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PERSONAL AND CONFIDENTIAL

CC:PA:LPD:PR (REG-155608-02)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue NW
Washington, D.C. 20044

Re: Proposed Regulations Under Internal Revenue Code section 403(b)

Dear Sir or Madam:

We are writing to provide comments on the regulations proposed to be promulgated under section 403(b) of the Internal Revenue Code of 1986, as amended ("Code"), which were published in the Federal Register on November 16, 2004 (the "Proposed Regulations"). These comments have been collected from our colleagues at Ice Miller. The Employee Benefits Group of Ice Miller provides counsel to a wide variety of clients, including employers and plans in the private, public, and non-profit sectors, as well as church plans.

While many of these comments are the result of our experience in advising our clients on section 403(b) plan matters, these comments are not being submitted on behalf of any one client.

We commend you on the massive effort required to update the rules under Code section 403(b) governing tax-sheltered annuity plans developed over the last fifty years. We particularly want to note two provisions which are very important to certain governmental plans. We are very grateful that you have chosen to handle them in the regulations the way that you have. The first such provision is at Proposed Treasury Regulation § 1.403(b)-8(c)(3). This represents a critical grandfathering for certain governmental systems, and we hope it will not materially change in the final regulations.

The second such provision is at Proposed Treasury Regulation 1.403(b)-4(d), particularly § 1.403(b)-4(d)(2), Example 2, which reflects an important approach historically used in certain long-standing programs. Again, we hope this section will not materially change in the final regulations.

We do have one conforming change suggestion to fully integrate this concept in the final regulations. This change is detailed in Item 2 below.

The following represents our specific comments on the proposed regulations.

1. We urge the Service to modify the definition of "church-related organization" in Proposed Treasury Regulation § 1.403(b)-2(6) to include organizations covered under Code section 414(e)(3)(B)(ii).

Proposed Treasury Regulation § 1.403(b)-2(6) defines "church-related organization" to mean "a church or convention or association of churches as described in section 414(e)(3)(A)." Code section 414(e)(3)(A) provides in relevant part that

> TREATMENT AS CHURCH PLAN. A plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches includes a plan maintained by an organization, whether a civil law corporation or otherwise, the principal purposes or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches, if such organization is controlled by or associated with a church or convention or association of churches.

We believe that this definition, which is used in a number of places in the Proposed Regulations, is too narrow because it does not specifically include an organization under Code section 414(e)(3)(B)(ii).

For example, Proposed Treasury Regulation § 1.403(b)-4(c)(3) sets forth a special 403(b) catch-up under Code section 402(g)(7) for certain qualified organizations. A "qualified organization" is defined in Proposed Treasury Regulation § 1.404(b)-4(c)(3)(ii) as including

> a church-related organization. All entities that are in a church-related organization are treated as a single qualified organization (so that years of service and any special section 403(b) catch-up elective deferrals previously made for a qualified employee for a church within a church-related organization are taken into account for purposes of applying this paragraph (c)(3) to the employee with respect to any other entity within the same church-related organization.

(emphasis added). Code section 402(g)(7)(B), however, defines a qualified organization as including "a church, or convention or association of churches," which "term includes any organization described in Code section 414(e)(3)(B)(ii)." (emphasis added). The definition of a qualified organization in Proposed Treasury Regulation § 1.403(b)-4(c)(3)(ii), therefore, is arguably narrower than that in Code section 402(g)(7)(B).

Similarly, Proposed Treasury Regulation § 1.403(b)-9(a)(2) defines a retirement income account to mean a defined contribution program established or maintained by a "church-related organization" which satisfies certain rules. Code section 403(b)(9)(B) provides that the term

> "retirement income account" means a defined contribution program established or maintained by a church, a convention or association of churches, including an organization described in section 414(e)(3)(A), to provide benefits under section 403(b) for an employee described in paragraph (1) or his beneficiaries.

(emphasis added). Again, the Code definition of retirement income account is broader than the definition in Proposed Treasury Regulation § 1.403(b)-9(a)(2).

A final example is Proposed Treasury Regulation § 1.403(b)-10(f)(1), which provides that certain arrangements established by a "church-related organization" and in effect on September 3, 1982 (a TEFRA church defined benefit plan) may be treated as a section 403(b) contract even though a defined benefit arrangement. However, TEFRA grandfathers any defined benefit arrangement which was "established by a church or a convention or association of churches (including an organization described in section 414(e)(3)(B)(ii))." TEFRA § 251(e)(5), Public Law 97-248. Once again, the TEFRA definition of grandfathered plans appears to be broader than that in the Proposed Treasury Regulation.

There are at least two other places in the Proposed Regulations where we believe that the use of "church-related organization" is too limiting because of its failure to include Code section 414(e)(3)(B)(ii) organizations:

- Proposed Treasury Regulation § 1.403(b)-4(e)(3)(ii) sets forth a special rule for determining years of service with respect to a 403(b) contract maintained by a church-related organization. Under this special rule, years of service that an employee of a "church-related organization" has with any other "church-related organization" that has an association (as defined under 414(e)(3)(D)) with the "church-related organization" are aggregated.

- The transition rules set forth in Proposed Treasury Regulation § 1.403(b)-11(c) provides for a delayed effective date in the case of a 403(b) contract maintained by a "church-related organization" for which the authority to amend the contract is held by a church convention.

We urge the Service to consider expanding the definition of church-related organization to include Code section 414(e)(3)(ii) organizations.

2. We urge the Service to broaden the wording in Proposed Treasury Regulation § 1.402(g)(3)-1(b) to reflect certain election features.

Proposed Treasury Regulation § 1.402(g)(3)-1(b) provides that elective deferrals do not include contributions made on or before the employee first becomes eligible to participate under the employer's plan. This works well for a variety of situations. However, there are certain long-standing practices that allow a defined employee group to elect between a defined benefit structure and a 403(b) structure. This selection occurs at hire into the defined group. If the selection is to the 403(b) structure, it may not be changed at any later point. If, however, there is a default "selection" into the defined benefit structure, *i.e.* if the employee takes no action, he or she going into the defined benefit structure, then the employee may later opt-out of the defined benefit structure and into the 403(b) structure. This structure essentially does not count the first default as an election that counts against the one-time irrevocable election. We hope the final regulations could allow this practice to continue.

3. We urge the Service to consider changing the definition of "employee" under Proposed Treasury Regulation § 1.403(b)-2(a)(9) to include a former employee in limited circumstances.

Code section 403(b)(1)(A) provides that if an annuity contract is purchased "for an employee" by an eligible employer (with the only exception being a contract purchased by a self-employed minister), then contributions by such employer for such annuity contract are excluded from the gross income of the employee for the taxable year, so long as the aggregate of the contributions does not exceed the Code section 415 limits. Proposed Treasury Regulation § 1.403(b)-3 similarly provides that "[a]mounts contributed by an eligible employer for the purchase of an annuity contract for an employee are excluded from the gross income of the employee under section 403(b)" if certain requirements are satisfied. (Emphasis added). Proposed Treasury Regulation § 1.403(b)-2(a)(9) defines "employee" to mean a "common law employee performing services for the employer, and does not include a former employee . . . ." These provisions would appear to clearly indicate that contributions made to a 403(b) plan on behalf of former employees are not excludable from gross income.

However, Proposed Treasury Regulation § 1.403(b)-3(b)(4)(i) states that the exclusion from gross income does not apply to contributions made for former employees, except as provided in Proposed Treasury Regulation § 1.403(b)-3(b)(4)(ii) and in Proposed Treasury Regulation § 1.403(b)-4(d). Proposed Treasury Regulation § 1.403(b)-3(b)(4)(ii) is reserved. Proposed Treasury Regulation § 1.403(b)-4(d) does not provide that contributions made to a 403(b) plan on behalf of a former employee will be excluded from gross income. Rather, Proposed Treasury Regulation § 1.403(b)-4(d)(1) provides in relevant part that "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." Examples 1 and 2 in Proposed Treasury Regulation § 1.403(b)-4(d)(2) describe scenarios where contributions are made to a 403(b) plan on behalf of a former employee. Proposed Treasury Regulation § 1.403(b)-4(d)(3) further provides that a former employee who is disabled may be treated as having continuing compensation under Code section 415(c)(3).

To make it clear that an employer may make post-retirement contributions on behalf of a former employee for the period of time that the former employee has compensation as set forth in Proposed Regulation § 1.403(b)-4(d), and that such contributions will not be included in gross income for that taxable year, we urge the Service to modify Proposed Treasury Regulation § 1.403(b)-2(a)(9) to state that a former employee is not an employee, except to the extent that the former employee is deemed to have compensation as set forth in Proposed Treasury Regulation § 1.403(b)-4(d) or as provided in Proposed Treasury Regulation § 1.404(b)-3(b)(4)(ii).

4. We urge the Service to change and/or clarify Proposed Treasury Regulation § 1.403(b)-3(b)(2), which provides for the disaggregation of excess annual additions.

Proposed Treasury Regulation § 1.403(b)-3(b)(2) provides that if an excess annual addition is made to a 403(b) contract that otherwise satisfies Proposed Treasury Regulation § 1.403(b)-3, then the portion of the contract that includes the excess annual addition fails to be a 403(b) contract, and is instead a 403(c) contract, and the remaining portion of the contract is a section 403(b) contract. Proposed Treasury Regulation § 1.403(b)-3(b)(2) further provides that the entire contract fails to be a section 403(b) contract if an excess annual addition is made to the contract and a separate account is not maintained with respect to the excess annual addition for the year of the excess and for each year thereafter. Proposed Treasury Regulation § 1.403(b)-3(c)(3) provides, in relevant part, that in the event that an excess annual addition that is non-vested is maintained in a separate account which treated as 403(c) contract, it is subject to taxation in accordance with section 403(c) when it becomes vested. We urge the following clarifications to Proposed Treasury Regulation §§ 1.403(b)-3(b)(2) and/or 1.403(b)-3(c)(3).

First, Proposed Treasury Regulation § 1.403(b)-3(b)(2) provides that an excess annual addition must be maintained in a separate account from the 403(b) contract for the year of the excess and each year thereafter. However, an excess annual addition may not be discovered until after the end of the year in which it is made, *e.g.* an excess annual addition is made in November, 2006, but not discovered until January, 2007. Since the excess annual addition was not maintained in a separate account in 2006, the year of excess, Proposed Treasury Regulation § 1.403(b)-3(b)(2) is not satisfied, and the entire contract fails to be a 403(b) contract. This result seems inappropriately harsh. Moreover, excess deferrals made to a 403(b) contract that are distributed in accordance with Treasury Regulation § 1.402(g)-1(e)(2) or (3) are not annual additions. *See* Treas. Reg. § 1.415-6(b)(1). Treasury Regulation § 1.402(g)-1(e)(2) states than an employee may notify his employer of any excess deferrals by the April 15 following the year that the excess deferral was made, and that the excess deferrals must be distributed by that April 15. As a result, it may not be known whether or not there are excess annual additions for a limitation year until after the end of the year in which the excess annual additions were made. Additionally, there are certain other circumstances in which amounts that exceed the section 415 limits are not characterized as excess annual additions for the year in which made, or at all. *See* Treas. Reg. § 1.415-6(b)(6). Again, contributions subject to these regulations under Code section 415 may not be identified until the year after they were made. In order to accommodate both the practical issues and the correction rules under Code section 415, we urge the Service to change Proposed Treasury Regulation § 1.403(b)-3(b)(2) to provide that excess annual additions, as well as any gains or losses accruing from the date that the excess annual addition

was actually made, must be segregated into a separate account within a reasonable period after discovery.

Second, we urge the Service to clarify what happens in the event that excess annual additions are made with respect to a custodial account or retirement income account. Proposed Treasury Regulation § 1.403(b)-3(b)(2) provides in relevant part that

> if an excess annual addition is made to a contract that otherwise satisfies the requirements of this section, then the portion of the contract that includes such excess annual addition fails to be a section 403(b) contract (and instead is a contract to which section 403(c) applies, as further described in paragraph (c)(1) of this section) and the remaining portion of the contract is a section 403(b) contract.

See also Prop. Treas. Reg. § 1.403(b)-3(c)(3). Although Proposed Treasury Regulation § 1.403(b)-2(16) provides that a section 403(b) contract means a contract described in Proposed Treasury Regulation § 1.403(b)-3, which encompasses annuity contracts, custodial accounts, and retirement income accounts, we do not believe that the Service intended that excess annual additions made to a custodial account or retirement income account should be treated as made to a Code section 403(c) nonqualified annuity contract. That treatment would be inconsistent with Proposed Treasury Regulation § 1.403(b)-3(c)(1), which provides that a custodial account or a retirement income account that fails to be treated as a 403(b) contract should be treated under 61, 83 or 402(b), and it is not clear how it would work in practice. Presumably, if excess annual additions are made to a custodial account or a retirement income account, the rules under Code sections 61, 83 or 402(b) would apply to the excess amounts, consistent with Proposed Treasury Regulation § 1.403(b)-3(c)(1). We believe that it would be helpful if the Service clarified this in Proposed Treasury Regulation §§ 1.403(b)-3(b)(2) and 1.403(b)-3(c)(1).

5. We urge the Service to specifically set forth in Proposed Treasury Regulation § 1.403(b)-3(c)(1) the consequences of failure to follow the terms of the Plan in form or in operation.

Proposed Treasury Regulation § 1.403(b)-3(b)(3) provides that a contract does not satisfy the Proposed Regulations unless it is maintained pursuant to a written defined contribution plan which in both form and operation satisfies the requirements of Proposed Treasury Regulation §§ 1.403(b)-4 through – 10. Proposed Treasury Regulation § 1.403(b)-3(c), entitled "Effect of Failure," provides under paragraph (1) that Code section 403(c) applies to nonqualified annuity contracts that are not treated as 403(b) contracts, and that section 61, 83, or 402(b) applies to custodial accounts and retirement income accounts that are not treated as 403(b) contracts. The Preamble to the Proposed Regulations more narrowly provides, under a section entitled "Failure to Satisfy Section 403(b)":

> The regulations clarify 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 is subject to the rules under section 61, 83 or 402(b) if the contribution is to a custodial account or retirement income account that fails to satisfy the requirements of section 403(b).

These provisions imply that a violation of a 403(b) plan in form or operation results in either a contract failure or simply a failure with respect to the contributions impacted, rather than plan failure.

Under current law, generally only a participant's contract – not the entire 403(b) plan - will fail due to a violation of the section 403(b) requirements with respect to a single contract, with an exception in the event that the non-discrimination rules are not satisfied. We urge the Service to clarify Proposed Treasury Regulation § 1.403(b)-3(c) that a failure remains confined to the affected contribution or affected individual, not the entire plan. Unlike with respect to 401(k) plans, employers sponsoring 403(b) plans have historically approved multiple vendors under the plan, and vendors have typically been responsible for much of the 403(b) plan administration and operation. Although employers will be required to undertake more control of their 403(b) plans under the Proposed Treasury Regulations than traditionally has been the case, we do not believe it would be appropriate to disqualify the entire plan due to a single vendor failure. Additionally, we are concerned that such a rule would result in significantly increased vendor fees due to greater exposure to a vendor for other vendor errors over which it has no control.

6. We urge the Service to clarify the written plan document requirement in Proposed Treasury Regulation § 1.403(b)-3(b)(3).

Proposed Treasury Regulation § 1.403(b)-3(b)(3) states that a 403(b) contract does not satisfy the requirements of Proposed Treasury Regulation § 1.403(b)-3(a) unless it is maintained pursuant to a written defined contribution plan which satisfies the requirements of §§ 1.403(b)-3 through -10 in both form and operation. For purposes of this rule

> the plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made.

Prop. Treas. Reg. § 1.403(b)-3(b)(3). The Preamble to the Proposed Regulations further provides, in relevant part, that

> [t]his rule does not require that there be a single plan document. For example, this requirement would be satisfied by complying with the plan document rules applicable to qualified plans.

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 § 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.

7. We urge the Service to clarify Proposed Treasury Regulation § 1.403(b)-3(c)(2), which provides that contributions subject to a vesting schedule will be treated as a Code section 403(c) contract until vested.

Proposed Treasury Regulation § 1.403(b)-3(a)(2) provides that the rights of an employee under a 403(b) contract must be nonforfeitable. Proposed Treasury Regulation § 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 § 1.403(b)-3(a)(2), then the 403(b) contract is treated as a contract to which Code section 403(c) applies. We believe that Proposed Treasury Regulation § 1.403(b)-3(c)(2) should be clarified as follows.

First, while Proposed Treasury Regulation § 1.403(b)-3(c)(1) sets forth the general rule regarding how to treat an annuity, custodial account, or retirement income account that fails to be a 403(b) contract, Proposed Treasury Regulation § 1.403(b)-3(c)(2) addresses only how to treat an "annuity contract issued by 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. Such a rule would be inconsistent with the Service's treatment of 401(k) plans, which are permitted vesting schedules for all investments. Moreover, we believe that a rule prohibiting vesting schedules for such accounts would harm employers who have workforces with high turnover, as well as their employees. Frequently these employers use a vesting schedule in order to be able to contribute more benefits on behalf of longer service employees. These employers may not be able to offer their employees investment opportunities in custodial accounts if vesting schedules were not permitted with respect to such accounts. We, therefore, respectfully request that the Service set forth in Proposed Treasury Regulation § 1.403(b)-3(c)(2) the treatment of non-vested amounts paid into a custodial or retirement income account.

Second, we urge the Service to clarify the implications of bifurcating a 403(b) plan into a Code section 403(b) component and a Code section 403(c) component for annuity contracts (and, as discussed in the preceding paragraph, into a Code section 403(b) component and a component subject to Code section 61, 83 or 402(b) for custodial accounts and retirement accounts). We believe that the bifurcated amounts would simply be subject to the taxation rules set forth in Code section 403(c), 61, 83 or 402(b), as applicable, and, that, therefore, so long as non-vested, there would be no

consequences of bifurcation (assuming that at the time contributions in the non-403(b) bifurcated components vest, the requirements set forth in Proposed Treasury Regulation § 1.403(b)-3(c)(2) have been satisfied).

Third, we request that the Service specifically set forth in the Proposed Treasury Regulations that Code section 409A does not applies to a bifurcated account under Code sections 403(c) (or 61, 83 or 402(b)), at least insofar that a 403(b) contract is bifurcated due to a vesting schedule. If the non-403(b) portion of the bifurcated contract were subject to section 409A, employers sponsoring 403(b) plans with a vesting schedule may face administrative burdens that would put them in a very different position from 401(k) plan sponsors. In fact, it is not clear whether it would be possible to have a vesting schedule in a 403(c) plan and be able to comply with section 409A. These burdens may be such that 403(b) plan sponsors would be discouraged from using vesting schedules, which could result in lower employer contributions for employees.

Fourth, we request that the Service clarify in Proposed Treasury Regulation § 1.403(b)-3(c)(1) what steps, if any, a vendor has to take in order to accomplish a bifurcation for vested and non-vested accounts. Proposed Treasury Regulation § 1.403(b)-3(b)(2), providing for disaggregation for excess annual additions, specifically requires segregation into a separate account. Proposed Treasury Regulation § 1.403(b)-3(c)(1), on the other hand, states that non-vested amounts will be "treated" as a contract to which section 403(c) applies. We believe, therefore, that bifurcation can be accomplished simply by applying the 403(b) plan's vesting schedule to a participant's account in order to determine which portion is treated as a 403(b) contract and which portion is treated as a 403(c) contract, and that no actual segregation under or particular language in the 403(b) contract is required.

Fifth, we ask that the Service clarify in the Proposed Regulations the implications, if any, of defining a "nonforfeitable right" in Proposed Treasury Regulation § 1.403(b)-3(a)(2) by reference to Treasury Regulation § 1.411(a)-4. Treasury Regulation § 1.411(a)-4 defines the term "nonforfeitable," and then provides that "to the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards in Code section 411 or the nondiscrimination requirements of Code section 401(a)(4), they may be forfeited without regard to any restrictions on non-forfeitability under the regulations." Since governmental and church plans are not subject to the minimum vesting standards under Code section 411, nor the nondiscrimination rules under Code section 401(a)(4), we do not believe that that this rule should apply to these types of employers.

Sixth, we urge the Service to clarify in Proposed Treasury Regulation § 1.403(b)-3(c)(2) the consequences if there is an error in plan operation or form during a period when amounts are bifurcated into Code section 403(b) and Code section 403(c) portions. Proposed Treasury Regulation § 1.403(b)-3(c)(2) provides, in relevant part, that:

> on or after the date on which the participant's interest [in the 403(b) contract] becomes nonforfeitable, the contract may be treated as a section 403(b) contract if . . . the contract has at all times satisfied the requirements of [Proposed Treasury Regulation 1.403(b)-3(a)] this section other than the nonforfeitable 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 section 1.403(b)-5.

We believe that this Proposed Treasury Regulation only requires that the 403(b) contract itself satisfy the Proposed Treasury Regulations while part or all of the 403(b) contract is bifurcated into a 403(c) account, and that violations in other 403(b) contracts under the 403(b) plan or 403(b) plan errors that did not impact the 403(b) contract would not fail to satisfy this requirement. However, it would be helpful if the Service clarified this issue. Moreover, we urge the Service to specify whether if the employer "corrects" the error through the Service's correction programs, the 403(c) account can then become part of the 403(b) contract when it vests. Lastly, we ask the Service to address what happens if a contract error within the meaning of Proposed Treasury Regulation § 1.403(b)-3(c)(2) occurs while there are non-vested amounts. For example, if the 403(c) account can never become part of the 403(b) plan, would an employer be able to distribute it to the participant, or would it remain subject to all the terms of the 403(b) plan?

Finally, we urge that the Service clarify that contributions subject to a vesting schedule count toward the Code section 415(c) limits when made rather than when vested. Proposed Treasury Regulation § 1.403(b)-4(b)(1) provides that the contributions for any participant under a "403(b) contract" cannot exceed the limitations imposed by Code section 415. Proposed Treasury Regulation § 1.403(b)-3(c)(2) provides that non-vested contributions are treated as a contract to which section 403(c) applies until vested, at which time they are treated as a 403(b) contract if certain requirements are satisfied. Taking non-vested contributions into account for purposes of section 415 when made is consistent with the treatment for qualified plans under Code section 401(a), and does not unduly penalize employers who use vesting schedules.

8. We urge the Service to eliminate the anti-conditioning rule in Proposed Regulation § 1.403(b)-5(b)(2).

Proposed Treasury Regulation § 1.403(b)-5(b)(2) provides that a 403(b) plan satisfies the universal availability rule 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. This Proposed Treasury Regulation further provides that

> 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.

This anti-conditioning requirement is similar to a requirement set forth in Code section 401(k)(4)(A) applicable to 401(k) plans. *See also* Treas. Reg. § 1.401(k)-1(e)(6). However, unlike 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.

Moreover, we believe that the anti-conditioning rule in Proposed Regulation § 1.403(b)-5(b)(2), if the Service interprets this language as it has Code section 401(k)(4)(A) in Treasury Regulation § 1.401(k)-1(e)(6), is sufficiently broad to prohibit common practices of employers under Code section 403(b) plans. For example, in our experience, a significant number of governmental school corporations provide for a contribution to a 401(a) plan on behalf of eligible participants that is equal to each participant's contributions to a salary deferral-only 403(b) plan up to a percentage of compensation. In other words, a participant is only entitled to a 401(a) plan contribution to the extent that the participant contributes to a salary deferral-only 403(b) plan. These arrangements are typically collectively bargained, and are designed in this manner in order to maximize the availability of the section 415 limits (since 403(b) and 401(a) plans are not aggregated for purposes of Code section 415 except in limited circumstances). Imposing a prohibition on the match would not seem to serve any purpose as to the employee's ability to make or change their elections under the 403(b) plan.

Given that there is no statutory or policy basis for an anti-conditioning rule, and that some popular practices would likely be prohibited under such a rule, we urge the Service to eliminate this requirement from the Proposed Regulations.

9. We urge the Service to retain the safe harbor exclusions under Notice 89-23 relating to the universal availability rule.

Code section 403(b)(12)(ii) provides that the following employees will be excluded when applying the universal availability rule: (i) any employee who is a participant in a Code section 457(b) plan or a Code section 401(k) plan of the organization, or another 403(b) contract, (ii) any nonresident alien, (iii) a student performing services described in Code section 3121(b)(10) if all such students are excluded from participation in the plan, and (iv) employees who normally work less than 20 hours a week if all such employees are excluded from participation in the plan.

Notice 89-23 also provides that the following additional employees may be excluded when applying the universal availability rule: (i) employees who make a one-time election to participate in a governmental plan under 414(d) instead of a 403(b) plan; (ii) employees covered by a collective bargaining agreement; (iii) professors employed by an educational organization described in section 170(b)(1)(A)(ii) who are providing services on a temporary basis to another 170(b)(1)(A)(ii) educational organization and for whom a contribution to a 403(b) plan or other tax-favored plan is being made at a rate no greater than the rate such professors would receive under the aggregated 403(b) annuity program of the original employer, for up to one year; and (iv) employees affiliated with a religious order who have taken a vow of poverty if the religious order provides for such employees in their retirement. In each of these cases, all such employees in the class must be prohibited from participation in the plan if any are prohibited.

First, it is our experience that certain higher education governmental employers permit employees a one-time election to either participate in the employer's 403(b) plan or to instead participate in the state-sponsored qualified defined benefit 401(a) plan. While these employers may also sponsor a salary deferral-only 403(b) plan or a 457(b) plan in which all employees may participate that satisfies the universal availability rule, this is not always the case. We believe there are some governmental employers that establish two entirely separate retirement programs and require employees to elect one in which to participate. In this type of case, there could be a significant administrative cost and burden in requiring such an employer to establish and administer a salary deferral 403(b) plan for all employees.

Second, it is our experience that many employers rely upon the collective bargaining exclusion under Notice 89-23 from the universal availability rule. Such an exclusion is consistent with exclusions available with respect to non-discrimination testing under sections 401(a), 401(k) and 410(b). *See* Treas. Reg. §§ 1.410(b)-2(b)(7), 1.401(a)(4)-1(c)(5), 1.401(k)-1(a)(7). The rationale for a collective bargaining exclusion would be no different under the universal availability rule.

Lastly, many religious colleges and universities rely on the exclusion for employees who have taken a vow of poverty. Due to their vow of poverty, these employees may have no W-2 income from the college or university, and, therefore, have no compensation to contribute to a salary deferral-only plan. The religious order meets the retirement needs of their members. Thus, it does not make sense to penalize the college or university for excluding them from the plan.

Each of these are very limited exclusions with narrow practical consequences, but important to the 403(b) plan sponsors relying on them. We respectfully request that the Service add these exclusions to the list of permissible exclusions under Proposed Treasury Regulations 1.403(b)-5(b)(4)(ii).

10. We urge the Service to clarify the exclusions for specific types of employees from the universal availability rule under Proposed Treasury Regulation § 1.403(b)-5(b)(4)(ii)(D) and (E).

Proposed Treasury Regulation § 1.403(b)-5(b)(4)(i) provides that a 403(b) plan will not fail to satisfy the universal availability requirement under Proposed Treasury Regulation § 1.403(b)-5(b) merely because it excludes certain types of employees set forth in subparagraphs (A) through (E) under Proposed Treasury Regulation § 1.403(b)-5(b)(4)(ii); provided, however, that if any employee listed in a subparagraphs (A) through (E) has the right to have section 403(b) elective deferrals made on his or her behalf, than no employees in that subparagraph may be excluded in testing under the universal availability rule. Subparagraphs (D) and (E), which set forth exclusions for employees who are students performing services described in section 3121(b)(10) and employees who normally work fewer than 20 hours per week, begin with the phrase "[s]ubject to the conditions applicable under section 410(b)(4)." This language parallels the requirements set forth in Code section 403(b)(12)(A).

Code section 410(b)(4)(A) provides a plan must exclude all employees not meeting the age and service requirements in Code section 410(a) from participation in the plan in order to exclude

such group of employees from coverage testing. Code section 410(b)(4)(B) provides that if employees not meeting the age and service requirements in section 410(a) are covered under a plan of the employer that satisfies the coverage rules separately for such employees, these employees may be excluded from coverage testing. Lastly, Code section 410(b)(4)(C) provides that an employee will not be treated as meeting the age and service requirements under section 410(a) until the first date on which under the plan an employee with the same age and service would be eligible to participate.

Code sections 410(b)(4)(B) and (C) do not appear to apply to the exclusions set forth in Proposed Treasury Regulation § 1.403(b)-5(b)(4)(ii)(D) and (E). Code section 410(b)(4)(A) seems to be repetitive of the general rule under Proposed Treasury Regulation § 1.403(b)-5(b)(4)(i). We, therefore, urge the Service to clarify whether application of Code section 410(b)(4) to Proposed Treasury Regulation § 1.403(b)-5(b)(4)(ii)(E) and (E) means anything more than the general rule under Proposed Treasury Regulation § 1.403(b)-5(b)(4)(i) that if any employee listed in a subparagraphs (A) through (E) has the right to have section 403(b) elective deferrals made on his or her behalf, than no employees in that subparagraph may be excluded in testing under the universal availability rule.

11. We urge the Service to clarify Proposed Treasury Regulation §§ 1.403(b)-5(b)(4)(ii)(E) and 1.403(b)-4(e) to exempt governmental and church plan employers from the Code section 410(a)(B) and (C) definition of hours of service, and to clarify application of these rules to all employers.

Proposed Treasury Regulation § 1.403(b)-5(b)(4)(ii)(E) sets forth an exclusion from the universal availability rule for employees who normally work fewer than 20 hours per week. Under this Proposed Treasury Regulation, employees can be excluded from testing "if and only if"

> (1) for the 12-month period beginning on the date the employee's employment commenced, 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. (see, however, section 202(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) . . . and regulations under section 410(a) of the Internal Revenue Code applicable with respect to plans that are subject tot Title I of ERISA.)

(emphasis added).

Proposed Treasury Regulation § 1.403(b)-4(e) describes the rules for determining years of service for purposes of determining includible compensation, the special section 403(b) catch-up for

qualified employees of certain organizations, and employer contributions for former employees. Proposed Treasury Regulation § 1.403(b)-4(e)(6) provides that for purposes of determining years of service,

> in measuring the amount of work of an individual performing particular services, the work performed is determined based on 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.

(emphasis added). As reflected above, Proposed Treasury Regulation §§ 1.403(b)-5(b)(4)(ii)(E)(1) and (2) and 1.403(b)-4(e)(6) refer to "hours of service" within the meaning of Code section 410(a)(3)(C) for certain purposes. However, governmental and church plan employers are not subject to the hours of service rules under Code section 410(a). Although Proposed Treasury Regulation § 1.403(b)-4(e)(6) allows alternative mechanisms to the amount of work performed, neither Proposed Regulation provides for any exceptions to the definition of hour of service. We urge the Service to modify Proposed Treasury Regulation §§ 1.403(b)-5(b)(4)(ii)(E)(1) and (2) and 1.403(b)-4(e)(6) to provide that governmental and church plans are not subject to Code section 410(a)(3)(c) in applying the hours of service rules in these Proposed Treasury Regulations.

Additionally, for nongovernmental and church plans, it is not clear that the equivalency and elapsed time rules under Treasury Regulation §§ 1.410(a)-5 (referring to 29 C.F.R. 2530.200b-2 and 3) and 1.410(a)-7 would apply in determining hours and years of service under Proposed Treasury Regulations §§ 1.403(b)-5(b)(4)(ii)(E)(1) and (2) and 1.403(b)-4(e)(6). We are not aware of any reason that these methods for determining an hour or year of service should not apply. We, therefore, request that the Service specifically provide in these Proposed Treasury Regulations that the equivalency and elapsed time rules under Treasury Regulation §§ 1.410(a)-5 and 1.410(a)-7 could be applied.

Finally, as quoted above, Proposed Treasury Regulation §§ 1.403(b)-5(b)(4)(ii)(E)(1) and (2) provide that an "employee normally works fewer than 20 hours per week if and only if" the employee is expected to and/or does work fewer than 1,000 hours of service (as defined in section 410(a)(3)(C)) in a 12 month period (emphasis added). While the ability to exclude employees who normally work fewer than 20 hours per week from testing is very important to institutions of higher education, its application to part-time faculty members and adjuncts has historically proven frustrating. Educational institutions do not typically track hours of service for faculty members, and the equivalency and elapsed time rules are not useful in applying the hours of service rules to part-time employees for purposes of this exclusion. In our experience, educational institutions have tended to use the number of course loads or full-time equivalent percentages as proxies for whether or not a faculty member normally works fewer than 20 hours per week. We, therefore, urge the Service to provide employers for whom it is difficult to track hours with an alternative mechanism

for determining whether the "normally works fewer than 20 hours per week" exclusion is satisfied with respect to an employee. Such a mechanism may parallel, for instance, the provision in Proposed Treasury Regulation § 1.403(b)-4(e)(6) which states that a plan may use a different measure of work than hours of service in determining whether an employee has a year of service, *e.g.* a university professor's work may be measured by the number of courses taught during an annual work period.

12. We urge the Service to clarify the beginning distribution date for the pre-1987 portion of an account balance under Proposed Treasury Regulation § 1.403(b)-5(b)(4).

Proposed Treasury Regulation § 1.403(b)-6(e)(6)(i) provides that the distribution rules under Code section 401(a)(9) do not apply to the undistributed portion of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings. Proposed Treasury Regulation § 1.403(b)-6(e)(6)(v) further provides that the pre-1987 account balance must be distributed in accordance with the incidental benefit requirement of Treasury Regulation § 1.401-1(b)(1)(i). However, these Proposed Treasury Regulations do not set forth any distribution rules for the pre-1987 portion of an account balance. Prior guidance from the Service indicates that distributions for pre-1987 account balances must commence by the end of the year when the participant attains age 75. *See* PLR 9345044; Chief Counsel Advisory 199921058; Internal Revenue Manual 4.72.13.7.3. We believe it would be helpful to plan sponsors if the Service set forth the distribution rules applicable for pre-1987 account balances, consistent with this prior guidance, in Proposed Treasury Regulation § 1.403(b)-6(e)(6)(i).

13. We urge the Service to clarify Proposed Treasury Regulation § 1.403(b)-8(b), which provides guidelines for the transfer of contributions to a vendor holding assets under the 403(b) plan.

Proposed Treasury Regulation § 1.403(b)-8(b) addresses when contributions should be transferred to the vendor holding assets under the 403(b) plan. Specifically, this Treasury Regulation provides that contributions to a 403(b) plan must be transferred to the vendor within a period that is not longer than is reasonable for the proper administration of the plan. Proposed Treasury Regulation § 1.403(b)-8(b) then sets forth an example for elective deferrals made to a section 403(b) plan that parallels the rules for ERISA covered plans. However, the Proposed Regulation does not provide any guidance as to application of this requirement for nonelective employer contributions or matching employer contributions. Employers for qualified plans have liberal rules as to when employer contributions can be contributed to the plan. Generally, so long as consistent with the terms of the plan document, contributions may be made at any time during the taxable year, and after the end of the taxable year up to the due date, including extensions, for the filing of the employer's federal income tax return for that year. We request that the Service permit sponsors of 403(b) plans the same flexibility with respect to nonelective and matching contributions.

14. We urge the Service to modify Proposed Treasury Regulation § 1.403(b)-10(f)(1) to allow grandfathered church defined benefit retirement income accounts to utilize the Code section 415(b) limits instead of the Code section 415(c) limits.

Proposed Treasury Regulation § 1.403(b)-10(f)(1) recognizes that a TEFRA church defined benefit plan may be treated as a section 403(b) contract even though it is a defined benefit arrangement. The Proposed Treasury Regulations then state that for purposes of applying Code section 415 to a TEFRA church defined benefit plan, the accruals under the plan are limited to the maximum amount permitted under section 415(c) when expressed as an annual addition.

TEFRA first subjected retirement income accounts to the Code section 403(b) rules effective for plan years after December 31, 1982. Code section 403(b) makes clear that it applies to defined contribution plans that are subject to Code section 415(c). Therefore, in enacting TEFRA, Congress grandfathered retirement income accounts that were defined benefit plans in existence on December 31, 1982. We do not believe that Congress intended that Code section 415(c) be applied to grandfathered defined benefit retirement income accounts under this provision. Rather, in permitting these defined benefit plans to remain in existence, it is logical that they would be tested under the rules applicable to defined benefit plans. Application of Code section 415(c) to these grandfathered plans is not justified since the same concern in limiting tax deferrals is accomplished by application of Code section 415(b). We respectfully request that the Service provide in Proposed Treasury Regulation § 1.403(b)-10((f)(1) that benefit accruals under a TEFRA defined benefit plan are limited by Code section 415(b).

15. We urge the Service to include a transitional rule for governmental plans under Proposed Treasury Regulation § 1.403(b)-11(b).

Proposed Treasury Regulation § 1.403(b)-11(b) states that the Proposed Regulations are generally effective for taxable years beginning after December 31, 2005. While Proposed Treasury Regulation § 1.403(b)-11(b) sets forth a delayed effective date for collectively bargained plans and for church plans, there is no such delay for governmental plans. Governmental plans are very often created by state statute, and frequently many of the terms of such plans are delineated in these state statutes. For governmental plans that must be changed by the legislature, it will be impossible for the necessary changes to be made by the general effective date in the Proposed Regulations. We, therefore, believe that there should be a delayed effective date for the Proposed Regulations as applicable to governmental plans. We suggest that the Proposed Regulations be effective the first taxable year after the first regular legislative session of the legislative body with the authority to amend the plan that begins after December 31, 2005, and that this delayed effective date for governmental plans in a particular state apply to all governmental plans in that state regardless of whether the legislative body has the authority to amend the governmental plan. This transition rule is similar to the transition rule under Notice 2005-5 relating to automatic rollovers.

Lastly, in the Employee Plan News Special Edition of November 17, 2004, Ms. Gold commented on the possibility of issuing determination letters on 403(b) plans. We would strongly support such a program. We think a forum such as the Determination Letter Liaison Group that was

used on the recent 401(a) program changes could be very helpful for giving the Internal Revenue Service feedback on how such a program could be structured.

Thank you for considering these comments. We would welcome the opportunity to discuss with you any of the issues addressed in this letter. We can be reached at the telephone numbers and e-mail addresses listed on the first page of this letter.

Very truly yours,

ICE MILLER

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