# Guidance on Sections 403(b) and 409A

By David Pratt*

This article covers two compensation-related topics, the long-awaited final regulations under section 403(b) and compliance with section 409A. On September 10, 2007, the Service issued Notice 2007-78, which extends the section 409A document compliance deadline by one year, to December 31, 2008. The Notice does not extend the January 1, 2008, effective date of the final regulations.

## SECTION 403(B): TAX-SHELTERED ANNUITY ARRANGEMENTS

Section 403(b) arrangements are tricky. They are misleadingly similar to the much more familiar 401(k) plans, but their governing rules differ from the 401(k) rules in many important respects. Some of these differences are historical; others reflect the characteristics of 403(b)-eligible employers (public educational institutions and 501(c)(3) organizations); some are puzzling even to 403(b) mavens.

On July 26, 2007, the Treasury Department issued comprehensive final regulations (T.D. 9340, 72 Fed. Reg. 41127) for the first time in more than 40 years. The regulations are generally effective for taxable years beginning after December 31, 2008, but there are several delayed effective dates and transition rules. The paragraphs below summarize major provisions of the regulations. The underlying theme is reducing differences between section 403(b) arrangements and other salary reduction arrangements.

1. Every 403(b) program (including governmental plans and other non-ERISA programs) must be maintained pursuant to a written plan that includes all of the plan's material terms and conditions [Treas. Reg. § 1.403(b)-3(b)(3)]. The written plan must include language covering the requirements of sections 401(a)(9), 401(a)(30), 401(a)(31) and (for annuities only) 401(g).
2. Certain 403(b) programs are exempted from ERISA by the statute, e.g., governmental plans and most church plans [see ERISA section 4(b)]. Certain other plans funded entirely by participant contributions are exempted by Department of Labor regulations [29 C.F.R. § 2510.3-2(f)], provided that the employer's involvement in the operation of the plan is appropriately limited. Comments on the proposed 403(b) regulations expressed concern that the increased employer involvement required would jeopardize this ERISA exemption. DOL Field Assistance Bulletin 2007-2 provides guidance on the relationship between this regulatory exemption and the new final regulations. Unfortunately, the FAB's facts-and-circumstances standard is not very helpful.
3. Under a 403(b) program (unlike a qualified plan), a participant is deemed to have compensation, for purposes of the section 415 limitations, for five years after his or her employment terminates. Accordingly, the employer may make non-elective contributions for all or part of that five-year period [Treas. Reg. § 1.403(b)-4(d)]. This five-year rule (1) does not apply to elective deferrals; (2) does not allow contributions after the individual's death; and (3) in the case of a non-governmental employer, requires compliance with the nondiscrimination requirements [sections 401(a)(4) and 410(b)].
4. Under a 401(k) plan, the employer can impose a minimum service requirement (not exceeding one year of service) before an employee is allowed to make elective deferrals. Under section 403(b)(12), all 403(b) programs (governmental or non-governmental), other than certain church plans, must satisfy a universal availability requirement rather than the Average Deferral Percentage test that applies to 401(k) plans. Subject to limited exceptions [see Treas. Reg. § 1.403(b)-5(b)(4)], all employees (including new employees) must be given an effective opportunity to make elective deferrals under the 403(b) program. The requirement generally applies separately to each common law entity [Treas. Reg. § 1.403(b)-5(b)(3)]. The regulations clarify the permissive exclusions for employees eligible under other plans, non-resident aliens, students, and employees who normally work fewer than 20 hours per week. The regulations do not continue other exclusions that were allowed under Notice 89-23, 1989-1 C.B. 654 (e.g., for union employees and visiting professors). Compliance with the universal availability requirement is very important, as it is a focus of Service audit activity: for example, the Service has recently expanded a project to ensure that eligible public school employees

* Albany Law School, Albany, NY.

are allowed to contribute. See IR-2007-123, June 21, 2007.

5. Non-elective employer contributions to non-governmental 403(b) programs are subject to the same nondiscrimination requirements as qualified plans [sections 401(a)(4) and 401(m)]. The regulations do not extend the good faith reasonable compliance standard of Notice 89-23.
6. Some amounts held under a 403(b) program are subject to special distribution timing restrictions [sections 403(b)(7) and (b)(11)]. Amounts that are not subject to these restrictions may be distributed only after severance from employment or on occurrence of a stated event (e.g., a fixed number of years, attainment of a stated age, or disability). Treas. Reg. § 1.403(b)-6(b). Severance has a special meaning in this context. Treas. Reg. § 1.403(b)-6(h).
7. For the first time, 403(b) plan provisions may permit plan termination and (without participant consent) distribution or rollover of all assets. Treas. Reg. § 1.403(b)-10(a)(1).
8. New rules for transfers will supersede the rules of Rev. Rul. 90-24, 1990-1 C.B. 97 [Treas. Reg. § 1.403(b)-10(b)], and the regulations also include new rules for church retirement income accounts under section 403(b)(9) [Treas. Reg. § 1.403(b)-9(a)].
9. As under section 401(k), participants' elective contributions must be transferred promptly to the appropriate funding vehicle under the plan. Under Treas. Reg. § 1.403(b)-8(b), elective deferrals under a non-ERISA 403(b) program must be transferred within a period that is no longer than is reasonable for proper plan administration. If the 403(b) program is subject to ERISA, then the program is subject to the same rules that apply to ERISA-covered qualified plans.
10. Tax-exempt employers do not have owners, and section 414 does not specifically provide for tax-exempt entities to be aggregated in testing compliance with the rules governing tax-favored employee benefits. The new regulations provide aggregation rules for tax-exempt entities other than governments and certain churches. Treas. Reg. § 1.414(c)-5. These regulations apply in testing *all* employee benefits to which section 414(c) applies, not only in testing 403(b) programs. Aggregation is based on an 80% director/trustee common control test. Tax-exempts with a common exempt purpose may be aggregated permissively.

## SECTION 409A: NON-QUALIFIED DEFERRED COMPENSATION

Section 409A was enacted as part of the American Jobs Creation Act of 2004, and was effective for compensation deferred after December 31, 2004, under a non-qualified deferred compensation program, as defined in the statute.

## ADMINISTRATIVE GUIDANCE

On April 17, 2007, Treasury issued final regulations [T.D. 9321, 72 Fed. Reg. 19233], which generally follow the proposed regulations [70 Fed. Reg. 57930] issued in October 2005. For a discussion of the proposed regulations, see David Pratt, *The Not-So-Brave New World of Deferred Compensation,* ABA SECTION OF TAXATION NEWSQUARTERLY, Fall 2005, at 8. See also *Special Report: Section 409A: Annotation and Analysis,* PENSION & BENEFITS REPORTER, June 12, 2007, at 1402-1465 (an annotated version of the regulations, with comments by Daniel Hogans of Treasury and Stephen Tackney of IRS, the regulations' principal author).

Before issuing the final regulations, the Service had issued interim guidance (listed in the preamble to the regulations) clarifying the scope of section 409A and providing transition rules and delayed effective dates for bringing programs into compliance. The issuance of the final regulations does not restrict this transition relief. The final regulations are generally effective January 1, 2008. For periods before that date, the standards and transition rules set out in Notice 2006-79, 2006-43 I.R.B. 763, continue to apply. See also section XI of the preamble to the proposed regulations.

The preamble to the regulations contains detailed information about the following topics [regulations section number in brackets]: the definition of "nonqualified deferred compensation plan" [§ 1.409A-1(a)]; the applicability of section 409A to short-term deferrals, stock options and stock appreciation rights, arrangements between partnerships and partners, foreign plans, separation pay, and reimbursement and fringe benefit plans [§ 1.409A-1(a), (b)]; the definition of a "plan" [§ 1.409A-1(c)]; the definition of "substantial risk of forfeiture" [§ 1.409A-1(d)]; the rules governing initial deferral elections [§ 1.409A-2(a)]; the time and form of payment of deferred compensation [§ 1.409A-3]; the prohibition of accelerated payments [§ 1.409A-3(j)]; subsequent changes in the time and form of payment [§ 1.409A-2(b)]; nonqualified deferred compensation plans linked to qualified plans and other arrangements [§§ 1.409A-2(a)(9) and 1.409A-3(j)(5)]; and the statutory and regulatory effective dates [§ 1.409A-6].

Under the final regulations, the plan document(s) must generally be brought into compliance by December 31, 2007.

The final regulations do not address (1) the calculation and timing of amounts required to be included in income under section 409A; (2) reporting and withholding requirements (see IRS Notice 2006-100, 2006-51 I.R.B. 1109 for transition rules for 2005 and 2006); or (3) offshore trusts and arrangements with financial triggers, with respect to which taxpayers may continue to rely on Notice 2006-33, 2006-15 I.R.B. 754, until further guidance is issued.

On August 7, 2007, the Service issued answers to frequently asked questions relating to deferral of compensation by teachers. See TAX NOTES TODAY, 2007 TNT 153-17 (Aug. 8, 2007).

### STATUTORY AMENDMENTS

The Pension Protection Act of 2006 amended section 409A to provide that if, during any "restricted period" with respect to a single-employer defined benefit pension plan of a plan sponsor, assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or arrangement, for purposes of paying deferred compensation of an "applicable covered employee," such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under section 83. The provision also applies if a nonqualified deferred compensation plan provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period of any defined benefit pension plan of the employer, or if assets are so restricted.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of the plan sponsor is in at-risk status; (2) any period in which the plan sponsor is in bankruptcy; and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the plan sponsor is terminated in an involuntary or distress termination.

Covered employees include the chief executive officer (or individual acting in such capacity), the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

If an employer provides directly or indirectly for the payment of any federal, state, or local income taxes with respect to any compensation required to be included in income under the rule, interest is imposed on the amount of such payment in the same manner as if the payment were part of the deferred compensation to which it relates. The payment is also subject to a 20% additional tax, and it is nondeductible by the employer.

### OTHER RECENT DEVELOPMENTS

In Notice 2007-62, 2007-32 I.R.B. 331, the Service and Treasury announced plans to publish guidance which will apply the section 409A definition of substantial risk of forfeiture [Treas. Reg. § 1.409A-1(d)] to 457(f) plans. The section 409A definition is narrower than the section 83 definition.

The minimum wage legislation passed by the Senate earlier this year included a cap on the amount of compensation that could be deferred each year under a nonqualified plan. The cap was the lesser of (1) $1 million or (2) the employee's average annual earnings for the preceding five years. This proposal was dropped, but it may reappear.

### CONCLUSION AND RECOMMENDATIONS

Section 403(b) plan sponsors and their advisors must consider the effect of the new regulations, and the changes that they will require to plan documentation and operational procedures. The 2009 effective date requires prompt action, particularly as many plan sponsors will need to make significant changes to their procedures and negotiate a new relationship with insurers and other providers.

Despite the best efforts of Treasury and the Service, the 409A rules are a morass, and compliance will be challenging for all affected employers. The 2008 effective date is uncomfortably close, and plan sponsors must (1) identify all affected plans, which will include many plans not commonly thought of as providing deferred compensation; (2) identify the changes to each plan that are required to bring the plan into compliance; (3) discuss the required changes with affected employees and corporate officials; (4) decide whether to amend or discontinue the plan; (5) prepare and execute the necessary documents; and (6) install procedures to ensure operational compliance.

A coalition of major law firms is requesting a one-year extension of the 409A compliance deadline, to December 31, 2008. Jeff Nash, *Heavyweight law firms to ask IRS for deferred comp plan delay,* FINANCIAL WEEK, Aug. 20, 2007, www.financialweek.com/apps/pbcs.dll/article?AID=/20070820/REG/70820010/-1/FWDailyAlert01. In a July 31, 2006, letter to congressional leaders, the ABA Section of Taxation requested a postponement of the effective date of section 409A, to consider narrowing its scope or repealing it, and wrote that "Congress has created a federal regulatory system that is largely unnecessary, will impose enormous administrative burdens on taxpayers, their advisers, employers and others, as well as on the IRS and Treasury, and is not a measured response to the underlying problems." This letter is available at http://www.abanet.org/tax/pubpolicy/2006/073106ircsec409altrtosenatecommittee.pdf. This conclusion is clearly correct and one can only hope that, on further consideration, Congress will realize, as it did with section 89, that the cure is worse than the disease. ■