Practical Implications of the 403(b) Regulations

Much of the initial attention following the release of the final 403(b) regulations in late July 2007 has been focused on the implications they will have on the public sector and, more specifically, their impact on public school districts and public universities. The new regulations will also profoundly impact the way 403(b) plans are run by 501(c)(3) organizations.

The purpose of this article is to focus primarily on the new regulations' implications for 501(c)(3) organizations sponsoring 403(b) plans. In light of the new contract exchange and plan transfer rules — which became effective on September 24, 2007 — particular attention will be given to the structural plan design decisions that plan sponsors will now be forced to make in order to be in compliance.

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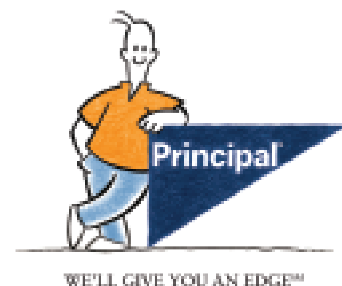

ExecutiveSummary

Commentary regarding the recent release of the final regulations impacting 403(b) plans, some of which took effect on September 24, 2007, has primarily focused on the implications for the public sector. These new regulations will also profoundly affect the operations of 403(b) plans by religious, charitable or other organizations subject to Internal Revenue Code (IRC) §501(c)(3).

Plan sponsors will now need to associate all 403(b) contracts issued in connection with their employees with one plan, and that plan must now be written, much as a qualified plan would be, detailing operations and administrative responsibility.

The revised transfer rules will create interesting new considerations for non-profit 403(b) plans.

Whether the plan in question was established as an actively sponsored, centralized plan; a non-actively sponsored, decentralized program; or an actively sponsored plan that is centralized enough to come under the Employee Retirement Income Security Act (ERISA) but also has multiple service providers, plan sponsors will find themselves wading through many different combinations of options for bringing their plans into regulatory compliance. Unfortunately, sponsors will also find there frequently are no clear-cut answers.

The objective of this paper is to help plan sponsors sort through the various options specific to their respective types of plan. Among the predicaments discussed will be that of actively sponsored plans previously converted from non-actively sponsored programs, a situation that may leave participants with “orphaned” annuities outside of the plan and may complicate any attempt to achieve compliance without tax consequence to participants. Similarly, the dilemma of non-actively sponsored programs will be addressed, along with the challenges of bringing the multiple service providers under some ERISA plans together into one plan.

To this end, a better understanding of the advantages and disadvantages associated with each potential solution will be developed to help plan sponsors devise a solution that can best meet the needs of their participants, while causing as minimal disruption as possible.

Background

The final 403(b) regulations were published in the Federal Register on July 26, 2007. They are intended to address the severe compliance concerns regulators had regarding 403(b) plans by imposing new oversight structures within plans.

Of particular significance for 403(b) plan sponsors is the new requirement that they have written documentation of the plan. One or more written documents will have to detail how the plan will operate and assign responsibility for its various administrative functions. With few exceptions, almost all 403(b) contracts will now need to be associated with a plan.

The regulations stop short of requiring a single, traditional qualified plan type document. This recognizes that, for many plans, there may be several documents — including the contracts, custodial accounts and service agreements — that comprise the "plan document." However, the regulations now require that the criteria for eligibility, contributions, distributions, application of statutory limitations (such as IRC §402(g) and §415 limits), loan requirements, hardship requirements and other key contract elements be clearly defined, in writing, with responsibility set forth for the various provisions. It is also now clear that the plan participants cannot be made responsible for ensuring compliance.

Of particular significance for 403(b) plan sponsors is the new requirement that they have written documentation of the plan.

The second provision of particular interest to 403(b) plan sponsors is the one regarding rules for transfers. The new regulations state that transfers cannot be made to or from a 403(b) plan to any different plan type such as a 401(a) or 457 plan. The one exception to this rule involves the purchase of service credits in a defined benefit plan for a government entity, but that is beyond the scope of this article. The transfers that are allowed by the regulations involve exchanges of 403(b) contracts within a 403(b) plan and transfers between 403(b) plans. These will be discussed, because the combination of plan requirements and transfer rules creates some interesting new considerations for 403(b) plan sponsors. Depending on the sponsorship status of the plan, these considerations and their possible solutions can be significantly different.

It is worth noting that the old transfer rules ceased to be in effect after September 24, 2007, and the new rules do not take effect until January 1, 2009, leaving a gap in coverage. The consensus seems to be that the better approach to transfers during that gap is to comply with the new provisions.

Sponsorship Status

Over time, two distinct models have evolved in the 403(b) marketplace: actively sponsored, centralized plans and non-actively sponsored, decentralized programs. The actively sponsored 403(b) plan can be thought of very much like a typical qualified plan. With these plans, there is a central, often single, governing plan document. The plan fiduciary is responsible for the administration of the underlying plan. Typically, a service provider is engaged to provide administrative services for required functions. It is a centralized model.

Actively sponsored, centralized plan

Non-actively sponsored, decentralized plan

For most private 501(c)(3) organizations, this actively sponsored plan is an ERISA plan, which requires a Form 5500 to be filed and the fiduciary to act in accordance with the fiduciary duties specified under ERISA. The exceptions to this rule are non-electing church plans and plans sponsored by governmental organizations. Church plans, while typically run in the actively sponsored model, are statutorily exempt from ERISA unless they elect to be covered.

The other main type of model is a non-actively sponsored 403(b) program. This is most often used by private 501(c)(3) organizations using the same model that public schools use. Traditionally, there is no plan document. Multiple service providers sell annuities or mutual funds in custodial accounts to individual participants, primarily in a retail environment. This is often referred to as the cafeteria approach. The various service providers are often literally available in the employee cafeteria to meet with participants, where they then try to sell their respective products to each individual participant. This approach has been consistent with Department of Labor (DOL) Regulation 29 CFR Section 2510.3-2(f), which requires that, in order to remain a non-ERISA arrangement, the plans can only allow elective deferral contributions, and employer involvement must be very limited. This is a decentralized model.

A third model does exist, though it is less common. It is an actively sponsored ERISA 403(b) plan that is centralized as far as the sponsor's involvement goes, but decentralized in the sense that it uses multiple service providers. This arrangement has some considerations that need to be addressed. These considerations extend beyond those needed for traditional actively sponsored plans using a single service provider.

Considerations for Actively Sponsored Plans

If a plan has always been run in an actively sponsored fashion, then the final regulations will cause little concern and few changes in how the plan needs to be administered, because a plan document and many of the plan's procedures are already in place. That document would address all the requisite details on how the plan works and who is responsible for each of its administrative functions. However, these plans should still be reviewed to help ensure they remain in compliance. This is especially true in cases where the plan has taken advantage of the transitional rules for non-discrimination under Internal Revenue Notice 89-23. But short of the changes required there, it is likely that only minor conforming amendments will be necessary to bring the plan into compliance with the new regulations.

The potential problems arise where a plan sponsor is currently running an actively sponsored plan that had been converted to this approach from a non-actively sponsored program. There has been a trend over the past 20-plus years toward such conversions. (As the IRS notes, the trend has been toward 403(b) plans looking more like 401(k) plans.) The benefits gained from having clearly defined responsibilities and liabilities under ERISA, rather than the open-ended liabilities that may exist under general state statutes, have appealed to many 501(c)(3) organizations. This is true as some 501(c)(3) organizations have become increasingly concerned about some of the individual annuity products offered through the cafeteria approach. The primary concern is that some of these products may be too expensive or too complicated for the typical participant to be able to make truly informed decisions. Coupled with the fact that a retirement plan service provider can be hired to provide services for the vast majority of the administrative requirements and provide investment platforms with a diverse, coordinated array of investment options for participants, this means that the open-ended multiple service provider approach is no longer the only way to serve participants.

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In conversion situations, where all of the prior plan funds moved into the actively sponsored arrangement, there is little to be concerned about. However, it is far more typical that all prior money did not move into the actively sponsored arrangement.

With a non-actively sponsored program, employer involvement is minimal, and there is no ERISA applicability; consequently, there is no fiduciary with the authority to direct the assets on behalf of participants and beneficiaries. Because it is left up to the participant to effect transfers, inertia often assures that a substantial portion of the assets will remain in the old arrangements.

This is further compounded by the fact that many service providers impose costs or conditions on withdrawals. They often impose surrender charges, which can be significant, or only allow withdrawals in installments occurring over several years. Under rules prior to the final regulations, employers simply started new programs and directed contribution flow into the new program. The old products would be left in place but would not be given any further deposits. Since ERISA did not control the program, the sponsor had less clear responsibility — perhaps none — and there was nothing preventing an individual 403(b) annuity from continuing to exist, nor any penalty for such tolerance.

Therein lies the problem. The final 403(b) regulations appear to require that most annuities be associated with a plan, although individual 403(b) contracts transferred under the Revenue Ruling 90-24 transfer rules prior to September 24, 2007, appear to be exempt from this requirement, unless they are again transferred after that date.

It is likely that the organization sponsoring a plan will have individual employees with individual 403(b) annuities that are outside of their plan. It appears such arrangements can no longer exist. So the question now becomes: what to do about it?

Because it came about in a non-ERISA environment, presumably the employer has no authority over the contracts and cannot simply direct that they be transferred into the actively sponsored plan. This creates a conundrum for the plan sponsor. If the contracts are not associated with a plan, then they may fail to be 403(b) contracts per the final regulations and could become taxable to the participants by being deemed contracts under IRC §403(c).

It is worth noting that there is an allowance under the regulations for distribution of a fully paid annuity contract in the event of the termination of a 403(b) plan, but this is not viable for active employees, because it is not allowed where there is a successor 403(b) plan and contributions are made on behalf of — more than 2 percent of — employees to an alternate contract. The actively sponsored ERISA plan is clearly such an arrangement, which prevents a deemed distribution.

At this point, the plan sponsor has several choices, none of which are ideal. The first option then would be to leave the current actively sponsored plan as is and form a new plan — a non-ERISA plan — that encompasses all of the old annuities. This is a daunting task for several reasons. First, because there was no active sponsorship of the old arrangement, it will be extremely difficult for employers to get their arms around all of the outstanding contracts and ensure they are all covered under the plan. The advantage to this approach is that the contracts would likely retain their tax-deferred status.

To the extent the plan sponsor is looking to limit its administrative obligation to a short-term timeframe, campaigns can be put into place to eventually eliminate the non-ERISA plan by getting employees to transfer to the actively sponsored plan, taking advantage of the allowance for plan-to-plan transfers. The disadvantage in doing this is that the requirements for administration of the non-actively sponsored plan are significant. These duties will likely fall to the plan sponsor. For example, with the potential for contracts spread across several dozen service providers, it remains to be seen if providers would be willing to take on the responsibility to monitor overall IRC §72(p) limits on loans when the providers will have no access to, or knowledge of, other providers. This seems to create an opportunity for a third-party administrator (TPA), who may be willing to take on this responsibility for a price. It remains to be seen how viable this model is in today's cost-conscious environment.

The second option would be to treat all of the old contracts as though they are part of the current actively sponsored plan. This option carries the same administrative coordination problems described above. It also brings added complexity. The service providers of those contracts are unlikely to recognize any fiduciary's authority to direct assets into an ERISA plan, because the contracts were clearly entered into on an individual basis with the employees in a non-ERISA environment. In addition, it is anticipated that the DOL will soon require financial information to be reported on Form 5500s for 403(b) plans. If the old contracts are part of the actively sponsored plan, these assets will likely need to be included in the financial reporting on Form 5500 for plan years after December 31, 2008.

The ability to implement one of these solutions is dependent on the plan sponsor's willingness to accept the responsibility of the administration — or pay for a TPA — and the willingness of individual annuity service providers (and participants) to amend their contracts to recognize the changing landscape caused by the final regulations.

Options for Conversion Situations

1

Leave the current actively sponsored plan as is and form a new plan that encompasses all of the old annuities.

2

Treat all of the old contracts as though they are part of the current actively sponsored plan.

3

Do nothing about the old contracts.

Short of the two options outlined above, the only other possibility is for the 501(c)(3) organization to do nothing about the old contracts. This may be a practical solution, but it carries significant employee relations considerations because, under the regulations, these amounts may become taxable to the participants. Prior to the effective date of the regulations — generally plan years beginning after December 31, 2008 — employees can transfer into the new actively sponsored plan, which will continue to be maintained by the organization in order to maintain the tax-deferred 403(b) status. Communication campaigns would likely be needed to ensure that employees understand the option and the potential tax effect of not transferring.

Considerations for Non-Actively Sponsored Programs

As described in the previous section, non-actively sponsored programs are going to need to take stock of all service providers that have issued contracts to the participants, and plan documents are going to have to be put in place outlining all of the administrative policies and procedures. The added dimension for non-actively sponsored plans is how they will decide to implement the rules.

The regulations do not mandate an actively sponsored approach. In fact, they clearly contemplate the non-actively sponsored multiple service provider approach that exists today, although changes are required that focus on making oversight more rigorous. The main question, however, is whether such a model continues to be practical, given the final regulations.

Once stock is taken of all the service providers and contracts, a decision has to be made as to whether to continue the program on a non-actively sponsored basis or switch over to an actively sponsored model. Prior to the final regulations, the major advantage of the non-actively sponsored model had been the limited employer involvement. Participants could generally use the service provider they wanted, and the 501(c)(3) organization did not need to do much other than facilitate the payroll deduction.

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Under the final regulations, significant administrative coordination is necessary, because there needs to be assurance that all the contracts agree with one another, and there must be some central documented policy (the plan) describing plan requirements with clear responsibility outlined for the various provisions. Because plan participants cannot be made responsible, other arrangements need to be made.

Although it remains to be seen, it is unlikely that one or more of the service providers will be willing to take on this responsibility. In essence, that would make them responsible for the actions of other service providers over whom they have no control. For example, it is unlikely that a service provider will be willing to take responsibility for monitoring suspension of elective deferrals after a hardship distribution, because that hardship distribution may be taken from another service provider's contract. Even if the service provider were willing to monitor a suspension contingent upon receipt of valid information, there is no incentive for all service providers under the plan to communicate constantly with one another and inform all other service providers in the event that a hardship distribution is taken. In fact, privacy concerns would likely prohibit this sort of communication. This places the burden of coordination for administrative functions squarely on the 501(c)(3) organization running the non-actively sponsored plan.

This situation negates the major benefit of having limited involvement. In fact, some would argue that the actively sponsored approach would now be less work, since a single service provider could be hired to help coordinate the plan needs, as in the qualified plan world. Of course, the final regulations create an opportunity for TPAs to step up for those organizations that wish to continue to run non-actively sponsored plans.

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Should the sponsor decide to move to an actively sponsored plan, the same considerations apply as described in the actively sponsored plan section above. In other words, the decision to move forward with an actively sponsored approach will still require decisions regarding the disposition of the current contracts in the non-actively sponsored arrangement. The decision to include old contracts in the new actively sponsored plan would be complicated by the lack of fiduciary status to direct the assets into an ERISA arrangement. Also, keeping the old contracts around in a separate plan frozen to new contributions would not alleviate the administrative burden on the plan sponsor. Where it is undesirable to take on either the additional administrative responsibilities or cost of a TPA, the sponsor has the option to refuse to take plan responsibility over those annuities.

This could cause some initial employee relations concerns, because the threat of creating taxable distributions is an unattractive one for employees. However, this could be addressed with a rigorous education program designed to explain the burden of the final regulations to employees, who would then be given the opportunity to transfer into the new actively sponsored plan prior to the regulations' effective date. Such a communication program would have to clearly spell out for the participants the need to weigh the taxability consideration against the contractual provisions, especially if the contract has a surrender charge.

If there is no other 403(b) plan, one other potential option is to take advantage of the allowance for distribution under the new plan termination rules. Here, amounts can be distributed to employees or can be deemed distributed as individual 403(b) annuity contracts, provided that there is no other 403(b) plan.

The 501(c)(3) organization can set up a 401(k) plan without violating this restriction. Of course, a 401(k) requires actual deferral percentage (ADP) testing on employee deferrals, so this has to be weighed in the decision. Also, because transfers between plan types are not allowed, participants must be given the option to take a distribution or roll over to the 401(k). As there is often a large incidence of employees taking distributions when given the option, organizations concerned about ensuring that employees save enough for retirement may not like this option.

Considerations for ERISA Plans with Multiple Service Providers

A situation not yet considered is a plan that is covered by ERISA, where the fiduciary has decided to use more than one service provider. This is different from the non-actively sponsored plan. In such plans, the plan sponsor has taken responsibility under ERISA but, rather than determining that a single service provider is appropriate, has selected more than one to provide a variety of choices to participants. Under such arrangements, plan sponsors are likely already aware of what contracts are available and used by participants, as they are fiduciary approved and likely to already have a plan document containing most, if not all, of the requisite provisions. Of course, a review is prudent to help ensure compliance with the final regulations.

A key point to consider is the interaction of the various service providers with the plan sponsor and with one another.

A key point to consider is the interaction of the various service providers with the plan sponsor and with one another. The plan sponsor will need to ensure that procedures are in place and responsibilities are clearly defined, so that any activity with one service provider that affects another service provider is communicated appropriately. The examples mentioned previously apply here as well. For example, there is still a need to ensure that loans are limited per IRC §72(p); that contributions are suspended following a hardship distribution; and that limitations on contributions are monitored overall for the plan.

As plan sponsors review current contracts and procedures, one area of particular caution stands out: some service providers do not differentiate their contract structures for ERISA plans and for non-ERISA plans. In these

cases, the service provider often does not even acknowledge that its contracts are part of an ERISA plan. Under such circumstances, it will become necessary for the sponsor to negotiate with the service provider to ensure that appropriate communication is initiated and that the service provider acknowledges the fiduciaries' duties, power and authority over the plan. If those service providers will not cooperate, consideration needs to be given to their removal, so that the plan sponsor can ensure the plan is in compliance with the regulations.

However, removal will be a challenge, because these contracts generally do not acknowledge the fiduciary authority to take such action. It remains to be seen how service providers of such contracts will react to the final regulations. It is also unclear whether they will adjust in reaction to the changing tide of the marketplace or if they will stand firm in order to protect the assets they currently have under management.

Conclusions

There are no clear-cut answers for plan sponsors. 501(c)(3) organizations will not only need to evaluate the current provisions of their 403(b) program in light of the final regulations, but also the underlying structure of the plan(s). With no perfect solutions, plan sponsors will also have to weigh short- and long-term pain points, as well as the costs of the various approaches.

What is clear is that plan sponsors cannot evaluate this by themselves. Consultants, financial advisors and legal counsel will need to step in to help sponsors sort through the pros and cons of various options. They will also need to help negotiate with the service providers to ensure the plans' needs are being met and to explore capabilities and costs associated with TPAs.

There has been some initial speculation in the industry that substantial consolidation of vendors under plans will result. This makes sense. It will be necessitated by the need to simplify the administration of 403(b) plans. This consolidation will likely accelerate the trend toward actively sponsored 403(b) plans with a single service provider. For many plans, once the short-term pain of addressing old arrangements is past, the model used in the qualified plan world seems well-suited for meeting the regulatory requirements in a reasonably cost-effective manner.

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