRS FORM 5500

When employers, vendors, and TPAs wrap up their first year of administration under the new regulations in 2009, they will face working through IRS Form 5500. The IRS has not provided relief or additional guidance, even though several key questions about this daunting requirement remain unanswered. To be clear, this filing requirement only affects ERISA 403(b) plans. The Form 5500 is not unknown to ERISA plans, but the additional schedules and audit report (if applicable), as well as the Summary Annual Report (SAR), are likely unfamiliar.

Under the previous rules, all ERISA plans (regardless of size) had to complete only select questions on the first two pages of the Form 5500. The new rules require the employer to complete the entire Form 5500, which includes various plan-related details, including statistics on employees and financial information. Depending on the size of the plan, not all of the schedules will have to be completed. If the plan has fewer than 100 participants, the employer will only have to complete the short Form 5500. All plans will need to have an SAR distributed to participants, both active and terminated, by the end of the two and a half months following the Form 5500 filing.

As in the 401(k) world, the challenge for many employers in the 403(b) world will be the audit report. The plan will be subject to an audit if the employer has more than 100 participants (as of the beginning of the 2009 plan year). The audit can be a very time-consuming procedure for all parties involved; therefore, the employer should take steps to have processes and files in order. The audit report will not only reconcile the trust assets, but also may review participant data files, plan operations, and plan investments.

In addition, if an employer has a frozen plan, the employer is not exempt from completing the entire Form 5500. If participants have not taken their money from the plan, the employer will have to continue to file the Form 5500 until the assets are distributed. In addition, an audit report will be required if the frozen plan has more than 100 participants.

If not already doing so, employers need to begin seeking out an independent auditor who will prepare their plan audit. Often, employers hire their current auditors to do the work, but they can seek out referrals from their TPA or an outside consultant. If employers are not currently paying fees from the plan trust, they might want to incorporate this extra administrative procedure into their budgets for 2010.

Although completing the Form 5500, the appropriate schedules, the audit report, and the SAR seems more of an added burden to employers, there are hidden benefits. Employers will have *fresh eyes* looking at various aspects of their plan administration and procedures. The employer will also have processes in place that will help it maintain good records from year to year and eventually make future audits easier to conduct.

### WHY ERISA?

So why would an employer with a non-ERISA plan want to subject itself to ERISA? This is a difficult question to answer, given that there are so many more rules for plans to follow. However, by the end of 2009, it may be a consideration for some employers.

- If an employer maintains multiple retirement plans—defined benefit and non-ERISA 403(b)—but decides to freeze the defined benefit plan, it may consider adding an employer contribution to the 403(b) plan (match or additional employer amounts) to make up for lost benefits. Both of these contributions can be discretionary

| Operational Activity | Sponsor Challenges | Operational Fix |
|---|---|---|
| Remittance of salary deferrals | Understaffing; issues with payroll vendor | Draft a procedure that delineates responsibilities internally, as well as with vendors |
| Universal availability for salary deferrals | Enrollment practices; changes in employee classifications | Provide clear employee communications; understand the permitted exclusions |
| Loans and hardship withdrawals | Coordinating limits and communication with vendors and third-party administrators (TPAs) | Limit loans to one vendor; clearly define employer and vendor responsibilities |
| Non-discrimination testing (matching test requirement) | Employers may be unaware of the requirement for ERISA-covered plans | Retain a qualified vendor to complete the required testing, or consider a safe-harbor contribution that would eliminate the required testing |
| Non-discrimination testing (controlled group) | Employers with ERISA plans that are subject to this requirement may be unaware of which tax-exempt participants are under *common control*, or may not understand the requirements | Consider retaining a TPA with expertise in this area to compile information and complete the testing |
| Section 415 limits | Payroll system errors | Draft a procedure that delineates responsibilities internally, as well as with vendors |

but would be prohibited in a non-ERISA plan, except for governmental or certain church plans.

- The employer may recognize the need to have better oversight of the plan investments by establishing an investment committee and consulting with an outside investment advisor. The employer may also want to improve participant education with regard to investments and investment advice. Although non-ERISA plans may provide for multiple vendors with multiple investments under an investment structure, such increased employer involvement potentially leads to the employer taking on a fiduciary role. Employers with non-ERISA plans need to understand how state laws governing fiduciary responsibilities may affect the employer involvement in the plan.

- An employer may be operating its plan as an ERISA plan but may not realize it. For example, the employer may be approving loans or hardship withdrawals instead of simply providing the data. In the process of trying to comply with the final regulations, the employer may cross the line and become subject to ERISA requirements.

### PLAN TERMINATION

If, by the end of 2009, the final regulations are causing an employer too much of an administrative burden, it may want to consider terminating the plan. The final regulations say that to consider a plan terminated, participants and beneficiaries must receive their total account balances as soon as possible after the plan termination. However, this is not an easy task to accomplish.

The employer has missed the IRS's December 31, 2008, deadline of allowing a plan to terminate without having a written plan document. Under the new regulations, the plan will need to satisfy the written-plan-document requirement and a plan-termination provision must be included. Existing investments and individual contracts may be the next hurdle for the employer to get over, because the employer may be unable to force the payout of the individual contracts and there may be fees associated with the contracts that would have to be paid before the money can be distributed. If all of the contracts and accumulated benefits are not paid out, the plan is not considered terminated. If the plan is funded with an annuity contract or invested in mutual funds, then distributing the assets, and thus terminating the plan, will be much easier.

Upon plan termination, the employer or any related employer cannot start up another *successor* 403(b) plan for at least 12 months from the date of termination. This is similar to 401(k) rules for plan termination. The employer may be able to start a 401(k) plan, but doing so would need careful consideration and review given the structure of these plans.

The 403(b) world is struggling to keep up with the new demands placed upon it. Slowly but surely, employers will be gaining momentum and should be able to take their 403(b) plans through 2009 and beyond. To do this, employers need to make sure they continue to address the plan issues they are currently faced with and not wait until they risk potential disqualification of the plan.

1. Employers need to understand their plan provisions and make sure they have draft documents to work with, finalizing the documents once the plan operations are set.

2. Employers need to know who their vendors are. If there is a payroll slot for a vendor, the employer should have a contract or an agreement in place with that vendor. Employers should communicate who the plan's approved vendors are to employees. Employers also need to know with whom they need an ISA.

3. Employers should consider consolidating their vendor pool down to a single vendor. Although doing so may not work for all plan sponsors, it may help ease plan administration and compliance, and improve overall plan controls. Before making such a decision, employers should consider such things as cost controls and vendor services.

4. Employers should make their best efforts to retain information about orphan contracts and contract exchanges that may have violated the exchange rules. Employers should provide communications to employees that explain the potential tax consequences of these violations. This may help facilitate a corrected exchange prior to July 1, 2009.

5. Employers should review areas they are struggling with in plan operations and work with their employees, vendors, and TPAs to improve and/or fix. This is especially important if a plan has multiple vendors. Employers may want to consider eliminating optional plan provisions such as loans and hardship withdrawals. This will reduce administrative costs and operation issues.

6. Employers with ERISA plans can start now in getting their information in order for the Form 5500 filing. If an employer has more than 100 employees, it will be subject to an audit, and thus should begin looking at and inquiring about independent auditors.

7. Employers should review with outside counsel or consultants the costs and benefits of both non-ERISA and ERISA status. Each type of plan presents a challenge for employers.

8. Employers need to know what, if any, fiduciary responsibilities they have. This will help them better understand their current 403(b) plans and the pressures of those demands in the current market.

Employers ought not believe they have a failed retirement plan because of the challenges of working through the final regulations. If anything, employers should take this opportunity to enhance or modify their plans, as well as their entire benefit structure.

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