Final 403(b) Regulations – Issues of Interest to Church Plans

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On July 23, 2007, the Internal Revenue Service (“IRS”) issued final regulations under section 403(b) of the Internal Revenue Code of 1986, as amended (“Code”). The Final Regulations are substantially the same as proposed regulations issued in 2004 (“Proposed Regulations”). Except as noted below, the Final Regulations are generally applicable for taxable years beginning after December 31, 2008. However, the Final Regulations can be relied on immediately, as long as such reliance is on a consistent and reasonable basis.

In drafting the Final Regulations, the IRS expressed an over-riding goal of diminishing the extent to which the rules governing section 403(b) plans differ from the rules governing other salary reduction programs, such as Code section 401(k) plans and Code section 457(b) plans.

The following summarizes the Final Regulations as they apply to church 403(b) plans, with emphasis on those portions of the Final Regulations that differ from the Proposed Regulations.

Terminology

Section 403(b) Plan and Section 403(b) Contract. The Final Regulations, like the Proposed Regulations, make a distinction between a “section 403(b) plan” and a “section 403(b) contract.”

According to the Final Regulations, a section 403(b) “plan” is “the plan of the employer under which the section 403(b) contracts for its employees are maintained.” A section 403(b) “contract” appears to be the underlying 403(b)(1) annuity contract, 403(b)(7) custodial account or 403(b)(9) retirement income account in which contributions are invested. ¹ For example, if an employer has entered into agreements with multiple mutual fund companies to fund 403(b)(7) custodial accounts, each of these agreements appears to be a separate 403(b) contract. All of these contracts together are then covered under the umbrella of a section 403(b) plan. The Final Regulations contemplate that, in a multiple vendor situation, there must be a single section 403(b) plan that wraps around all of the separate 403(b) contracts.

Comment: As we understand the IRS approach, a section 403(b) contract is the type of funding mechanism utilized under the employer’s section 403(b) plan.

¹ We say “appears to be” because, in certain contexts, the term “contract” could refer to what might commonly be considered to be the plan’s investment options, and in another context (dealing with the consequences of compliance failures) the term “contract” could be considered to be the participant’s plan account.
Thus, the Final Regulations contemplate that there can be multiple contracts within a single plan. However, the IRS is attempting to ensure that there is plan-wide compliance coordination with respect to the different contracts by treating them as part of a single plan.

Church and Church-Related Organization. The Final Regulations define “church” to include churches, conventions or associations of churches and qualified church-controlled organizations (“QCCOs”). The definition of the term “church-related organization” includes churches, conventions or associations of churches and church pension boards. However, as currently drafted, neither definition covers non-QCCOs, such as church-related hospitals, universities and nursing homes.

Comment: The Church Alliance, a coalition of the chief executive officers of around 40 church benefit programs submitted comments to the IRS on the Proposed Regulations requesting that these definitions be changed to include non-QCCOs. In an apparent attempt to address the issue raised by the Church Alliance, the IRS modified the definition of “church-related organization” in the Final Regulations. However, the revised definition, while an improvement, needs further revision.

Plan Document Requirement

The Final Regulations retain the requirement from the Proposed Regulations that all 403(b) contracts (i.e., all annuity contracts, custodial accounts and retirement income accounts) be maintained pursuant to a written plan document which satisfies the requirements of Code section 403(b) in both form and operation. The “plan” must contain all material provisions, including those relating to eligibility, benefits, applicable limitations, and the time and form under which benefit distributions will be made. In conjunction with this plan document requirement, the Final Regulations, like the Proposed Regulations, require 403(b) plans to contain certain specific provisions, including the Code section 402(g) limit on elective deferrals, the Code section 401(a)(9) minimum distribution requirements, and the Code section 401(a)(31) rollover requirements.

The Final Regulations do not require there to be a single plan document, and instead permit a 403(b) plan to incorporate other documents (including the underlying section 403(b) contracts) by reference to satisfy the plan document requirement.

Comment: In the case of a plan that is funded through multiple issuers, the Final Regulations contemplate that the employer will adopt a single plan document to coordinate administration among the issuers – essentially the plan document would wrap around all of these 403(b) contracts.

Note: This plan document requirement applies to church 403(b)(9) retirement income account programs. However, it apparently does not apply to 403(b)(7) custodial accounts or 403(b)(1) annuity contracts maintained by churches.
Delegation of Administrative Duties

The Final Regulations include a new provision to allow the plan document to coordinate responsibilities for administration. As discussed above, the Final Regulations contemplate a plan document that wraps around the separate 403(b) contracts that employers may have with different vendors. Under the Final Regulations, this plan document can allocate administrative duties (including the responsibility for 403(b) compliance) to persons or entities other than the employer. Any such allocation must identify who is responsible for compliance with the statutory and regulatory requirements that apply based on the aggregated contracts issued to a participant. The Final Regulations make it clear that these administrative responsibilities cannot be allocated to participants. This may mean that participants will not be able to “self-certify” their right to take certain actions, such as receive a plan loan.

Comment: The Final Regulations contemplate that a single entity will be responsible for coordinating plan administration, even if a plan is funded through multiple issuers, and that this entity will be the employer unless compliance duties are explicitly allocated to a vendor or third-party administrator. Thus, employers who utilize multiple vendors for their 403(b) programs will need to be sure that they coordinate compliance with the vendors. In the absence of any specific allocation of plan administration duties, the employer will be responsible for plan-wide compliance. This requirement will undoubtedly create administrative difficulties for employers trying to coordinate among multiple 403(b) vendors to ensure compliance with a number of requirements, such as the dollar limits on participant loans and the 6-month suspension of elective deferrals under the hardship distribution safe harbor, both of which apply to the aggregated contracts issued to each participant.

Contributions

The Final Regulations cover in great detail the contribution requirements applicable to 403(b) plans and include some newly-added provisions to allow for designated Roth contributions. Unless otherwise indicated, the provisions discussed below are essentially unchanged from the Proposed Regulations.

Elective Deferrals. The Final Regulations provide that a 403(b) elective deferral (including elective deferrals of designated Roth contributions) must be made pursuant to a cash or deferred election that meets the requirements of Code section 401(k) and the applicable regulations. That means that, as is true for 401(k) elective deferrals, 403(b) elective deferrals are subject to an anti-conditioning rule (modeled on the 401(k) anti-conditioning rule) so that employers generally cannot condition any other benefits on the employee’s election to contribute or not contribute to the 403(b) plan.

3 Note: The special provisions in the Final Regulations relating to designated Roth contributions apply for taxable years beginning on or after January 1, 2007.
**Special 15-Years of Service Catch-Up Contributions.** Code section 402(g)(7) permits a special catch-up contribution for employees who have 15 or more years of service with the same employer. This limit is the least of: (1) $3,000; (2) $15,000 less any prior pre-tax elective deferrals made pursuant to the special catch-up contributions rule, plus any designated Roth contributions; or (3) $5,000 multiplied by the employee’s years of service minus elective deferrals made in all prior years. The Final Regulations thus contemplate that information on elective deferrals will be maintained for all prior years in order to determine whether participants are eligible to make the catch-up contribution.  

**Comment:** Code section 402(g)(7) was amended in 2005 to take into account designated Roth contributions. As written, the statutory provision would reduce the aggregate $15,000 limit on section 402(g)(7) catch-up contributions by all designated Roth contributions, whether or not such designated Roth contributions were made pursuant to the special catch-up contribution rule. However, the preamble to the Final Regulations recognizes that the statutory language is inconsistent with legislative intent and notes that Treasury has recommended a change in the statutory language to provide that “the reduction for designated Roth contributions . . . be limited to designated Roth contributions that have been made pursuant to the special section 403(b) catch-up rules.”

**Ordering of Elective Deferrals.** The Final Regulations confirm the ordering rule for employees who are eligible for both age 50 catch-up contributions and also for “15 years of service” catch-up contributions. Elective deferrals by such employees are treated first as “15 years of service” catch-up contributions, and then as age 50 catch-up contributions. Thus, in the case of an employee who is eligible for both the “15 years of service” catch-up contribution and the age 50 catch-up contribution, elective deferrals in excess of the normal Code section 402(g) limits must first be treated as a “15 years of service” catch-up contributions, until the $15,000 lifetime limit on these contributions has been exhausted.

**Nonelective Contributions on Behalf of Former Employees.** The Code permits employers to make contributions to their 403(b) plans on behalf of former employees. The Final Regulations provide that any contributions made on behalf of former employees must be nonelective employer contributions. (No salary deferrals or employee after-tax contributions are permitted.) These nonelective contributions can be made through the fifth year following the year in which the participant terminated employment (which actually would permit contributions to be made for nearly six years following termination, in the case of an employee who separates from service early in the year). In making these contributions, a non-QCCO (or any other employer that is subject to the

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4 Approximately 20 years ago, Congress directed the IRS to come up with a different approach to calculating the third prong of the Code section 402(g)(7) limit because some employers had not maintained records distinguishing between elective and nonelective contributions made prior to the enactment of this provision. The Church Alliance’s comment on the Proposed Regulations reminded the IRS of this Congressional directive, but the IRS did not change this provision in the Final Regulations.
403(b) nondiscrimination rules) cannot discriminate in favor of former employees who were highly compensated employees within the meaning of Code section 414(q).  

**Vesting.** The Final Regulations allow 403(b) plans to include a vesting schedule for employer contributions, but non-vested amounts must be accounted for separately. The Final Regulations provide that the non-vested portion of a 403(b) contract will be treated as an annuity contract to which Code section 403(c) (or Code section 402(b), as appropriate) applies.

**Comment:** The value of a Code section 403(c) annuity contract (or a participant’s interest in a section 402(b) trust) is not taxable until the employee’s rights in the contract become vested. Thus, treating the non-vested portion as covered under Code section 403(c) (or section 402(b)) will not result in current taxation to the participant and, when vesting occurs, the newly-vested amount will not be taxable to the participant as long as all of the other section 403(b) requirements have been satisfied with respect to these amounts prior to becoming vested.

**Coordination of Contribution Limits Between 403(b) and 401(a).** The Final Regulations confirm that an employee who participates in both a 403(b) plan and a qualified 401(a) plan can take advantage of two 415(c) contribution limits, unless the employee controls the organization sponsoring the qualified 401(a) plan. This coordination rule had originally been based on language in Code section 415(e), which was repealed a number of years ago. However, the Final Regulations now provide a clear regulatory basis for claiming two different limits.

**Excess Contributions.** The Final Regulations provide that any contribution that exceeds either the Code section 415 maximum contribution limits or the Code section 402(g) elective deferral limit constitutes an excess contribution that is included in the participant’s gross income for the taxable year in which it was contributed and must be accounted for separately. The Final Regulations provide that, in general, the portion of the contract that includes any excess contribution will fail to be a 403(b) contract and will instead be a 403(c) contract or a 402(b) trust. The remaining portion of the contract that does not include any excess contributions will continue to be a 403(b) contract. However, a 403(b) plan may provide that contributions in excess of the Code section 402(g) limits (along with allocable net income) will be distributed by April 15 of the following taxable year.

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As discussed later in this summary, the 403(b) nondiscrimination and coverage rules do not apply to churches and QCCOs, but do apply to non-QCCOs.

The coordination provision is actually in Treas. Reg. § 1.415(f)-1(f)(2), which is cross-referenced in the Final Regulations.

If the excess contribution is subject to a vesting schedule, it is taxable in the year in which the excess contribution becomes nonforfeitable.
**Crediting Contributions.** The Final Regulations retain the requirement in the Proposed Regulations that contributions to a 403(b) plan be transmitted to the funding vehicle “within a period that is not longer than is reasonable for the proper administration of the plan.” The Final Regulations indicate that transferring elective deferrals within 15 business days following the month in which these amounts would otherwise have been paid to the participant is considered reasonable.\(^8\)

**Comment:** Although the Final Regulations do not specifically limit this requirement to salary reduction contributions, it is unclear what a “reasonable” period necessary “for the proper administration of the plan” means in the context of other types of contributions.

**Nondiscrimination and Coverage Requirements**

**General Rules.** Most 403(b) plans are subject to specific coverage and nondiscrimination requirements under Code section 403(b)(12). The nondiscrimination rules do not apply to churches or QCCOs. However, these rules are applicable to non-QCCOs, such as church-related hospitals, universities, colleges and nursing homes.

Currently, in accordance with guidance in Notice 89-23, 403(b) plans have been allowed to apply a “reasonable, good-faith standard” in satisfying these requirements. Notice 89-23 also includes two safe harbors that 403(b) plans can use to comply with the nondiscrimination and coverage requirements. Under the Final Regulations, however, Notice 89-23 will become obsolete, and 403(b) plans subject to the coverage and nondiscrimination rules will no longer be able to utilize the special coverage and nondiscrimination safe harbors contained in that Notice.

**Nondiscrimination Rule for Employer Contributions.** Like the Proposed Regulations, the Final Regulations require that employer contributions and employee after-tax contributions comply with the nondiscrimination requirements applicable to qualified plans. That means that 403(b) plans (again, other than those maintained by churches and QCCOs) must comply with the nondiscrimination requirements for contributions, benefits, and coverage under Code sections 401(a)(4) and 410(b), the limitation on the amount of compensation that can be taken into account under Code section 401(a)(17), and the average contribution percentage rules of Code section 401(m) (relating to matching and after-tax contributions).

**Universal Availability – Excludable Employees.** The Code requires that the right to make salary reduction contributions to a 403(b) plan must be universally available. Thus, if the employer allows one employee to make elective deferrals, all statutorily eligible

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\(^8\) This regulatory provision is similar to rules already applicable to ERISA plans, which require that elective deferrals must be paid to the plan trustee by the earliest date on which the contributions can be reasonably segregated from the employer’s general assets, but not later than the 15th business day of the month following the month in which the contributions would otherwise have been payable to the participant.
employees must be allowed to make elective deferrals. Under Notice 89-23, certain categories of employees could be excluded from plan participation, in addition to those categories that are excludable under Code section 403(b)(12). For example, Notice 89-23 allowed employers to exclude from plan participation certain visiting professors, employees affiliated with a religious order who have taken a vow of poverty, employees covered under a collective bargaining agreement, and employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan. The Final Regulations, like the Proposed Regulations, eliminate all of these additional participation exclusions. A plan containing these additional Notice 89-23 exclusions on July 26, 2007 generally has until the first day of the taxable year beginning after December 31, 2009 to eliminate them.

Comment: Although the Final Regulations eliminate the additional exclusions permitted under Notice 89-23, the preamble notes that other rules may provide relief with respect to individuals subject to a vow of poverty. According to the preamble, such individuals are generally considered to be “agents” of the church and not “employees,” and therefore are not subject to the universal availability requirements.

Universal Availability – Meaningful Notice Requirement. The Final Regulations, like the Proposed Regulations, provide that the universal availability requirement is met only if the employer provides employees with a continuing “effective opportunity” to make salary reduction contributions. Whether or not an employee has the required effective opportunity depends on the relevant facts and circumstances, including whether meaningful notice is given, the period of time during which the election may be made, and any other conditions imposed on the election.

Distributions

Distribution Restrictions. The provisions in the Final Regulations dealing with distribution restrictions are substantially the same as those in the Proposed Regulations.

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9 The statutorily permissible exclusions include: employees eligible to make elective deferrals under a 401(k) plan or another 403(b) plan of the employer, non-resident aliens with no U.S. source income; certain students providing services described in Code section 3121(b)(10), and employees who normally work fewer than 20 hours per week. The Final Regulations provide that an employee is treated as an employee working fewer than 20 hours per week if (1) the employer reasonably expects the employee to work fewer than 1,000 hours during the first year of employment; and (2) for each plan year ending after that first year of employment, the employee actually works fewer than 1,000 hours in preceding year.

10 Although the Final Regulations discuss the permissible exclusions only in the context of the universal availability requirement, the exclusions under Notice 89-23 also apply to the nondiscrimination and coverage safe harbor applicable to employer contributions. As discussed above, all of the nondiscrimination and coverage rules in Notice 89-23 will become obsolete when the Final Regulations become effective.
- **Elective Deferrals.** The Final Regulations reflect the statutory rules regarding when distributions of elective deferrals can be made from a 403(b) plan, confirming that salary reduction contributions generally may only be distributed upon severance from employment, death, disability, attainment of age 59½, or in the event of hardship. (These distribution restrictions apply to all contributions to a section 403(b)(7) custodial account, both employer and employee).

For purposes of these restrictions, a “severance from employment” occurs when the employee ceases to be employed by an eligible employer maintaining the 403(b) plan. Thus, a severance from employment would occur when an employee transfers from a 501(c)(3) organization (such as a church-related hospital) to a for-profit subsidiary of that 501(c)(3) organization that is ineligible to maintain a 403(b) plan. In addition, a minister who is serving as a chaplain for an entity that is not eligible to maintain a 403(b) plan would have a severance from employment if he or she ceases to perform services as a minister, even if he or she continues working for the same employer.

- **Employer Contributions.** Under the Final Regulations, all employer contributions (whether discretionary, nondiscretionary or matching) to a 403(b)(1) annuity contract or a 403(b)(9) retirement income account may be distributed only upon severance from employment, the prior occurrence of a specified event or attainment of a specified age or number of years, as set forth in the underlying plan. The preamble to the Final Regulations makes it clear that financial need, “including a need to buy a home,” is a permissible distribution event for these contributions. This presumably would permit the withdrawal of employer contributions prior to retirement to purchase or build a retirement home.

  **Comment:** This distribution restriction on nonelective contributions does not apply to an annuity contract issued by an insurance company before January 1, 2009. However, the restriction would apply to all employer contributions held in a 403(b)(9) retirement income account on or after January 1, 2009, even if those accounts were established prior to that date.

- **Rollover Contributions and After-Tax Contributions.** The Final Regulations confirm that no distribution restrictions apply to rollover contributions. In addition, in a change from the Proposed Regulations, the Final Regulations specifically provide that employee after-tax contributions are not subject to any distribution restrictions.

- **Hardship Distributions.** The Final Regulations, like the Proposed Regulations, confirm that the hardship distribution regulations under Code section 401(k) apply to 403(b) plans.

  **Loans.** The Final Regulations confirm that loans may be made to participants from a 403(b) plan, subject to the requirements of Code section 72(p).
Minimum Distribution Requirements. The Final Regulations confirm that, in general, the Code section 401(a)(9) minimum distribution requirements apply to 403(b) plans. However, these rules do not apply to benefits accruing before 1987 (not including any earnings on these pre-1987 amounts), as long as such amounts are accounted for separately.

Annuity Contract Exchanges and Plan-to-Plan Transfers

The Final Regulations retain the provisions in the Proposed Regulations that permit contract-to-contract exchanges within the same plan and plan-to-plan transfers, with some important changes and clarifications. 

Caution: The following discussion is based on our understanding of the Final Regulations in their current form. However, there has been considerable confusion with respect to the rules applicable to contract exchanges and plan-to-plan transfer. Therefore, we anticipate that the IRS will issue further clarification in this area.

Contract Exchanges. The Final Regulations permit investment changes between contracts within the same 403(b) plan, but impose the following new requirements:

- the plan under which the contract is issued must specifically provide for the exchange;
- the recipient contract must include distribution restrictions not less stringent than those imposed on the contract being exchanged; and
- the employer must enter into an information-sharing agreement with the issuer of the recipient contract under which the employer and the issuer will provide each other with information on the participant’s employment, along with other information that takes into account the existence of other section 403(b) contracts or qualified plans. For example, the employer and issuer must agree to share information about whether there has been a severance from employment, whether the hardship distribution rules have been satisfied, and participant plan loan information.

Comment: This last requirement is intended to ensure plan-wide compliance across all vendors and puts the burden on the employer to enter into an information-sharing agreement with the issuer of the recipient contract so that compliance is coordinated with respect to information that needs to take into account other section 403(b) contracts or qualified plans.

These rules apply to exchanges occurring after September 24, 2007. However, the IRS has informally indicated that, despite the specificity of this effective date, plans do not have to be in complete compliance with the information-sharing requirement on September 25, 2007, as long as the required information-sharing procedures are in place.
as soon as practicable thereafter. The IRS has further indicated that the actual information-sharing agreement need not be in place until January 1, 2009.

*Plan to Plan Transfers.* The Final Regulations, like the Proposed Regulations, allow in-service transfers between 403(b) plans subject to the following conditions: (1) the receiving plan must impose distribution restrictions on transferred amounts that are no less stringent than those imposed under the transferring plan; (2) the participant whose assets are being transferred must be either an employee or former employee of the employer (or the business of the employer) maintaining the receiving plan; and (3) if the transfer is of only a portion of the participant’s interest, the different types of funds must be transferred on a *pro rata* basis (e.g., if 25% of the participant’s account in the transferring plan consists of after-tax contributions, then 25% of the transfer must consist of after-tax amounts).

**Comment:** The Final Regulations, like the Proposed Regulations, continue to explicitly prohibit plan-to-plan transfers from a 403(b) plan to any other plan that is not a 403(b) plan.

**Plan Termination**

The Final Regulations adopt the provisions in the Proposed Regulations which permit an employer to terminate a 403(b) plan and allow the terminating plan to distribute accumulated benefits to plan participants as long as the employer (including any entities in the employer’s controlled group) does not make contributions to another 403(b) contract during the 12 months before or after the termination. (Currently, termination of a 403(b) plan is not a distributable event permitting the distribution of elective contributions.) In order for a 403(b) plan to be considered terminated, all of the participants’ accumulated benefits must be distributed as soon as administratively practicable after the termination.

**Comment:** In the case of a plan termination, normal rollover rules would apply, and the participants could roll their termination distributions over to another eligible retirement plan.

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11 A plan-to-plan transfer may also be made by the beneficiary of a deceased participant, as long as the participant was either an employee or former employee of the employer (or the business of the employer) for the receiving plan. The Final Regulations thus broaden the scope of the transfer provisions. The Proposed Regulations permitted only transfers to a 403(b) plan maintained by the current employer of the participant or beneficiary making the transfer.

12 There is one exception to this rule. If at all times during the 12-month period before and after the termination, fewer than 2 percent of the employees who were eligible under the terminating section 403(b) plan as of the date of plan termination are eligible under the alternative section 403(b) plan, the alternative plan can be disregarded.
Effect of Failure to Comply

The Final Regulations include new provisions detailing the effect of a failure to comply with the statutory and regulatory requirements. Different types of failures have different consequences.

Failures Relating to the Individual Contract. A failure that relates to a contract issued to an individual by an employer will cause both that individual contract and any other 403(b) contract purchased for that individual by the same employer to fail to be a 403(b) contract. Such a failure will not affect the 403(b) contracts of any other individuals.  

Operational Failures. An operational failure, including a failure to follow the terms of the plan document, will adversely affect all of the contracts issued by the employer to all employees with respect to whom the operational failure has occurred.

Other Plan Failures. Plan failures that are not operational failures will adversely affect all contracts issued under the plan. Such failures include: failures to comply with the nondiscrimination rules; employer eligibility failures; and failures to have contracts issued pursuant to a plan that meets the regulatory requirements for a written plan document. According to the Final Regulations, if any of these failures occurs, none of the contracts issued under the plan will constitute 403(b) contracts and all of the contributions and earnings will be taxable.

Miscellaneous Provisions

The following portions of the Final Regulations reiterate the Proposed Regulations with no substantive changes:

Incidental Life Insurance. The Final Regulations prohibit 403(b) plans from providing incidental life insurance, health or accident insurance, endowment contracts, or property, casualty or liability insurance. This rule does not apply to contracts issued before September 24, 2007.  

Determination of Years of Service. The Final Regulations retain the provisions in the Proposed Regulations regarding the method for determining years of service for employees who work part-time, or who perform a fractional year of service. Thus, in determining whether a person is employed full-time, the amount of work actually

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13 In this section of the Final Regulations, the IRS discusses 403(b) failures in relation to contracts purchased for individuals by the employer. As noted previously, the notion of individual contracts purchased for, and issued to, plan participants by the employer seems to be a different concept than the 403(b) contracts entered into between the employer and a 403(b) vendor.

14 The Proposed Regulations provided that this incidental life insurance rule would not apply to contracts issued after February 14, 2005. However, in the Final Regulations, the effective date for this provision was extended, without explanation.
performed is compared with the amount of work normally required of similarly-situated individuals. Fractional years of service are not rounded up (with the exception of an employee who has accumulated less than one year of service).

**Taxation of Distributions.** The Final Regulations reflect the normal Code section 72 rules that amounts are includible in gross income of participants in the year in which they are distributed, except to the extent that such amounts are rolled over to another eligible retirement plan.

**Rollover Requirements.** The Final Regulations confirm that 403(b) plans are subject to the statutory requirements applicable to eligible rollover distributions, including the mandatory 20% withholding and participant notice requirements. For purposes of the notice rules, the 403(b) contract payor must provide the required notice.

**QDROs.** The Final Regulations clarify that the Code section 414(p) rules on qualified domestic relations orders (“QDRO”) apply to 403(b) plans.

### Special Rules Applicable to Church Plans

The Final Regulations include a number of special rules applicable to 403(b)(9) church retirement income accounts, all of which are virtually identical to the Proposed Regulations. The effective date for the application of the Final Regulations is extended a year to January 1, 2010, in the case of a plan maintained by a church-related organization, but only if the church convention has the authority to amend the plan.

**Definition of Retirement Income Account.** A “retirement income account” must be a defined contribution program established or maintained by a church-related organization which meets all of the following requirements:

- The plan document must specifically state the intent to constitute a retirement income account pursuant to Code section 403(b)(9).

  **Comment:** Thus, a plan adopted by a church on a vendor’s 403(b)(1) or 403(b)(7) document will not be a 403(b)(9) retirement income account unless that document is revised to provide specifically that the plan is intended to constitute a retirement income account pursuant to Code section 403(b)(9).

- The retirement income account’s interest can be commingled with other amounts devoted exclusively to church purposes, but must be separately accounted for if so commingled.

- Investment performance must be based on gains and losses on the retirement income account’s assets.

- The assets of the retirement income account must be held for the exclusive benefit of plan participants or their beneficiaries. The Final Regulations specifically preclude loans and any other extension of credit to the employer from plan assets, effective
July 26, 2007. A plan that has provided a loan or extended other credit to the employer prior to that date must take reasonable steps to eliminate the loan or other extension of credit before the effective date otherwise applicable to the plan, or “as promptly as practical thereafter.”

**Permissible Investments.** The Final Regulations provide that any asset of a 403(b)(9) plan that is owned or used by a participant or beneficiary (e.g., artwork) will be treated as a distribution.

**Chaplains and Self-Employed Ministers as Eligible Employers.** The Final Regulations provide that a minister described in Code section 414(e)(5)(A) (i.e., a chaplain or a self-employed minister) is an “eligible employer” with respect to a 403(b)(9) retirement income account established for that minister. Thus, this definition confirms that chaplains and self-employed ministers can make employer contributions to a 403(b)(9) plan on their own behalf.

**Years of Service for Church Employees.** The Final Regulations confirm that, for purposes of the special Code section 402(g)(7) catch-up contributions, years of service includes service with all church-related organizations that are within the same denomination.

**Includible Compensation for Self-Employed Ministers.** The Final Regulations essentially reiterate the statutory definition of “includible compensation.” However, they also specifically provide that includible compensation for a self-employed minister means the minister’s earned income (computed without regard to Code section 911).

**Coordination with Custodial Account Rules.** A 403(b)(9) account is treated as such even if the assets are invested in stock of a regulated investment company (i.e., a mutual fund) or any other asset.

**Payment of Annuity Benefits.** The Final Regulations, like the Proposed Regulations, permit 403(b)(9) plans to provide life annuities only if the following two conditions are satisfied:

- The amount of the distribution form must have an actuarial present value at the annuity starting date that is equal to the participant’s accumulated benefit, based on reasonable actuarial assumptions (including assumptions regarding interest and mortality); and

- The plan sponsor must guarantee benefits in the event that a payment is due that exceeds the participant’s or beneficiary’s accumulated benefit.

**Commingling Assets.** Assets in a section 403(b)(9) plan that are held in trust can be combined with assets held under a Code section 403(b)(7) custodial account, and 403(b)(9) assets held in trust also may be invested in a group trust with trust assets held under a qualified plan or IRA. In addition, 403(b)(9) assets can also be commingled with amounts devoted exclusively to church purposes. (The 403(b)(9) assets apparently do not
need to be held in trust for this permitted commingling to occur.) However, it appears that only trusteed 403(b)(9) plan assets can be commingled with qualified plan assets (or 403(b)(7) assets or IRAs) – other church assets held by a church benefit board cannot be commingled.

**Tax-Exempt Trust.** A trust that holds only 403(b)(9) plan assets (or a custodial account that is treated as a trust under Code section 401(f)) is exempt from taxation under Code section 501(a).

**Defined Benefit Plans.** The Final Regulations confirm that church-related organizations may maintain a 403(b)(9) defined benefit plan if that plan was in effect on September 3, 1982. However, the IRS continues to require that accruals under a defined benefit 403(b)(9) plan be subject to both the contribution limits under Code section 415(c) and the benefit accrual limits under Code section 415(b).

**Roth Contributions.** The Final Regulations specifically provide that designated Roth contributions can be made to 403(b) plans. This provision, in conjunction with a cross-reference to regulations under Code section 401(k), confirms that self-employed ministers and foreign missionaries can make designated Roth contributions to a denominational 403(b) plan, to the extent permitted under such plan.

**Controlled Group Rules**

In addition to the Final Regulations under Code section 403(b), the IRS also published final regulations under Code section 414(c) regarding controlled group rules for tax-exempt entities, which are effective for plan years beginning after December 31, 2008. These final rules are substantially the same as proposed regulations issued in 2004 and apply not only in the case of 403(b) plans, but also to qualified plans and other welfare benefit plans. As discussed below, these rules do not apply to churches and QCCOs.

- **Basic Rule.** Tax-exempt organizations are considered to be under common control if 80 percent of the directors or trustees of one 501(c)(3) organization either are representatives of, or are directly or indirectly controlled by, the other exempt organization.

- **Permissive Aggregation.** Tax-exempt organizations can choose to be aggregated if they maintain a single plan covering one or more employees from each organization and if the organizations regularly coordinate their day-to-day exempt activities. The only significant change in the Final Regulations is the addition of a new provision authorizing the IRS to issue guidance permitting other types of combinations of entities that include tax-exempt entities to elect to be treated as part of the same controlled group. However, the preamble to the final section 414(c) regulations notes that it expects that this authority will not be exercised unless the IRS “determines that the organizations are so integrated in their operations as to effectively constitute a single coordinated employer.”
- **Permissive Disaggregation for Church Plans.** Church plans receiving contributions from more than one entity, at least one of which is a non-QCCO, may disaggregate so that the churches and QCCOs are treated separately from the non-QCCOs.

**Comment:** Churches and QCCOs are explicitly exempted from these rules; non-QCCOs are not. However, the preamble to the Final Regulations suggests that churches and QCCOs may be still subject to the controlled group rules in Notice 89-23.\(^\text{15}\) In one place, the preamble indicates that the Notice 89-23 controlled group rules “will continue to apply” to churches and QCCOs, and later, the preamble states that churches and QCCOs “can continue to rely” on the Notice 89-23 controlled group rules.

\(^{15}\) Under Notice 89-23, the controlled group of a contributing employer includes: (1) any entity of which at least 80% of the directors, trustees or other individual members of the entity’s governing body are either representatives of or directly or indirectly control, or are controlled by, the contributing employer; and (2) any entity that provides directly or indirectly at least 80% of the contributing employer’s operating funds, if there is a degree of common management or supervision between the entities.