

To: Clients and Friends  
From: Smith & Downey  
Date: September 20, 2007  
Re: 501(c)(3) and Public School Employers – 9/25/07 403(b) Change; IRS 403(b) Audits

As employers whose employees participate in 403(b) plans know, the IRS recently issued Final 403(b) Regulations. Although the Regulations generally are not effective until January 1, 2009, one important aspect of the new rules becomes effective on September 25, 2007 -- next Tuesday. In addition, the IRS has instituted an audit program to determine if 403(b) plans are meeting the requirement that virtually all employees be allowed to participate in the plan.

New Rule Effective September 25, 2007

Specifically, effective on September 25, 2007, participants in 403(b) plans may direct transfers from one product vendor to another under the so-called "90-24 transfer rules" only if the receiving vendor and the participant's employer enter into an "Information Sharing Agreement". (Those two parties have until January 1, 2009 to enter into that Agreement, so long as it is retroactive to September 25, 2007.) The IRS has indicated that it will release within the next couple of months sample 403(b) document language which would comply with the Regulations. We are hoping the IRS also will release sample language for the Information Sharing Agreements required under the Regulations, but the IRS has not yet done so.

If a transfer is made on or after September 25, 2007 and the required Information Sharing Agreement is not in place by January 1, 2009, the 403(b) plan is disqualified for violating the distribution rules in the Regulations.

Because of this plan disqualification risk, employers might be inclined to prohibit all transfers until they are certain that the appropriate Information Sharing Agreements are in place. However, 501(c)(3) employers that take the position that their 403(b) plans are not ERISA-governed should be aware that the DOL has suggested that a 501(c)(3) employer's imposition of such a restriction on a non-ERISA-governed plan would result in the plan becoming ERISA-governed because of "employer involvement" with the 403(b) plan (and therefore would become subject to the rules requiring spousal consents to death benefit beneficiaries, annual Form 5500s, SPDs, etc.).

Many affected employers are hopeful that the various transferor vendors will refuse to make transfers-out without ensuring that the required Information Sharing Agreements are in place. However, even if this ends up resolving this dilemma for 501(c)(3) employers, affected employers should discuss with their employees' 403(b) vendors this new restriction on employees' ability to transfer 403(b) accounts between vendors.

We recommend that our clients that maintain 403(b) plans confirm with their vendors that the vendor will not be allowing these types of transfers out of their 403(b) arrangements until an Information Sharing Agreement is in place. If any vendor will be permitting these transfers, employees should be advised that these types of transfers could compromise the qualification of the employees' 403(b) arrangement.

## IRS Audits of Universal Availability Requirement

If any employee of a 501(c)(3) or public school employer is allowed to make salary deferrals into a 403(b) plan, virtually all employees of the employer must be allowed to make salary deferrals into the plan. The IRS has determined that this "universal availability" requirement frequently is disregarded. As a result, the IRS has instituted a program to determine if employers are meeting this requirement. The targeted employer receives a letter from the IRS asking the employer to provide information related to the requirement. If the IRS determines that the requirement is not met, a second letter is sent to the employer offering two corrections (which must be completed within 240 days), both of which require the employer to make contributions on behalf of employees who were excluded from participation in the 403(b) plan.

For example, a common mistake is for an employer to exclude janitorial staff from eligibility in the 403(b) plan. If the janitorial staff members are employees of the employer, this exclusion is not permitted. As a result, the IRS correction requires that the employer make contributions on behalf of the janitorial staff equal to either 1.5% of compensation or ½ of the average salary deferrals made by similar employees. In addition, any related matching contribution must be made on behalf of the improperly excluded employees.

Exclusions that ARE permitted under the 403(b) rules are: (1) any employee who is eligible to make salary deferrals to a 457(b) plan, to a 401(k) plan or to another 403(b) plan; (2) any nonresident alien with no U.S. source income; (3) students who perform services for the employer, but for whom the employer is not required to make FICA or FUTA contributions (as long as all such students are excluded); (4) employees who normally work less than 20 hours per week (as long as all such employees are excluded); and (5) until at least 2010, certain collectively bargained employees.

We recommend that our clients that maintain 403(b) plans confirm that they meet the universal availability requirement. If you determine that you do not meet this requirement, we recommend that you begin meeting this requirement immediately. In addition, if you have received a letter from the IRS under its new universal availability audit program, we recommend that you consult with us before providing a response.

Please contact us if we can be of assistance on any 403(b) issue.