



Employee Benefits Law Information Memo

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INTERNAL REVENUE SERVICE PROPOSES CONTROLLED GROUP AND 403(b) REGULATIONS

The Internal Revenue Service recently issued proposed regulations that provide updated and consolidated guidance to tax-exempt employers that sponsor Internal Revenue Code ("Code") Section 403(b) plans or that offer employees the opportunity to purchase tax-sheltered annuity contracts through salary reduction contributions. The proposed regulations would amend a number of current regulations to conform those regulations to statutory changes that have occurred over the last 30 or more years and to reflect the increasing similarities among Code Section 403(b) plans, Code Section 401(k) plans and Code Section 457(b) plans.

The regulations, if approved as proposed, generally would become effective for taxable years beginning after 2005. The proposed regulations, however, may not be relied upon until they are issued in final form.

The proposed regulations include the following:

Plan Document

Every Code Section 403(b) arrangement will have to be set forth in a written defined contribution plan that contains all the material terms and conditions regarding eligibility, benefits, contribution limitations, available contracts, and the time and form under which benefit distributions will be made. A plan also may contain certain optional features (e.g., hardship withdrawal and loan features), so long as the optional features meet the relevant requirements of Code Section 403(b) and the implementing regulations. Annuity contracts provided by an insurance company or custodial account provider likely will not be sufficient to satisfy the plan document requirement.

For Code Section 403(b) plan sponsors that already maintain "stand-alone" plan documents, satisfying the new plan document requirements should not be particularly burdensome. However,

for an employer that has taken the position that its payroll practice that allows employees to make voluntary salary reduction contributions toward the purchase of Code Section 403(b) tax-sheltered annuities is exempt from the application of ERISA, compliance with the new plan document requirements could result in the arrangement being subject to the requirements of ERISA.

Non-discrimination Requirements

The proposed regulations would replace the safe harbor non-discrimination guidance provided in Internal Revenue Service Notice 89-23. Under the proposed regulations, a Code Section 403(b) plan that provides for employer contributions, and/or employee after-tax contributions, will have to satisfy the same non-discrimination rules that generally apply to tax-qualified retirement plans under Code Section 401(a)(4) and Code Section 410(b). Employee elective deferrals to a Code Section 403(b) plan would still have to satisfy the so-called universal availability requirement, which generally means that all employees must be able to make elective deferral contributions if any employee may make such contributions in excess of \$200. For purposes of the universal availability rule, employees who are eligible to contribute to a Code Section 401(k) plan and/or to a Code Section 457(b) plan may be excluded from participating in the Code Section 403(b) arrangement. The proposed regulations provide that no other benefits (other than matching contributions) may be contingent on an employee's elective deferral to a Code Section 403(b) arrangement.

Vesting

In the case of a Code Section 403(b) plan that provides for a vesting schedule for employer contributions, the proposed regulations provide that, in the year of vesting, the accumulated

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account balance must be compared to the then current Code Section 415 maximum contribution limit (\$42,000 in 2005). If an employee's accumulated account balance exceeds the Code Section 415 limit, the employee can be subject to excise taxes for excess contributions. The proposed regulations are structured to encourage employers to design Code Section 403(b) plans to provide for full and immediate vesting.

Distributions

One of the permissible distribution events under a Code Section 403(b) plan is the covered employee's "severance from employment". Under the proposed regulations, a severance from employment will occur when the covered employee ceases to be employed by the entity that is eligible to maintain the Code Section 403(b) plan. A distribution will be permitted, even if the affected employee remains employed by another entity in the same controlled group of employers. For example, an employee of a college who leaves employment with the college to work for the college's for-profit subsidiary would be considered to have incurred a severance from employment for purposes of receiving a distribution from the college's Code Section 403(b) plan.

Plan Terminations

Until now, there was no guidance that authorized the sponsor of a Code Section 403(b) plan to terminate the plan. The proposed regulations would provide explicit authority to terminate a Code Section 403(b) plan, so long as the sponsoring employer did not make contributions to another Code Section 403(b) plan within 12 months before or after the termination. The termination of a Code Section 403(b) plan would then permit the distribution of amounts accumulated under the plan.

Ordering Rule For Catch-up Contributions

In Code Section 403(b) plans maintained by educational organizations, hospitals, and certain health agencies, an employee who has completed 15 years of service may be able to make catch-up contributions equal to an aggregate of \$15,000 over a period of five or more years. In addition, an employee who is at least age 50 may be able to make catch-up contributions of a specified annual amount (\$4,000 in 2005). Under the proposed regulations, catch-up contributions by an employee who is eligible to make both types of catch-up contributions will be considered made under the 15-year catch-up rule first and then under the age-50 catch-up rule. Under this ordering rule, an eligible employee might unknowingly use up some or all of the employee's 15-year catch-up contribution maximum earlier than planned.

QDROs

The proposed regulations make it clear that Code Section 403(b) plans must honor "qualified domestic relation orders" or "QRDOs". This will require plan sponsors to adopt QDRO procedures that will govern the evaluation of court orders that attempt to divide a participant's plan benefit. Coordination with annuity contract or custodial account providers also will be necessary.

FICA Taxation of Mandatory Contributions

Some Code Section 403(b) plans are designed to require that eligible employees must make contributions to the plan as a

condition of employment with the plan sponsor. The proposed regulations include a temporary regulation, with a current effective date, requiring that such mandatory (condition of employment) contributions be taken into account for FICA tax purposes. This proposed/temporary regulation was effective November 16, 2004 and will expire no later than November 15, 2007.

Controlled Group Rules

Also included in the proposed regulations regarding Code Section 403(b) plans is a proposed regulation that would make official the Internal Revenue Service position on controlled group status for tax-exempt organizations. Under the proposed regulations, an exempt organization would be combined with another organization, and the two would be considered a single employer for most employee benefit plan purposes, if at least 80 percent of the directors or trustees of one organization are either representatives of, or are directly or indirectly controlled by, the other organization. For this purpose, a trustee or director will be considered a representative of another organization, if he or she also is a trustee, director, agent, or employee of the other organization. Existence of control will be based on the facts and circumstances of each case.

Although included in the proposed regulations under Code Section 403(b), the controlled group regulations will have broader application than just to Code Section 403(b) plans of exempt organizations. For example, an exempt organization that has a for-profit subsidiary may be required to take the subsidiary's employees into account when performing non-discrimination tests on the exempt organization's plans. The opposite is also true; employees of the exempt organization may have to be taken into account when performing non-discrimination tests on the subsidiary's plans.

If you have any questions about the materials summarized in this Memorandum, or about the proposed regulations in general, please contact any of the following members of our Employee Benefits Law Practice Group:

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