

**STAYING AHEAD OF THE CURVE:
FIDUCIARY ISSUES, 401(k) FEES AND BEST PRACTICES, AND
NEW 403(b) REGULATIONS**

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STAYING AHEAD OF THE CURVE:
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I. Are You A Fiduciary? At what point in its efforts to assist an employer with the employer's responsibilities in relation to a 401(k) plan does an investment professional or TPA take on a fiduciary role under the ERISA? This is a critical question, since ERISA has rules governing fiduciaries that do not apply to non-fiduciary service providers.

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it. Regardless of whether he has knowledge of his status, an ERISA fiduciary must (1) act for the exclusive purpose of providing retirement benefits to plan participants, (2) fulfill a duty of loyalty to the participants, (3) act prudently, and (4) avoid conflicts of interest and acts of self-dealing known as prohibited transactions.

The definition of a fiduciary includes any person who exercises any authority or control respecting the management or disposition of plan assets. Assuming that an investment professional lacks such control, he could also be a fiduciary to the extent that he renders advice for a fee or other direct or indirect compensation, with respect to any moneys or other properties of the plan, or has any authority or responsibility to do so. In other words, if you receive compensation for which you have the responsibility to provide investment advice or for which you actually provide investment advice, you will be a fiduciary.

To determine whether you are a fiduciary under the forgoing definition, you must also know what constitutes investment advice and what is considered to be compensation. The Department of Labor has issued regulations that attempt to answer these questions. Reduced to their essentials, they indicate that investment advice must (1) make recommendations about investing in securities or other property, and (2) be targeted to the individual needs of the plan and, (3) by some form of mutual agreement, serve as the primary basis for making investment decisions. Thus, advice regarding general investment strategy or the establishment of a plan's investment policy does not necessarily make you a plan fiduciary.

As to what constitutes compensation for purposes of identifying a fiduciary, the Department of Labor takes the broad view that any compensation received incident to the rendering of investment advice will be taken into account, including a commission where no other payment specifically allocated as a fee for advice is identified. This broad interpretation makes it very difficult for certain investment professionals, broker dealers for example, to argue that they were not compensated for giving investment advice. If you know that you are providing investment advice, you should make sure that your compensation is consistent with ERISA's fiduciary and prohibited transaction rules.

II. Hidden 401(k) Plan Fees and Expenses.

A. Background. An important part of a fiduciary's responsibility includes identifying, understanding, and evaluating fees and expenses associated with plan investments, investment options and services. When they initially consider a new investment, fiduciaries should be aware of all hard dollar payments made directly by plans as well as "revenue sharing" and similar payments made indirectly by third parties. The latter are sometimes referred to as "hidden fees." Fiduciaries should also monitor such payments to determine if they continue to be reasonable. While the reasonableness of fees and expenses is a concern for all qualified plans, it is particularly important for 401(k) plans, because they generally bear a higher proportion of the fees and expenses. Monitoring fees and expenses is an ongoing fiduciary responsibility.

B. Types of Hidden Fees. There are at least eight kinds of hidden 401(k) plan fees and expenses that fiduciaries need to be aware of: (i) SEC Rule 28(e) Soft Dollars, (ii) Sub-transfer Agent Fees, (iii) 12b-1 Fees, (iv) Variable Annuity Wrap Fees, (v) Investment Management Fees, (vi) Sales Charges, (vii) Revenue Sharing Arrangements, and (viii) Float.

1. SEC Rule 28(e) Soft Dollars. Brokerage firms may charge extra commission that can be used by investment advisors and others to purchase services, such as, valuable investment research. Such excess commission must be reasonable with respect to the services provided. Illegal Rule 28(e) fees violate ERISA Sections 403(c)(1), 404(a)(1) and 406(a)(1)(D). Fiduciaries should know whether they are being charged Rule 28(e) fees.

2. Sub-transfer Agent Fees. Brokerage firms and mutual funds often sub-contract recordkeeping and other services related to participant shares to a third party called a sub-transfer agent. Payments to these third parties are sub-transfer agent fees. The problem is not the receipt of such fees by the third parties, but whether the fee fairly represents the value of the services being rendered. The DOL, in its publication A Look at 401(k) Plan Fees, has made it clear that a plan sponsor must understand the value and associated compensation of each company providing services to the plan.

3. 12b-1 Fees. 12b-1 fees are, in general, distribution expenses paid by mutual funds from fund assets. They may include commissions to brokers, advertising or other marketing expenses, and fees for administrative services provided by third parties to fund shareholders. 12b-1 fees can be as much as 1% of a fund's assets on an annual basis. Fiduciary audits have revealed that plan sponsors who have invested in mutual funds with high 12b-1 fees could have invested in a similar mutual fund without paying any 12b-1 fee or a lower 12(b)-1 fee.

4. Variable Annuity Wrap Fees. Variable annuities are insurance products that invest in mutual funds. Internal investment gains in such annuities are tax-deferred but the product is subject to commissions. Therefore, one must ask if it is prudent to invest in a variable annuity and pay for commissions if gains under an ERISA-covered plan are already tax deferred. Also, variable annuities have expenses that may be greater than the costs charged by mutual funds. These are wrapped into a single aggregate fee called a "wrap fee." Wrap fees include investment management fees, surrender charges, mortality and expense risk charges, administrative fees, fees and charges for other features, and bonus credits. Investing in a variable annuity could be considered imprudent if the same underlying mutual funds are available at a lower cost outside of the variable annuity.

5. Investment Management Fees. Investment management fees are fees for managing investment assets and they are usually charged as a percentage of the assets invested. These fees are usually deducted directly from the investment return.

6. Sales Charges. Sales charges are also known as loads or commissions. These are transaction costs for buying and selling investment products.

7. Revenue Sharing Arrangements. Revenue sharing is the practice by mutual funds or other investment providers of paying other plan service providers, e.g., the plan's recordkeeper or other third party administrator, for performing services that the mutual fund might otherwise be required to perform.

8. Float. Float refers to earnings retained by a service provider (usually a bank or brokerage company) that result from short-term investments in liquid accounts used to facilitate cash transactions. Funds held in these accounts could include funds to cover checks issued for benefit payments by benefit plans that are not yet presented for payment by the recipient, or uninvested funds awaiting investment instructions from a plan fiduciary. The Department of Labor requires service providers to inform plan fiduciaries of the existence of float and the circumstances under which it will be earned and retained. See FAB 2002-3.

Comment: There is recently introduced classification of mutual funds of which employers should be aware. These are so-called "R funds" which generally offer the same types of mutual funds that can be purchased through normal brokerage systems, but they are specifically designed for pension plan investments and often carry one or more of the above-referenced hidden fees.

C. Hidden Fee Litigation. A not unexpected by-product of the increased public and regulatory interest in 401(k) plan fees and expenses has been the filing of lawsuits against some of the nation's largest employers and investment providers charging that they breached their fiduciary duties by failing to monitor hidden fees (as well as hard dollar payments) and to establish and follow procedures to determine whether such payments were reasonable. The complaints filed against plan sponsors allege that the defendants failed to monitor and control, or even to inform themselves, of such payments, failed to establish procedures to determine that they were justified, and also failed to disclose such fees to plan participants.

1. The First Salvo. Claims by plan fiduciaries against service providers contending that the providers violated ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks).

a. Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006). This decision denied a motion for summary judgment by an investment provider that had been sued by the trustees of five employer sponsored retirement plans over the provider's receipt of fees from mutual funds offered as investment options under variable annuity contracts. The Court held that there were triable issues of fact as to the following issues:

i. Whether Nationwide was a plan fiduciary because it retained the discretion to add or delete fund options to the investment mix or whether it was a fiduciary merely as a result of initially choosing funds for its investment platform;

ii. Whether revenue sharing payments made to Nationwide were plan “assets” within the meaning of the prohibited transaction provisions of ERISA, notwithstanding an acknowledgement by the Court that assets held by mutual funds are not plan assets; and

iii. Whether Nationwide’s receipt of revenue sharing could have involved prohibited transactions even if revenue sharing payments are not plan “assets.” The Court noted that a trier of fact might be able draw the inference that Nationwide provided only nominal services to the plan and that service contracts with mutual funds pursuant to which revenue was shared were merely shelf space arrangements.

b. Ruppert v. Principal Life Insurance Company S.D. ILL.
Complaint alleges that Principal is a fiduciary by virtue of providing investment advice to plan participants and that it committed violations of Sections 406(b)(1) and 406(b)(3) of ERISA by receiving revenue sharing payments from mutual funds. The complaint contains additional allegations that Principal’s failure to disclose the existence of its revenue sharing arrangements to the plans and to participants was a fiduciary breach.

c. Phones Plus, Inc. v. Hartford Financial Services (D.Conn).
Complaint brought by a 401(k) plan fiduciary against the Hartford alleging that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients. As in the *Haddock* and *Ruppert* complaints, there is an allegation that revenue sharing payments are plan assets.

2. The Main Thrust. Participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlichter, Bogert & Denton of St. Louis, Mo. Defendants include sponsoring employers, plan committees, company officers, directors and employees, but not plan providers. The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers. Notwithstanding the fact that the mutual funds themselves were not joined as defendants, this claim is an indirect attack on excessive mutual fund expense ratios based on the contention that plan fiduciaries had a duty to challenge such fees.

a. List of cases:

- i. *Abbot v. Lockheed Martin Corp.* (S.D. Ill.)
- ii. *Beesley v. International Paper Company* (S.D. Ill.)
- iii. *George v. Kraft Foods Global, Inc.* (S.D. Ill.)

- iv Kanawi v. Bechtel corp. (N.D. Cal.)
- v. Loomis v. Exelon Corp. (N.D. Ill.) The claim for damages for investment losses in this case was dismissed on February 21, 2007).
- vi Martin v. Caterpillar, Inc. (W.D. Mo.)
- vii. Spano v. Boeing Co. (S.D. Ill.)
- viii. Taylor v. United Technologies Corp. (D. Conn.)
- ix. Will v. General Dynamics corp. (S.D. Ill.)

b. Issues.

- i. Whether defendants acted prudently in selecting investment options.
- ii Whether defendants are entitled to protection under Section 404(c) of ERISA.
- iii. Whether plan fiduciaries have a duty to seek mutual funds with the lowest expense ratios.
- iv. Whether the protection of Section 404(c) of ERISA is lost as a result of the failure to fully disclose to participants the amounts and nature of direct as well as hidden fees.
- v. Whether the failure to disclose direct and hidden fees to participants constitutes a fiduciary breach.

3. New Tactics - Additional Complaints Joining Providers. In December of 2006, the Schlicter law firm filed three new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers such as Fidelity Management Trust Company and Fidelity Management & Research Company claiming that they had breached their fiduciary duties by (i) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (ii) “secretly” charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

a. List of cases:

- i. Hecker v. Deere & Co. (W.D. Wis.)
- ii. Renfro v. Unisys Corp. (C.D. Cal.)
- iii. Kennedy v. ABB, Inc. (W.D. Mo.)

4. Implications of Hidden Fee Cases.

a. Since most of the cases are in the preliminary phases of litigation, it is unclear whether they will result in significant recoveries for the plaintiffs.

b. Since the facts in these cases are very similar to those of many other employer sponsored 401(k) plans, victory by the plaintiffs would mean that these plans would face a significant exposure to liability.

c. Additional law suits are likely to be filed and some copycat claims have already been made.

d. Publicity generated by the litigation will increase the pressure to make regulatory as well as legislative changes that will require detailed fee disclosures by plan sponsors. In any event sponsors are, themselves, likely to demand more extensive disclosure from plan providers in order to protect themselves against claims.

D. Department of Labor Initiatives on Disclosure.

1. Form 5500 Reporting.

a. Current Rule. Fees and expenses paid by the plan must be disclosed on the Form 5500 using either the Schedule A which is used to report commissions or related fees paid to insurance companies or the Schedule C which is used to report fees paid to service providers. Service providers, such as insurance companies, have traditionally narrowly interpreted their duty to disclose. For example, investment management fees, soft dollars and internal fund expenses are not disclosed on either Schedule A or C of the Form 5500. There is little reporting of hidden fees.

b. Proposal. In July of 2006, the Department of Labor proposed changes to Schedule C that would require reporting of virtually all “indirect compensation,” i.e., payments to plan service providers by third parties “in connection with that person’s position with the plan or services rendered to the plan.” This would effectively place the burden of obtaining such information on the plan administrator and in this regard does not necessarily require the cooperation of service providers.

2. Change to Prohibited Transaction Regulations. Plan service providers are parties in interest to a plan, and as such, must satisfy the statutory and regulatory conditions for exemption from the prohibited transaction rules. Under DOL Regulation Section 2550.408b-2(a), these conditions require the services to be “necessary,” that the arrangement under which they are provided be “reasonable,” and that no more than “reasonable compensation” be paid for the services. The Department of Labor is reported to be considering a proposal to amend this regulation to make disclosure by the service provider a condition of exemption. The required disclosure would likely be designed to ensure that service providers furnish a plan fiduciary with information sufficient to allow the plan fiduciary to determine

a. Whether the plan is paying reasonable fees for services,

b. Whether the service provider’s total compensation, including indirect payments from third parties, is reasonable, and

c. Whether the service provider's advice is affected by conflicts of interest.

E. Best Practices. The Department of Labor ("DOL") has made it clear that in enforcing ERISA they will not judge fiduciaries on the results they achieve, but on the processes they follow. Such processes should not be static but should change with the times. For example, processes that were appropriate in 1974 would not necessarily be appropriate in 2007, because fiduciaries are being held to increasingly greater expectations. So, as standards for fiduciaries evolve, fiduciaries should take the steps to withstand a challenge from the DOL. Such steps include the following:

1. Identify Fees. Make a concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Obtain an exact dollar breakdown of the amounts being charged.

2. Disclosure. Make sure that all fees, including soft dollar and revenue sharing arrangements, are fully disclosed to participants.

3. Draft and Follow a Written Investment Policy Statement. ERISA requires an investment policy. While not required to be in writing, it is easier to demonstrate compliance with the policy statement if it is in writing. A policy statement should include clear standards for choosing investments, how they will be monitored and what triggers must occur to place an investment manager on a watch list. The roles of interested parties should also be clearly stated. The policy should contain enough detail so that the DOL (or a plaintiff's counsel) can clearly understand how or why an investment decision was made. The investment policy should be reviewed annually and modified as necessary.

4. Document Reviews of Investment Vehicles. Fiduciaries should document their reviews of investment vehicles, including negotiations related to direct as well as hidden fees. Such documentation should address key questions or discussions, and decisions made. The ability to provide documentation demonstrates a thoughtful process and alleviates the need to rely on memory.

5. Continuous Monitoring. Continuous monitoring should be the standard for all plans, and when appropriate, quarterly reporting for all but the smallest plans. Monitoring should directly reference back to the investment policy. Monitoring should also include a broad range of qualitative and quantitative metrics for each fund and/or manager. Fiduciaries should understand what the analysis means for the plan and the participants (*e.g.*, what are the fees? are they reasonable with respect to the services being provided?)

6. Utilize an Independent Third Party Investment Expert. Vendors often provide reporting and recommendations for analysis, placing funds on watch or replacing funds. However, there is an inherent conflict of interest when vendors report on proprietary funds, sub-advised funds and even nonproprietary funds where long-term business relationships and revenue agreements entwine with the investment decision process. As a result, fiduciaries should consider using the advice of an independent third party investment expert.

7. Replace Funds that Do Not Meet Investment Criteria. Many fiduciaries are reluctant to make decisions to replace poorly performing funds, and as a result, often add investment vehicles without removing the fund that the new investment vehicle was intended to replace. This could demonstrate an unwillingness on the fiduciary's part to perform his or her duties as required under ERISA.

8. Expense Ratios/Fees. An investment's expense ratio or manager's fees should not be above the median of its peer group (exceptions may be made for funds or managers with superior performance).

9. Conduct Fiduciary Audit. When appropriate, the fiduciary should hire an independent third party to conduct a fiduciary audit. A fiduciary audit should be conducted when vendors fail to adequately disclose fees or fees do not seem reasonable.

III. Do You Need Professional Liability Insurance? Under ERISA, fiduciaries may be held personally responsible for losses resulting from a breach of their responsibilities in the administration of employee benefit plans, the handling of plan assets or the rendering of investment advice. Professional liability insurance is not required by ERISA but is strongly recommended, since retirement plans and fiduciaries are increasingly the prey of litigation.

Professional liability insurance (which may also be called errors and omission insurance and may be combined with other coverages, such as directors and officers insurance or employment practices liability insurance) should be distinguished from fidelity bonds that must be obtained by certain fiduciaries that handle plan assets and that protect a plan in the event of fiduciary dishonesty but offer no protection for fiduciaries themselves. In addition, it should not be confused with fiduciary liability insurance that is purchased by a plan sponsor.

When buying professional liability insurance, you should evaluate the insurance carriers based on their experience, claims handling and financial strength. Three of the most prominent carriers in the field today are Chubb, the Hartford and AIG.

In addition to the characteristics of the carrier, it is imperative that you thoroughly analyze the terms of the policy before you buy. You should make sure that the definition of professional services that are covered by the policy is broad enough to cover all of your firm's activities.

You must also determine whether you can live with the policy's exclusions. In certain cases, identifying exclusions will not be difficult. For example, most policies will contain an endorsement (*i.e.*, an additional schedule or addendum to the policy) excluding late trading and market timing activities. Nevertheless, such an endorsement can often be deleted through negotiation if the insured has a good history on the issue. In today's environment, an endorsement that precludes coverage of liability arising from soft dollar or revenue sharing arrangements may be more difficult to negotiate away. However, while it may require the assistance of a skilled broker and detailed disclosure of a fiduciary's soft dollar practices, it is still possible to have such an exclusion removed.

Not all exclusions appear in separate policy endorsements, and prospective purchasers of professional liability insurance must carefully read the policy itself for embedded exclusionary language. You should consider avoiding a policy that contains language excluding complaints arising out of disputes over fees, commissions, or compensation.

IV. The Benefits of a Fiduciary Audit. In today's environment, the financial integrity of employee benefit plans is subject to heightened scrutiny. ERISA requires most plans with 100 or more eligible participants to undergo an annual audit as part of the plan's obligation to file an annual Form 5500. Typically, the accounting firm prepares a plan financial statement which includes a representation that the plan has been operated in accordance with its terms and applicable law. Plans with fewer than 100 eligible participants may also be subject to the audit requirement if they fail to meet certain conditions relating to their plan investments, bonding, and disclosure requirements.

If the audit or resulting plan financial statements are found to be inadequate, the Department of Labor will reject the Form 5500 and treat it as if it had not been filed. The likelihood of this occurring has increased, since the Department began an enforcement initiative in April of 2005 in response to unacceptably high levels of audit failure. One of the common audit deficiencies noted by the Department of Labor relates to an accounting firm's failure to document an understanding of the plan's internal controls. It is important to understand that internal controls are not the numbers resulting from a financial audit but the process by which they are determined. Thus, it has become more important than ever for plans to have effective procedures in place with respect to matters such as administration and investments.

The enhanced role of internal controls is seen in Section 404 of Sarbanes-Oxley which requires the management of public companies to establish, maintain, and assess the effectiveness of internal control procedures for financial reporting, and also requires public accounting firms to attest to and report on management's assessment. These requirements presumably extend to benefit expenses included in a company's financial statements. And while Sarbanes-Oxley is not technically applicable to private employers and tax-exempts, the standards it has established are rapidly becoming the norm for such employers.

One response to the increasing demand for the creation and oversight of plan controls is the establishment of a fiduciary self-audit procedure. Third party specialists can be engaged to perform an independent review of a plan's controls. Among other things, this would include a review of the minutes of benefit and investment committees to ensure that decisions are fully and accurately documented. Contracts and fee arrangements with third-party service providers would be examined with the objective of avoiding conflicts of interest. By attending to such matters, a fiduciary audit would safeguard plan assets and also enable plan sponsors to identify and correct violations of tax qualification and ERISA requirements before an audit by the Internal Revenue Service or the Department of Labor. In short, a well designed fiduciary audit assists plan sponsors and other fiduciaries in fulfilling their fiduciary responsibilities.

V. New 403(b) Regulations.

On July 26, 2007, the Internal Revenue Service published its long awaited final regulations under Section 403(b) of the Internal Revenue Code of 1986 (the “Code”). The final regulations, which were issued in proposed form in November 2004, will replace regulations issued in 1964 that have not been comprehensively revised in more than 40 years.

The final regulations, like the proposed rules, consolidate legislative and regulatory developments over the last four decades that have significantly eroded the differences between 403(b) plans and other salary reduction arrangements such as 401(k) and 457(b) plans. While the new regulations generally codify existing rules, they also impose new documentary requirements; eliminate good faith compliance with the statutory nondiscrimination requirements for nonelective contributions; and generally narrow the universal availability standard for elective deferrals by requiring that each employee have an effective opportunity to make deferrals and limiting some of the categories of employees that may be excluded in applying the universal availability requirement.

In conjunction with the issuance of the IRS regulations, the Department of Labor has issued Field Assistance Bulletin 2007-2 in which it discusses the impact of the IRS’s final regulations on its safe harbor regulation under which employer programs for the purchase of annuity contracts or custodial accounts funded solely through salary reduction agreements are not treated as employee pension benefit plans for purposes of Title I of the Employee Retirement Income Security Act of 1974 (“ERISA”).

The IRS’s final regulations are generally effective January 1, 2009, although deferred effective dates apply to certain church plans and 403(b) plans maintained pursuant to a collective bargaining agreement in effect on July 26, 2007.

A. **Statutory Background.** Section 403(b) of the Code provides an exclusion from an employee’s gross income for contributions made by an eligible employer to purchase an annuity contract for the employee’s benefit. A 403(b) plan may be funded in one of three ways:

1. Through annuity contracts issued by an insurance company and purchased for the employee by the employer;
2. Through custodial accounts meeting the requirements of Section 401(f)(2) of the Code and invested solely in mutual funds, which are treated as annuity contracts under Section 403(b)(7) of the Code; and
3. In the case of a church employer, through retirement income accounts.

To qualify for the exclusion from gross income provided by Section 403(b) of the Code, contributions under the 403(b) plan must be nonforfeitable, meet certain nondiscrimination requirements and be limited in amount.

B. 403(b) vs. 401(k). While the effect of various amendments made to Section 403(b) of the Code in the past 40 years has been to diminish the distinctions between 403(b) plans and other tax-favored employer-provided retirement plans (such as 401(k) plans and 457(b) plans for state and local government entities), the following significant differences continue to exist:

1. 403(b) plans are limited to certain employers and employees, *i.e.*, employees of a public school, employees of an organization exempt from tax under Section 501(c)(3) of the Code, and certain ministers.
2. 403(b) plans may only be funded with an annuity contract, a custodial account holding only mutual fund shares, or a church retirement income account.
3. The coverage and nondiscrimination rules applicable to elective contributions under 401(k) plans do not apply to 403(b) plans. Instead, there is a universal availability requirement for elective deferrals.
4. The consequences of failing to satisfy many of the Section 403(b) rules differ, and frequently are less severe, than their qualified plan counterparts.
5. The Code Section 415 plan aggregation rules apply differently to 403(b) plans.
6. Catch-up elective deferrals unique to 403(b) plans are not available under the other types of plans that permit employee elective contributions.
7. Employers may make nonelective contributions for former employees for up to five taxable years after termination of employment.

C. Plan Document Requirement. A major change effected by the final (and proposed) regulations, and consistent with the trend toward making 403(b) plans and qualified plans uniform, is the new requirement that a 403(b) plan be maintained pursuant to a written defined contribution plan which, in both form and operation, satisfies the Section 403(b) regulations. The plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, and the time and form under which distributions will be made. The plan may incorporate by reference other documents, such as the insurance policy or custodial agreement, which, as a result of the reference, become part of the plan. In the event of any conflict between the plan and documents incorporated by reference, the plan governs. The plan document may allocate responsibility for performing administrative functions and must identify who is responsible for complying with those Code requirements, such as loans and hardship withdrawals, that apply on an aggregated basis to all contracts issued to a participant. The IRS has stated that it expects to publish guidance that includes model plan provisions that may be used by public school employers to satisfy the written plan requirement.

Responding to concerns that the adoption of a written plan document would jeopardize the exclusion from ERISA coverage of salary reduction-only plans under the Department of Labor's safe harbor for Section 403(b) programs, Field Assistance Bulletin 2007-2 addresses the

interaction of ERISA and the final IRS regulations. Specifically, the Field Assistance Bulletin provides guidance (to the Employee Benefits Security Administration's national and regional offices) on the extent to which compliance with the IRS regulations would cause employers to exceed the limitations on employer involvement permitted under the Department of Labor's safe harbor.

According to the Department, the following activities by an employer would not cause its tax sheltered annuity program to be excluded from the safe harbor:

- conducting administrative reviews of the program's structure and operation for tax compliance defects;
- discrimination testing and compliance with maximum contribution limitations under the IRS regulations;
- fashioning and proposing corrections of operational failures;
- developing improvements to the program's administrative processes to avoid the recurrence of tax defects;
- obtaining the cooperation of independent entities involved in the program to correct tax defects;
- keeping records of its activities;
- terminating the program in accordance with the IRS regulations;
- certifying to an annuity provider facts within the employer's knowledge, such as employee addresses, service records and compensation levels; or
- limiting the funding media or products available to employees, or the annuity providers that may approach an employee, to a number designed to afford employees a reasonable choice of investments.

The Field Assistance Bulletin confirms, however, that an employer could not remain within the safe harbor if it had responsibility to make, or in fact made, discretionary determinations in administering the program, such as authorizing plan-to-plan transfers, processing distributions, satisfying joint and survivor annuity requirements, or making determinations with respect to hardship distributions, qualified domestic relations orders or eligibility for, or enforcement of, loans.

The Field Assistance Bulletin concludes that tax exempt employers will be able to comply with the new IRS 403(b) regulations while remaining within the Department of Labor's safe harbor, although the question of whether any particular employer has established or maintains an ERISA plan as a result of complying with the IRS's 403(b) regulations will continue to be determined on case-by-case basis.

D. Nondiscrimination Rules. Nonelective contributions – For contributions other than elective deferrals, the IRS's final regulations replace the nondiscrimination standard that previously applied under Notice 89-23 (a reasonable, good faith interpretation of the statutory nondiscrimination rules in Section 403(b)(12) of the Code) with the same rules that apply to employer contributions to qualified plans. As a result, contributions to a 403(b) plan, other than elective deferrals and after-tax employee contributions, must satisfy the coverage and amount testing that apply to such contributions when made under a qualified plan. Similarly, matching and after-tax employee contributions must satisfy the actual contribution percentage test that

applies to qualified plans. A failure to satisfy these nondiscrimination requirements or the universal availability requirement described below affects all contracts issued under the plan.

Elective deferrals; Universal Availability. Elective deferrals under a 403(b) plan are not subject to the above nondiscrimination requirements. Instead, there is a universal availability requirement: if any employee of the employer is eligible to make elective deferrals, all employees must be eligible. To be considered eligible to make an elective deferral, an employee must have an effective opportunity to make or change a deferral election at least once each plan year, as well as notice of the availability of the right to make an elective deferral, the period of time during which an election to defer may be made and any other conditions on deferral elections. Eligibility to make elective deferrals may be conditioned upon deferring more than \$200 each year. Under the final regulations, the right to make elective deferrals includes the right to designate elective deferrals as Roth contributions if any employee of the employer may elect to make designated Roth contributions.

For purposes of determining whether all employees are eligible to make elective deferrals, the following categories of employees are not taken into account:

1. Employees who are eligible to make elective deferrals under another 403(b) plan or a 457(b) eligible governmental plan of the employer;
2. Employees who are eligible to make a cash or deferred election under a 401(k) plan of the employer;
3. Nonresident aliens;
4. Students performing services for a school; and
5. Employees who normally work less than 20 hours per week (or a lower number of hours per week specified in the plan).

Collectively bargained employees, employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan, visiting professors at public schools and religious order employees who have taken a vow of poverty are not excluded under the universal availability rule, even though they had been excluded under earlier IRS guidance. While the last three categories of employees are not excluded in the final regulations, the preamble to the regulations explain that other rules may provide relief for individuals who are under a vow of poverty and certain university professors. Moreover, there is transition relief for all four categories of employees.

Subject to the above exclusions, the employees who are looked at to determine whether there is universal availability are all employees of the employer (see subsection I for a discussion of the rules for determining when separate tax exempt entities must be treated as a single employer). If the 403(b) plan covers the employees of more than one Section 501(c)(3) organization, the universal availability requirement applies separately to each common law entity, *i.e.*, each Section 501(c)(3) organization. In the case of a 403(b) plan that covers employees of more than one State entity, the universal availability requirement is applied separately to each

entity that is not part of a common payroll. Finally, if an employer has historically treated one or more of its geographically distinct units (i.e., units in separate Standard Metropolitan Statistical Areas) as separate for employee benefit purposes, it may treat the unit as a separate organization for purposes of the universal availability requirement if it is operated independently on a day-to-day basis.

Church plans; Governmental Plans. Church 403(b) plans are not subject to either the nondiscrimination rules described above or the universal availability rule. Governmental plans are subject to the universal availability requirement and to the requirement that compensation in excess of the Code Section 401(a)(17) limit may not be taken into account, but are not subject to the other nondiscrimination rules.

E. Contributions; Limits on Contributions. The exclusion from income provided by Section 403(b) of the Code applies only to amounts that do not exceed the limit on elective deferrals under Section 402(g) and the overall limit on annual additions in Section 415 of the Code. The limit on elective deferrals, including elective deferrals under all other plans, contracts or arrangements of the employer, must be stated in the annuity contract.

Overall Limit on Contributions. Contributions for a participant under a 403(b) plan (nonelective employer contributions, including matching contributions, elective deferrals and after-tax employee contributions) must not exceed the overall limit on contributions under Section 415 of the Code (\$45,000 for 2007). For purposes of Section 415, a 403(b) plan is treated as a plan maintained by the employee rather than the employer (even if the 403(b) plan is established and maintained by the employee's employer and covered by Title I of ERISA), unless the employee controls either the employer maintaining the 403(b) plan or another employer. If the employee controls any employer, then the 403(b) plan is treated as a defined contribution plan maintained by both the controlled employer and the participant and is aggregated for purposes of Section 415 with any other defined contribution plans maintained by the controlled employer. For example, if a doctor is employed by (but does not control) a nonprofit hospital which is tax exempt under Section 501(c)(3) of the Code and which maintains a 403(b) plan for the doctor, and the doctor also owns more than 50% of a professional corporation by which he or she is employed, any defined contribution plan maintained by the professional corporation must be aggregated with the hospital's 403(b) plan for purposes of Section 415. This is the case whether the 403(b) contributions are elective deferrals by the doctor or nonelective (or matching) contributions by the hospital. Because of this aggregation rule, it is important that any employer contributing to a 403(b) plan for an employee obtain information from participants regarding other employers controlled by the participant and plans maintained by those controlled employers in order to monitor compliance with applicable limitations and to comply with reporting and withholding obligations.

Catch-Up Contributions. Age 50 catch-up contributions (which are not subject to the Section 415 overall limit) are permitted under 403(b) plans, as is a special catch-up election under Code Section 402(g)(7) (which is subject to Section 415) for employees who have completed 15 or more years of service with an educational organization, hospital or certain other organizations described in the regulations. The final regulations have expanded the list of organizations whose employees qualify for this catch-up provision to include adoption agencies and agencies assisting substance abusers and the disabled. Under the special 403(b) catch-up

election, employees with the requisite number of years of service with a qualifying organization may make an additional elective deferral each year of up to \$3,000. Where an employee is eligible to make both the special 403(b) catch-up election and age 50 catch-up contributions, catch-up contributions are treated first as made under the special 403(b) catch-up election and then under the age 50 catch-up provision.

Former Employees. For purposes of applying the contribution limits to a 403(b) plan, a former employee is deemed to have includible compensation until the end of the fifth complete taxable year of the employee beginning after termination of employment (which could be a period approaching six years, depending upon when employment terminates). Based upon this compensation, the employer may continue to contribute to a 403(b) plan on behalf of a former employee, subject to the Section 415 limit (either the applicable dollar limit or 100% of the former employee's includible compensation, whichever is less). Unlike severance payments made directly to the former employee, these contributions would not be subject to FICA taxes. They are, however, subject to the nondiscrimination requirements applicable to nonelective employer contributions.

The final regulations also permit elective deferrals to be made from the same post-employment compensation as is permitted for 401(k) plans under the final Section 415 regulations, *i.e.*, certain compensation paid by the later of 2-1/2 months after severance from employment or the end of the limitation year in which severance from employment occurs. This change applies for taxable years beginning on or after July 1, 2007.

Excess Contributions. Any contribution made to a 403(b) plan for a year on behalf of an employee that exceeds the above limits is includible in the employee's income for that year. If the contribution exceeds the overall limit under Section 415 of the Code, it must be held in a separate account; if it is not, the annuity contract ceases to be a 403(b) contract. Any excess allocated to a separate account may be distributed to the employee. Excess deferrals may be distributed by April 15 following the taxable year in which contributed (together with allocable income). In this case, the excess deferral is included in the employee's income for the year of deferral and the income is included in the employee's gross income for the year of distribution. If distributed after April 15, there would also be a 10% penalty tax for early distribution.

Time for Contributions. Contributions to a 403(b) plan must be transferred to the insurance company issuing the annuity contract (or to the entity holding assets of a custodial or retirement income account treated as an annuity contract) within a period that is no longer than is reasonable for the proper administration of the plan. A plan may require the transfer of elective deferrals within a specified period after the amounts would otherwise have been paid to the participant, such as within 15 business days following the month in which the amounts would otherwise have been paid. If the 403(b) plan is subject to Title I of ERISA, Department of Labor regulations would require elective deferrals to be transferred to the annuity contract as soon as reasonably practicable but in no event later than 15 business days following the month in which the amounts would otherwise have been paid to the employee.

F. Distributions. When distributions may be made from a 403(b) plan depends upon the type of contribution involved and the funding medium in which it is held in the 403(b) plan.

Amounts Not Held in a Custodial Account and Not Attributable to Elective Deferrals. These amounts may be distributed no earlier than the first to occur of the employee's severance from employment or the occurrence of an identified event, such as the occurrence of a financial need (including a need to buy a home), the passage of a fixed number of years, the attainment of a stated age or disability. After-tax employee contributions (and earnings) and excess deferrals are not subject to this distribution restriction. Nor does it apply to prevent distributions on termination of a 403(b) plan.

Amounts Held in a Custodial Account that are Not Attributable to Elective Deferrals. These amounts may not be distributed before the employee severs from employment, dies, becomes disabled or attains age 59-1/2. Amounts transferred from a custodial account to an annuity contract or retirement income account (in the case of a church plan), including earnings, continue to be subject to this distribution restriction.

Amounts Attributable to Elective Deferrals. These amounts are subject to the same distribution restrictions as amounts held in a custodial account, except that they may be distributed earlier on account of the employee's hardship. The amount that may be distributed on account of hardship, and the circumstances that constitute a hardship, are determined in the same way as under Section 401(k) of the Code and may not exceed the employee's aggregate elective deferrals, not including earnings. If the 403(b) plan includes both elective deferrals and other contributions, the elective deferrals must be maintained in a separate account to be distributable on account of hardship.

Severance from Employment. For purposes of the distribution rules, a severance from employment occurs when an employee ceases to be an employee of the eligible employer (including other entities treated, under the controlled group rules described in subsection I, as the same employer as the employer maintaining the plan) that maintains the 403(b) plan. There is therefore no severance from employment if the employee transfers from one Section 501(c)(3) organization to another such organization that is treated as the same employer under the controlled group rules. There is, however, a severance from employment when an employee of a Section 501(c)(3) organization transfers to another entity that is treated as the same employer but is not an eligible employer (for example, to a for-profit subsidiary of a non-profit organization) or to employment that is not employment with an eligible employer (for example, when an employee performing services for a public school continues to work for the same State employer).

Minimum Distribution. 403(b) plans are subject to the same minimum distribution rules as qualified plans, with some minor modifications. For this purpose, they are treated as IRAs under the minimum distribution rules of Code Section 401(a)(9), except that a surviving spouse may not elect to treat a 403(b) contract as his or her own contract.

Loans. Loans are permitted under 403(b) plans. Whether the availability of a loan, the making of a loan or a failure to repay a loan is to be treated as a distribution depends on the facts and circumstances.

Termination of 403(b) Plan. The final regulations permit a 403(b) plan to be terminated or amended to eliminate future contributions for existing participants or to limit participation to existing participants and employees (subject to the nondiscrimination requirements discussed above, including the universal availability rule). On plan termination, accumulated benefits must be distributed as soon as possible, and this may be accomplished by the delivery of a fully paid individual annuity contract. If the distribution restrictions on elective deferrals and custodial accounts described above apply to the 403(b) plan, the plan may be terminated (and accumulated benefits distributed) only if the employer (including all entities that are treated as the same employer under the controlled group rules) does not contribute to any other 403(b) plan during the period beginning on the date of plan termination and ending 12 months after the distribution of all assets from the terminated plan. An exception applies if fewer than 2% of the employees under the terminated plan are eligible under the alternative 403(b) plan.

Qualified Domestic Relations Orders. A distribution from a 403(b) plan pursuant to a qualified domestic relations order is permitted even if the employee from whose contract distribution is made has not had a severance from employment or other event permitting a distribution.

Transfers. The final regulations permit three types of transfers from annuity contracts that are not treated as distributions:

1. An exchange of one 403(b) contract for another within a plan;
2. A transfer of the assets of a 403(b) plan to another 403(b) plan; and
3. A transfer of the assets of a 403(b) plan to a qualified plan to purchase permissive service credit under the receiving defined benefit plan.

Contract exchanges within the same plan are permitted if the 403(b) plan provides for the exchange; the employee's accumulated benefit is not reduced by the exchange; the new contract is subject to the same (or more stringent) distribution restrictions as the exchanged contract; and the employer enters into an agreement with the issuer of the new contract under which the employer and the issuer will provide each other with certain information.

A plan-to-plan transfer is permitted if the participant or beneficiary for whom or with respect to whom the transfer is made is an employee or former employee of the employer for the receiving plan; both the transferor and transferee plan provide for transfers; the participant's or beneficiary's accumulated benefit is not reduced by the transfer; and the transferee plan imposes the same (or more stringent) distribution restrictions on the transferred amount and treats the amount transferred as a continuation of the participant's or beneficiary's interest in the transferor plan.

Except in the case of permissive service credit, a transfer may not be made from a 403(b) plan to a qualified plan or to a 457(b) eligible governmental plan.

Rollovers. Amounts distributed from a 403(b) plan may be rolled over, either by means of a direct rollover or within 60 days of the distribution, to an eligible retirement plan. An eligible retirement plan includes a qualified plan, a 403(a) annuity plan, a 457(b) eligible governmental plan, an individual retirement account or annuity, and another 403(b) plan. Amounts that are not taxable upon distribution may only be rolled over by means of a direct rollover, except where the rollover is to an IRA.

The 403(b) plan must permit direct rollovers of eligible rollover distributions and the payor must provide the distributee with a notice of rollover rights under Section 402(f) of the Code. The 20% income tax withholding on eligible rollover distributions that are not directly rolled over applies to distributions from a 403(b) plan, as does the automatic rollover requirement of Code Section 401(a)(31) for mandatory distributions where the distributee does not affirmatively elect a direct rollover or a distribution.

G. Effect of Failure to Satisfy Section 403(b). The effect of failing to satisfy the requirements of the regulations varies with the type of failure. If there is a failure that relates to the annuity contract of one individual only (for example, an excess contribution), since all annuity contracts purchased for an individual by an employer are treated as a single contract, any other contract purchased for that individual by that employer will also be treated as failing to satisfy Section 403(b) of the Code. Other individuals covered by the 403(b) plan are not affected.

A failure to operate in accordance with the terms of the 403(b) plan affects all of the contracts issued to the employee or employees with respect to whom the operational failure occurs. It does not affect other individuals covered by the 403(b) plan unless the operational failure involves noncompliance with the discrimination requirements or the employer is not an employer eligible to maintain a 403(b) plan. If the nondiscrimination requirements are not met, the employer is not an eligible employer or there is no written plan, all contracts issued under the plan fail to be Section 403(b) annuity contracts, and all contributions and earnings would be taxable to employees.

H. Controlled Group Rules for Tax Exempt Organizations. The employer for a plan maintained by a tax exempt organization includes the organization whose employees participate in the plan and other organizations with which it is under common control. The common control rules must be considered when applying the nondiscrimination requirements, the overall limit on benefits and contributions under Section 415 of the Code and the minimum distribution rules under Section 401(a)(9) of the Code. While the controlled group rules generally do not apply to church entities or governmental entities (such as public schools), they apply for purposes beyond Section 403(b) of the Code including for purposes of the qualification rules relating to Section 401(a) plans.

Common control generally exists between two exempt organizations if at least 80% of the directors or trustees of one organization are representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is a representative of another organization if he or she is a trustee, director, agent or employee of the other organization. A trustee or director is controlled by another organization if that other organization has the general power to remove the trustee or director and designate a new trustee or director.

In addition to mandatory aggregation of exempt organizations, the regulations permit exempt organizations that maintain a single plan covering one or more employees of each organization to treat themselves as under common control if each organization regularly coordinates its day-to-day activities with the other. As an example, emergency relief organizations operating within different geographic regions may treat themselves as under common control if they have a single plan covering employees of both entities and regularly coordinate their day-to-day exempt activities. Similarly, an exempt hospital and another exempt organization with which it coordinates the delivery of medical services or medical research may treat themselves as under common control in an appropriate case. The final regulations authorize the IRS to issue further rules or rulings permitting permissive aggregation of tax exempt entities. Permissive disaggregation is permitted between churches and entities that are not churches that jointly contribute to a church plan. Finally, the regulations authorize the IRS to treat an entity (including a taxable entity) as being under common control with an exempt organization if the entities are structured to avoid or evade the common control rules or other requirements under Section 401(a), 403(b) or 457(b) of the Code.

I. Effective Dates. The final regulations are generally applicable for taxable years beginning after December 31, 2008.

Collective Bargaining Agreements. If a 403(b) plan is maintained under one or more collective bargaining agreements in effect on July 26, 2007, the regulations do not apply before the earlier of the date on which the last collective bargaining agreement terminates or July 26, 2010.

Church-Related Organizations. If authority to amend a 403(b) plan is held by a church convention, the regulations do not apply until the first plan year beginning after December 31, 2009.

Transition Rules. The universal availability rule does not apply to plans that exclude certain categories of employees on July 26, 2007, until the first taxable year beginning after December 31, 2009. The excluded categories of employees are those who make a one-time election to participate in a governmental plan, certain visiting professors and religious order employees who have taken a vow of poverty. Where collectively bargained employees are excluded from eligibility to make elective deferrals, the universal availability rule does not apply until the first taxable year beginning after December 31, 2008, or, if later, the first to occur of the date on which the collective bargaining agreement terminates or July 26, 2010.

Governmental Plans. Governmental plans that exclude the categories of employees mentioned above have until January 1, 2011, or the earlier close of the first post-2008 legislative session of the body with authority to amend the plan.

In-Service Distributions. The prohibition on in-service distributions of nonelective contributions from annuity contracts does not apply to contracts issued before January 1, 2009, and any amendment to a 403(b) plan to eliminate in-service distributions is not subject to the anti-cutback rules if adopted before January 1, 2009.

Designated Roth Contributions. The provisions of the regulations addressing Roth contributions are effective for taxable years beginning after 2006.

Special Rules for Certain Contracts. The final regulations limit the types of contracts that qualify as an annuity contract. For example, life insurance, endowment and health or accident insurance contracts do not qualify. This new rule does not apply to a contract issued before September 24, 2007.

The changes to the rules governing contact exchanges do not apply to a contract received in an exchange that occurs before September 25, 2007, provided the exchange satisfied the IRS guidance in effect at the time of the exchange.

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