HUNTON& WILLIAMS

CLIENT ALERT

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# New Compliance Rules for 403(b) Tax-Sheltered Annuity Programs

After years of neglect, 403(b) plans (also known as tax-sheltered annuities) are finally getting the attention they deserve, whether plan sponsors are ready or not. Final regulations adopted by the Internal Revenue Service (the "Service") under Section 403(b) of the Internal Revenue Code (the "Code") are effective on the first day of the 2009 plan year.

One of the most significant requirements of the final regulations is that plan sponsors must adopt written plan documents that satisfy the requirements of the final regulations and contain all material terms regarding conditions of eligibility and benefits under the plan. In December 2008, the Service extended until December 31, 2009, the deadline for 403(b) plan sponsors to adopt written plan documents. Until a written plan document is adopted, sponsors must operate their 403(b) plans in compliance with the final regulations beginning on the first day of the 2009 plan year. After the written plan is adopted, plan sponsors have until the end of the 2009 plan year to retroactively correct back to the new plan's effective date any operational failures caused by inconsistencies between plan administration and the terms of the plan document.

The final 403(b) regulations introduce a number of new requirements that bring the operation of 403(b) plans more into line with the operation of traditional qualified plans. For example:

- **Maximum Contributions**. The final regulations clarify that the maximum annual contribution limit that applies to qualified plans also applies to 403(b) plans.
- **Hardship Distributions**. The final regulations specifically adopt the 401(k) rules for hardship distributions.
- **Elective Deferral Transfers**. The final regulations provide a new timing rule for transferring elective deferral contributions that mirrors the requirements applicable to 401(k) contributions (*i.e.*, elective deferrals must be transferred to the annuity provider no later than the 15th business day of the month after the month in which the employer would have otherwise paid the amount to the participant).

Other new significant compliance issues in the final regulations include:

- **Universal Availability**. The final regulations provide that a 403(b) plan permitting employee elective deferrals must allow all employees an opportunity to elect to defer a portion of their compensation into the 403(b) plan. The only permitted exceptions to this "universal availability" rule are employees who (1) are eligible under another tax-favored plan, (2) are nonresident aliens, (3) are students performing services for their respec-

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tive schools or (4) normally work less than 20 hours per week.

The final regulations provide a uniform rule for determining which employees "normally work less than 20 hours per week." In an employee's first year of employment, an employee will be deemed to normally work less than 20 hours per week if the employer reasonably expects the employee to work fewer than 1,000 hours during the year. In subsequent years, if the employee worked fewer than 1,000 hours in the previous year, the employee is deemed to normally work fewer than 20 hours per week.

- **Withdrawals**. The final regulations provide that employer contributions to 403(b) annuity contracts, other than custodial accounts, may not be distributed before the participant's severance from employment or the occurrence of a specified event, such as a fixed number of years or the attainment of a stated age. Elective deferrals and employer contributions to custodial accounts may not be distributed prior to the participant's severance from employment, disability, death or attainment of age 59½. Elective deferrals may also be distributed in the event of a hardship.

- **Contract Exchanges**. A 403(b) plan participant's exchange of an annuity contract for an annuity contract from a different provider (previously known as "90-24 Transfers") will not be deemed a taxable distribution if certain conditions are satisfied. The tax-free exchange is permitted only if (1) the plan document allows them, (2) the participant's benefits are unaffected, (3) the distribution restrictions under each contract are identical and (4) the employer and new annuity provider, other than a designated fund sponsor of the plan, enter into an information-sharing agreement.

On April 15, 2009, the Service announced that it intends to establish a pre-approved 403(b) prototype plan program and published sample language for drafting such plans. The Service is contemplating a remedial amendment program for individually designed plans as well, but the priority will be the pre-approved plan program. In addition, the Internal Revenue Service expects to expand its voluntary correction program to include certain corrections for 403(b) plan failures.

Finally, beginning with the 2009 plan year, 403(b) plans that are subject to ERISA must satisfy the same Form 5500 reporting requirements as other retirement plans, including the requirement that plans with more than 100 or more participants as of the beginning of the year obtain an audit from an independent qualified public accountant. Although the reporting obligation will not occur before July 31, 2010, plans subject to the audit requirement should begin discussions now with their fund providers and auditors because the audit will require an opening year balance for 2009.

**What 403(b) Plan Sponsors Should Do Now:**

- review plan eligibility requirements to ensure compliance with the Universal Availability rule;
- review plan documents to determine whether changes need to be made to comply with the final regulations;
- if the plan does not already have a formal written plan document, review annuity contracts and custodial accounts to determine whether they will satisfy the written plan document requirement, and, if not, adopt a new plan document;
- review plan administration and documents to ensure compliance with maximum contribution limit, timing rules for transmission of elective deferrals, hardship rules and withdrawal limitations;
- review agreements with fund sponsors and other annuity contract providers to determine whether new information-sharing agreements are necessary; and
- determine whether the audit requirement will apply to the plan, and, if so, begin discussions with fund sponsors and accountants to establish an opening balance for the 2009 plan year.

We welcome the opportunity to assist you in complying with these requirements.