Leaders need to pay close attention to the final 403(b) regulations

By Danny Miller

The Internal Revenue Services (IRS) issued revised final regulations under Internal Revenue Code section 403(b) in July of 2007. This rewrite of the 403(b) regulations was the first major revision of these regulations in more than 40 years and reflects many changes that have occurred to Code section 403(b) during that period.

One of the major changes to section 403(b) occurred through enactment of the Tax Equity and Fiscal Responsibility Act of 1982, when Congress added a new type of 403(b) funding vehicle for churches — church retirement income accounts described in Code section 403(b)(9). The regulations contain an entire section devoted to church retirement income account programs, for the first time gathering into one place in the regulations (Treas. Reg. § 1.403(b)-9) the special rules governing (b)(9) retirement income accounts.

As a quick reminder, 403(b) contemplates three types of funding vehicles:

- Annuity contracts issued by licensed insurance companies (referred to as "(b)(1)" annuity contracts)
- Custodial accounts maintained with mutual fund companies providing registered mutual funds as the only investment options under the 403(b) plan (referred to as "(b)(7)" custodial accounts)
- The 403(b)(9) retirement income accounts (which are not limited to investing in insurance company annuity contracts or registered mutual funds — a (b)(9) can invest in any assets other than those designed for personal use, like an automobile, antiques or art)

The final 403(b) regulations clear up an issue involving 403(b) arrangements adopted by churches other than through a denominational 403(b) plan (e.g., a 403(b) plan adopted by an independent, nondenominational church). It has been a common practice for a church in this situation to sponsor a 403(b) annuity contract or custodial account purchased from an insurance company or mutual fund family, and the documentation related to the annuity contract or custodial account would typically describe the church's 403(b) arrangement as (b)(1)s or (b)(7)s, respectively.

Which account does your church have?

But a church (b)(9) retirement income account can invest in anything, including insurance company annuity contracts or registered mutual funds. So, in this situation, what does the church have — a (b)(9), a (b)(1) or a (b)(7)? This question is especially important in the case of registered mutual fund purchases, because all (b)(7) assets must be subjected to distribution restrictions, while only employee elective deferrals need to be so restricted in the case of (b)(9) retirement income accounts, and excess contributions to a (b)(7) are subject to an excise tax — that's not the case with a (b)(9).

The final 403(b) regulations resolve this issue — if a church wants the 403(b) plan it maintains to be a (b)(9) retirement income account program, it must say so — otherwise the program will be either a (b)(1) or a (b)(7), depending on the type of 403(b) funding vehicle purchased.

One of the 403(b) regulation requirements that was the subject of much comment when the regulations were issued in proposed form is the requirement that 403(b) plans must be maintained pursuant to a written plan document. However, as was the case under the proposed 403(b) regulations, this written plan document requirement does not apply if a church purchases a (b)(1) contract from an insurance company or a (b)(7) custodial account from a mutual fund family.

However, (b)(9) retirement income accounts are required to be maintained pursuant to a written plan document. (This is not an issue for all denominational plans with which I am familiar, as all have been maintained pursuant to fairly comprehensive written plan documents for some time.)

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BUT WAIT, THERE'S MORE

The final 403(b) regulations are not the only regulation provisions with January 1, 2009 effective dates. Church nonqualified plans are subject to the requirements of Code section 409A, and the plan document and election rules under that Code section become effective next January 1.

In addition, when the IRS released the 403(b) regulations, they also finalized regulations that determine when nonprofit employers are required to take other related employers into account for purposes of various benefits rules and testing. These "controlled group" regulations do not apply just to retirement plans, they also apply to cafeteria plans, self-funded medical plans and other types of welfare benefit arrangements.

Churches should also consider the possible impact of these two sets of regulations on their benefit programs.

Issues of interest to churches

The final 403(b) regulations address a number of other 403(b) issues of interest to churches. They reflect the special rule that permits service for a number of churches in a denomination to be aggregated for purposes of the special 403(b) "catch-up" contribution rule that is only available if an employee has 15 or more years of service with an employer; they clearly state that 403(b) plans maintained by churches and so-called "qualified" church-controlled organizations are not subject to any coverage and nondiscrimination rules, unlike most other non-governmental 403(b) plans; and they mirror the legislative history of 403(b)(9) which provides, among other things, that the assets of a 403(b)(9) retirement income account arrangement can be commingled for investment purposes with the assets of a section 401(a) qualified plan or other assets devoted exclusively to church purposes (e.g., church endowment funds).

Additional provisions

Two additional provisions of the final 403(b) regulations deserve mention. First, the regulations make it clear that, if an employer is contributing to more than one 403(b) vendor, 403(b) compliance must occur on a plan-wide (or vendor-wide) basis.

This means that, if a church contributes to its denominational 403(b) retirement plan on behalf of its pastors and employees, but also permits pastors or employees to contribute to another 403(b) provider or providers, the 403(b) rules (e.g., loan limits, hardship withdrawal requirements, and contribution limits) have to be applied to all of a participant's accounts on an aggregated basis, across all vendors. The final regulations make it clear that it's the employer's responsibility to make sure this compliance occurs, unless the employer delegates that duty to another organization.

The second provision involves a fairly common situation encountered by 403(b) employers (including churches) — that in which the employer has contributed to a 403(b) vendor in the past but is no longer contributing to that vendor (because the vendor is no longer an approved vendor under the plan, or the vendor is holding assets of a former employee). The revised, final 403(b) regulations become effective on January 1, 2009. Prior to that date, churches that have adopted 403(b)(9) retirement income account arrangements must have a written plan document in place (if they do not participate in a denominational 403(b) plan) that meets that requirement.

In addition, churches that allow their employees to contribute to more than one 403(b) vendor need to think through how 403(b) compliance can be carried out on a plan-wide (or vendor wide) basis going forward, and they also need to consider what action they should take, if any, with respect to orphan 403(b) contracts, including those maintained in behalf of former employees or beneficiaries of deceased employees. Welcome to the new world of 403(b).

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