


## The Basics

On Monday, July 23, 2007, the U.S. Treasury Department and the Internal Revenue Service (IRS) released final regulations under section 403(b). This summary of the final regulations is provided to assist you in understanding of and transition to the new requirements.

Since the proposed regulations were first released in November 2004, Great American Financial Resources<sup>®</sup> has been very active in the regulations process. We independently filed two comment letters with the Treasury Department and we facilitated a grass-roots campaign. We participated with the Committee of Annuity Insurers in filing additional extensive comments, and provided input to the Department of Labor (DOL) regarding ERISA implications of the proposed 403(b) regulations. Our in-house legal counsel was asked by the Committee of Annuity Insurers to testify on behalf of the Committee at the official hearing on the proposed regulations in February 2005. While the final regulations did not reflect all of our comments, we feel that the final regulations are an improvement over the original proposals.

If you have any questions regarding the final regulations, please call us at **(800) 789-6771 ext. 10228**, or contact us by e-mail at [403bregs@gafri.com](mailto:403bregs@gafri.com).

You will find regular updates and educational materials at [www.GAFRI.com/403bregs](http://www.GAFRI.com/403bregs).



# Summary of the Final Regulations Under Section 403(b)

A detailed summary appears on the following pages to further assist in your understanding of the new regulations and requirements.

## Quick Highlights

- ✓ Final 403(b) regulations generally take effect on **January 1, 2009**.
- ✓ Written Plan Documents will be required, with model plan language to be provided by the IRS for public school use.
- ✓ Information sharing between issuers of 403(b) contracts and issuers may no longer rely on employee self-certification regarding severance from employment, hardships and loans.
- ✓ Tax-free transfers (previously allowed by Rev. Rul. 90-24) continue to be permitted, but must meet new requirements that take effect **September 24, 2007**.
- ✓ Rollovers to an IRA or eligible retirement plan are not affected by the new rules
- ✓ 403(b) plans that allow salary deferrals must be universally available to employees, and the exclusion of collective bargaining groups will no longer be allowed. Furthermore, 403(b) plans that allow Roth 403(b) contributions must also make this option universally available to employees.
- ✓ Department of Labor issued a Field Assistance Bulletin to provide guidance for 501(c)(3) organizations that wish to maintain a salary-deferral only 403(b) plan but avoid ERISA rules.
- ✓ Prohibited funding a 403(b) plan with life insurance, endowment, health or accident, property, casualty and liability policies. Annuity contracts may continue to include death benefits as long as they are within the incidental benefit rule.

# Detailed Summary

## Effective Date

Final regulations generally take effect on January 1, 2009.

A number of special transition rules exist, including:

- ✓ New rules for tax-free transfers take effect for contracts exchanged after September 24, 2007;
- ✓ New withdrawal restrictions on employer contributions to 403(b) plans will not apply to contracts issued before January 1, 2009;
- ✓ New prohibition on life insurance does not apply to 403(b) life insurance policies issued before September 24, 2007;
- ✓ New termination rules may be used immediately, but require compliance with the new requirements before distribution of benefits;
- ✓ New rules on post-employment contributions generally take effect January 1, 2008; and
- ✓ New Roth 403(b) rules take effect January 1, 2009.

## Plan Document Requirement

Final regulations require all 403(b) plans to maintain a written plan that satisfies requirements of section 403(b) in both form and operation.

- ✓ Plan document does not need to be a single written instrument and may incorporate other documents, such as the annuity contract, by reference.
- ✓ Administrative responsibilities may be allocated to issuers, but the plan document must clearly reflect such allocations.
- ✓ Participants cannot carry compliance responsibility for 403(b) plans, although they must provide information that is relevant to compliance (e.g. participant's age and basis for a hardship distribution).

Additionally, the IRS will soon release model plan language for governmental 403(b) plans. Documents that satisfy requirements of the final regulations must be in place by January 1, 2009, subject to any special effective dates for certain collectively bargained plans, and also plans that must be amended by a legislative body or church convention.



## Transfers and Exchanges

As expected, Rev. Rul. 90-24 has been revoked and is now replaced by more limited “transfers” and “exchanges” guidelines. The final regulations provide for three types of non-taxable transfers of amounts in section 403(b) contracts:

- ✓ a mere change of investment within the same plan (contract exchange);
- ✓ a plan-to-plan transfer, so that there is another employer plan receiving the exchange; and
- ✓ a transfer to a governmental defined benefit retirement plan to purchase permissive service credits

Note that these rules do not apply to rollovers of eligible rollover distributions, which are not affected by the final regulations.

**Exchanges** of one contract for another under the same plan is considered a mere change of investment and is permitted, but only if certain conditions are met. Most notably, the employer must enter into an agreement with the issuer of the new contract for the sharing of certain information. The information would include information with respect to the participant's employment (for example, whether a severance had occurred) and information with respect to other section 403(b) contracts owned by the participant (to facilitate compliance with rules such as the loan limits of section 72(p)). This new requirement does not need to be met for a contract received in an exchange that occurred on or before September 24, 2007 if the exchange satisfies Revenue Ruling 90-24. Contracts that are received in an exchange after September 24, 2007 will need to meet the new requirements, but not until January 1, 2009. However, it would be ill advised to enter into an exchange after September 24, 2007 unless the new requirements are met. It is not clear whether or not contracts received in an exchange on or before September 24, 2007 must then comply with the new exchange requirements if they are exchanged again after September 24, 2007. The IRS is authorized to issue guidance of general applicability allowing such exchanges in cases not otherwise described in the final regulations. The authority is limited to cases in which the IRS determines that sufficient procedures are in place to share information needed to ensure compliance, such as whether a severance from employment has occurred for purposes of the distribution restrictions. Procedures that rely on representations from the participant generally will be insufficient.

**Transfers** of contracts between different plans are allowable if both plans provide for transfers and the participant must be an employee or former employee of the employer that sponsors the receiving plan.

Both the “exchange” rules and the “transfer” rules also require that the “accumulated benefit” immediately after the exchange or transfer must at least equal the “accumulated benefit” of the participant or beneficiary immediately before the exchange or transfer. The Committee of Annuity Insurers requested a clarification of this requirement to make it clear that the net cash amount that would be payable to a participant upon a liquidation or partial surrender of a section 403(b) contract may be exchanged or transferred to another section 403(b) contract. The final regulations do not provide that clarification.

## Department of Labor Guidance

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The Department of Labor has indicated that 501(c)(3) organizations can comply with the new 403(b) regulations and also remain within the DOL's safe harbor exemption for tax-sheltered annuity programs that are funded solely by salary deferrals. However, DOL noted that the final regulations offer employers "considerable flexibility" in shaping the extent and nature of their involvement in a 403(b) plan, and that in determining whether a tax-sheltered annuity program will be subject to Title I of ERISA, a case-by-case analysis should be conducted. In conjunction with the publication of the final regulations, DOL issued a Field Assistance Bulletin that provides additional guidance on the interaction of the safe harbor requirements and the final regulations. The Field Assistance Bulletin is available on the DOL website, at [www.dol.gov/ebsa](http://www.dol.gov/ebsa) and on our web site at [www.gafri.com/403bregs](http://www.gafri.com/403bregs).

### Timing of Distributions and Benefits

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Amounts attributable to salary deferrals have been subject to distributions restrictions since 1988. Custodial account funds have been subject to distribution restrictions since 1978. The final regulations make it clear that an insurer may not rely merely on the employee's certification that a severance from employment has occurred.

In addition, the final regulations apply new distribution restrictions to amounts attributable to employer contributions that are not custodial account funds. Under the final regulations, these amounts may only be distributed after severance from employment or upon the prior occurrence of an event, such as after a fixed number of years, the attainment of a stated age, or disability. The new distribution restrictions do not apply to after-tax employee contributions or the earnings on such contributions. The final regulations also provide a grandfathering rule under which the new distribution restrictions on employer contributions do not apply to contracts issued by an insurance company before January 1, 2009.

If there is not separate accounting for salary deferrals, custodial account funds, and employer contributions, then the account may not be distributed until the most stringent distribution restriction is met.

The final regulations state that distribution restrictions do not apply to after-tax employee contributions or the earnings on such contributions. The final regulations also state that distribution restrictions do not apply to rollover contributions or earnings on such contributions that are held in a separate account.

### Taxation of Distributions and Benefits

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A number of rules regarding the taxation of distributions and benefits from contracts now exist. These rules generally track the statutory requirements applicable to such contracts (for example, section 72 applies to tax only amounts actually distributed; eligible rollover distributions are not taxed if directly rolled over or transferred to an eligible retirement plan; non-direct rollovers are subject to mandatory withholding; and the payer must give proper written notice regarding eligible rollover distributions). The final regulations incorporate guidance on Roth 403(b) accounts.



### Failure to Satisfy Section 403(b)

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The final regulations include a new discussion of the effect of 403(b) plan failures. The final regulations provide that, in the ordinary course, only the contracts to which a defect relates will be adversely affected by the defect. As a result, operational defects will typically only effect only the contracts of the employee to which the defect relates. However, a failure in one 403(b) contract of an employee will generally result in the disqualification of all contracts of that employee under the 403(b) plan. Furthermore, a failure to maintain a plan document, a nondiscrimination failure or an employer eligibility failure will affect all contracts under the plan.

### Nondiscrimination Requirement for Employer Contributions

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Employer contributions and after-tax employee contributions (other than Roth 403(b) contributions) are subject to certain nondiscrimination requirements. The final regulations generally end a good faith noncompliance standard for 501(c)(3) employers and the administrative safe harbors that were provided under Notice 89-23. Instead, the final regulations apply the nondiscrimination rules that apply to 401(k) plans and therefore provide standards for aggregating affiliated 501(c)(3) employers. Governmental employers are exempt from these nondiscrimination requirements other than the limits on the compensation on which an employer contribution may be based.

### Universal Availability

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The universal availability requirement applies in the case of a 501(c)(3) entity, on a common law entity basis, and, in the case of a governmental employer, on a common payroll basis. In addition, they repeal a number of the prior law administrative exemptions from the universal availability requirement that were in Notice 89-23, including the exemption of employees in a collective bargaining unit, but compliance with this change may be delayed for certain employers. Additionally, the final regulations provide guidance for applying the exemption from the universal availability requirement for part time employees. The final regulations clarify that the universal availability rules apply to the right to make Roth 403(b) contributions if the plan permits any employee to do so.



## Funding, Including Life Insurance

Contributions to a section 403(b) plan must be transferred to the insurance company issuing the annuity contract or the custodian of a custodial account “within a period that is not longer than is reasonable for the proper administration of the plan.”

A life insurance contract, an endowment contract, a health or accident insurance contract, or a property, casualty or liability insurance contract may not be used to fund a 403(b) plan. The final regulations provide an exception for 403(b) life insurance contracts issued before September 24, 2007.

The final regulations also state that “death benefits” under an annuity contract are permitted so long as they do not cause the contract to fail to satisfy the “the incidental benefit requirement.” The extent to which this new provision of the regulations will require annuity death benefits that are not life insurance under state law or federal tax law to be limited by the incidental benefit requirement is unclear.

## Plan Terminations

As a new rule, an employer may now terminate a section 403(b) arrangement that it sponsors at any time. A termination will generally allow benefits to be distributed to employees without satisfaction of the distribution restrictions so long as the employer does not sponsor another 403(b) plan within the 12 months following the distribution.

## Required Minimum Distributions

A section 403(b) contract must meet the section 401(a)(9) minimum distribution rules in both form and operation.

## Contributions

Salary reduction contributions for an employee who has severed employment may only be made with respect to (1) compensation payable for the pay period in which the severance occurred, (2) compensation paid within 2½ months of severance if such compensation would have been paid without a severance (such as regular compensation for past periods, overtime pay, commissions, or bonuses, and (3) accrued sick leave, vacation time or other leave paid within 2½ months of severance, but only if and to the extent the employee could have actually used such time off if employment had continued. Salary reduction contributions may not be made with respect to severance payments, 457 plan or other nonqualified deferred compensation plan payments, or parachute payments. Employer contributions may be made for up to five years following severance from employment, but for any year may not exceed the section 415 limitations calculated as if the employee, so long as living, continued to earn each month during that five year period an amount equal to 1/12<sup>th</sup> of his compensation for the last year of service. These rules generally take effect on January 1, 2008.

If an employee is eligible for both the age 50 catch-up contribution under section 414(v) and the special section 403(b) catch-up contribution for employees with at least 15 years of service, a catch-up contribution is treated first as a special section 403(b) catch-up contribution up to the extent such contribution is permitted, and then as an amount contributed as an age 50 catch-up contribution.

The proposed regulations provided that for purposes of the special section 403(b) catch-up contribution applicable to employees of a qualified organization, the term “health and welfare service agency,” is defined as either an organization whose primary activity is medical care, section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals, or which provides substantial personal services to the needy (e.g., a tax-exempt organization that provides meals to needy individuals) or an agency that provides either home health services or assistance to individuals with substance abuse problems or that provides help to the disabled..



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