

Summary of Key Provisions of the Final 403(b) Regulations

On July 26, 2007, the Treasury Department and the Internal Revenue Service (“IRS”) released final regulations under section 403(b) of the Internal Revenue Code of 1986. Proposed regulations had been issued on, and have been pending since, November 16, 2004. The final regulations are the first comprehensive rewrite of the tax rules affecting 403(b) arrangements since 1964. The general effect of the final regulations will be to require a greater level of employer involvement in the documentation and operation of 403(b) arrangements.

EFFECTIVE DATE: The final regulations are generally effective beginning in 2009. Prior to 2009, employers may comply with either current law or the final regulations. There are a number of exceptions to the 2009 effective date, including both earlier and later effective dates for particular rules. Special effective dates are discussed below as applicable.

Issue	Current Law & Practice	Final 403(b) Regulations
Plan Requirements		
In General	Under current law, unless subject to ERISA, there is no explicit plan requirement under section 403(b) (though there is one under ERISA) and many non-ERISA 403(b) arrangements are maintained without a formal plan document.	The final regulations require that all 403(b) annuity contracts and custodial accounts be issued pursuant to a written plan document which satisfies the applicable requirements in both form and operation, whether subject to ERISA or not.
Plan Documents	Section 403(b) arrangements are often operated pursuant to a collection of documents, including salary reduction agreements, custodial account agreements, and annuity contracts. Often, there is no employer-maintained document, for example, that describes eligibility.	<p>The plan document must set forth the material terms of the arrangement, including, (among others): eligibility, benefits, investment alternatives, and the time and form of payments.</p> <p>The plan document need not be a single written instrument and the document may incorporate other document references, such as annuity contracts and salary reduction agreements. However, the final regulations generally anticipate that the employer will need to maintain a document that provides certain basic terms (e.g., eligibility to participate, available investment options). In addition, the final regulations state that the IRS expects a master plan document where the arrangement makes annuity contracts and/or custodial accounts offered by more than one financial institution available for investment.</p> <p>Model Documents. The IRS has released model plan language for public school 403(b) plans.</p>
Administrative Responsibility	Employers that offer section 403(b) arrangements often limit their role to providing payroll deduction to employees and determining the accounts and contracts to which contributions will be made.	The final regulations indicate that the employer-maintained plan document should coordinate the responsibilities of the employer and the financial institutions that administer the custodial accounts and/or annuity contracts to comply with section 403(b) on an aggregate basis. For example, the regulations generally anticipate that an employer will provide the financial institution that administers the plan’s underlying investments with adequate information to allow for the administration of loans and hardship distributions, and to determine when distributions are permitted as a result of severance from employment (if the financial institution takes on those responsibilities).
Effect of Document and Operational Failures	Many of the common defects in the operation of a 403(b) plan only affect the contracts and accounts to which the error relates. This contrasts sharply with defects in the operation of a tax-qualified retirement plan, which generally affect the entire plan.	<p>A failure to maintain a plan document or to comply with non-discrimination and employer eligibility requirements will cause a plan to fail to be a 403(b) plan.</p> <p>Otherwise, a failure to administer or operate a 403(b) plan will generally only adversely affect the contracts and accounts of the participants to which an operational defect relates.</p>

Issue	Current Law & Practice	Final 403(b) Regulations
Universal Availability Requirement		
In General	<p>The universal availability requirement generally provides that, subject to limited exceptions, <u>all</u> employees of any employer normally working 20 or more hours a week must be permitted to elect to have salary reduction contributions made on their behalf if <u>any</u> employees of the employer have that right.</p> <p>Church plans are exempt from this requirement.</p>	<p>The IRS has an ongoing nationwide enforcement initiative in effect dealing with the universal availability requirement. In an attempt to clear up some of the uncertainty related to this requirement, the final regulations include a number of provisions regarding its application.</p>
Excludable Classes of Employees	<p>There are limited statutory exceptions from the universal availability requirement for certain classes of employees, including employees who normally work fewer than 20 hours per week (“part-time employees”).</p> <p>In 1989, the IRS added other classes of employees that may be excluded from eligibility to make salary reduction contributions, including employees covered by a collective bargaining agreement.</p>	<p>Statutory Exceptions. The regulations expand on the exemption from the universal availability requirement for “part-time employees,” providing that employees will be deemed part-time employees if they are reasonably expected to work less than 1,000 hours in their first year of employment and, thereafter, if they did not have 1,000 hours of service in the preceding year.</p> <p>Administrative Exceptions. The final regulations generally repeal the administrative exceptions under the 1989 guidance, including the exception for collectively bargained employees.</p> <p>Special Transition Rules. The final regulations include a number of delayed effective dates and transition rules related to changes in eligibility that employers will have to make as a result of the change made in the final regulations to the universal availability requirement. The particular effective date depends on the type of employer and the class of employees affected by the changes.</p>
Effective Opportunity	<p>Current law does not specifically address the extent to which employers must communicate the right to make salary reduction contributions.</p>	<p>The regulations provide that universal availability requires an effective opportunity to make salary reduction contributions. Whether an employee has an effective opportunity depends on all the facts and circumstances. However, the final regulations provide that an employee will not be considered to have an effective opportunity unless notice of the right to make salary reduction contributions is provided at least once during each year.</p>
Non-Discrimination Requirements for Employer Contributions		
In General	<p>Non-discrimination rules apply to employer contributions to a 403(b) arrangement, including matching contributions and non-elective employer contributions. Church and governmental plans are largely exempt from the nondiscrimination requirements. The rules apply primarily to tax-exempt employers (other than churches).</p> <p>IRS guidance from 1989 discusses the requirements as they apply to tax-exempt employers, creates a good-faith compliance standard, and provided some safe harbors.</p>	<p>Governmental and church plans (other than church hospital, university and nursing home plans) remain largely exempt from the non-discrimination requirements for employer contributions.</p> <p>The final regulations apply the non-discrimination rules which apply to employer non-elective contributions, and ends the current law “good faith” compliance standard for tax-exempt employers and the safe harbors from the 1989 IRS guidance.</p> <p>The final regulations also provide standards for aggregating affiliated tax-exempt employers in applying the non-discrimination tests based on whether the employers have overlapping boards of directors, and allow permissive aggregation of entities having a common exempt purpose in some instances.</p>

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Exchanges & Transfers		
Investment Changes	Many plans allow participants to direct the investment of their plan balances among a menu of investment options, for example, separate account investments in a variable annuity contract.	The final regulations do not affect participants' ability to reallocate amounts between separate account investments within a variable annuity contract or change in mutual fund investments within a custodial account.
Exchanges	Today, it is not uncommon for employers that maintain 403(b) arrangements to offer to make contributions to custodial accounts and/or annuity contracts issued by more than one financial institution. Some arrangements also allow participants to move all or some of their account or contract balances to other financial institutions that offer 403(b) custodial accounts or annuity contracts, regardless of whether the account or contract receives contributions from the employer. These transactions are generally called "90-24 transfers" (referring to the IRS guidance that permitted such investment changes), without income tax inclusion, so long as the receiving contract or account includes distribution restrictions at least as stringent as the old contract or account.	<p>The final regulations permit investment exchanges between accounts and contracts (called "exchanges") only if the accounts and contracts are part of the employer's plan and certain requirements, discussed below, are satisfied.</p> <p>Information Sharing Requirement. Among other requirements, an exchange is permitted only if the plan provides for the exchange and the employer enters into an information sharing agreement with the issuer or custodian of the new contract or account. The information sharing agreement must specify that the employer will share information sufficient for the institution providing the account or contract to satisfy the applicable requirements, including administering loans and hardship distributions and determining whether an employee has had a severance from employment.</p> <p>Effective Date for Information Sharing Requirement. Although the regulations are generally effective on January 1, 2009, accounts or contracts that receive amounts from another account or contract after September 24, 2007 will be subject to the new exchange requirements. As a result, an information sharing agreement with any institution that receives an exchange after September 24, 2007 will generally be needed before January 1, 2009 in order for the account or contract to remain a 403(b) account or contract.</p> <p>More guidance is expected from the IRS in this area.</p>
Transfers	Existing IRS guidance on 90-24 broadly permits transfers to new contracts or accounts and does not require coordination between the institution that receives the transfers and the employer that sponsors the arrangement. Given this flexibility, there are numerous accounts and contracts that have been transferred to financial institutions outside the plan, i.e., to institutions that do not have a relationship with the employer sponsoring the arrangement (often referred to as "orphan contracts").	<p>The final regulations distinguish transfers from exchanges and generally define transfers as any movement of funds outside the employer's plan. Transfers are generally prohibited except for transfers between two 403(b) plans or to a tax-qualified defined benefit plan to purchase service credit.</p> <p>Orphan Contracts. The final regulations exempt orphan accounts and contracts from the information sharing requirement, discussed above, if received in an exchange or transfer on or before September 24, 2007.</p>
Grandfathered Contracts	Other than orphan contracts which were the subject of a 90-24 transfer before September 25, 2007, and are grandfathered by the final regulations from having to be treated as part of the plan, it has been unclear how employers would bring old, dormant accounts and contracts -- or accounts and contracts with post-September 24, 2007 transfers -- into compliance with the regulations by the effective date.	<p>The IRS issued additional transition guidance in Rev. Proc. 2007-71. Generally, under that transition guidance:</p> <ul style="list-style-type: none"> • Accounts or contracts issued before 2005, with no contributions after 2004, may essentially be disregarded. • Accounts or contracts which were the subject of a post 9/24/07 transfer under 90-24 (so not grandfathered) may be corrected if they are subsequently re-exchanged for a 403(b) compliant account or contract before July 1, 2009. • Accounts or contracts issued after 2004, but for which contributions cease before 2009, are subject to the requirement that the employer has to make a reasonable, good faith effort for information sharing. However, that reasonable good faith effort can include the issuer taking action before making any distribution or loan to contact the employer and exchange any information that may be needed in order to satisfy section 403(b). • Accounts and contracts issued before 2009 for employees or beneficiaries who are former employees as of January 1, 2009, are generally not required to be part of the plan, but if the participant requests a loan under Code section 72(p), the issuer has to make reasonable efforts to make certain that the loan meets the 72(p) limits in the aggregate.

Issue	Current Law & Practice	Final 403(b) Regulations
Interaction with ERISA		
Overview	<p>Governmental and church 403(b) plans are exempt from the Employee Retirement Income Security Act of 1974 (“ERISA”).</p> <p>Plans maintained by tax-exempt employers are generally subject to ERISA. However, the Department of Labor (“DOL”), which administers ERISA, has long taken the position that certain 403(b) arrangements offered by tax-exempt employers are exempt from ERISA because the employer has limited involvement in the arrangement.</p>	<p>Governmental and church 403(b) plans continue to be exempt from ERISA.</p> <p>In connection with issuance of the final regulations, the DOL published guidance (Field Assistance Bulletin 2007-02) which provides that a plan of a tax-exempt employer may satisfy the requirements of the final 403(b) regulations and remain exempt from ERISA. The DOL guidance notes that there will be different approaches to compliance with the final regulations and, depending on the facts and circumstances, some approaches may involve a level of employer involvement that will cause a plan to fall outside of the safe harbor.</p>
Permitted Employer Involvement	<p>Long-standing DOL regulations provide a safe harbor exemption from ERISA for plans that do not provide for employer contributions and that are administered with very limited employer involvement.</p>	<p>In general, the new DOL guidance permits employer involvement, to the extent necessary, to ensure that the program continues to be compliant under section 403(b). For example, an employer is permitted to share information with financial institutions, coordinate plan administrative responsibilities, adopt a plan document and limit exchanges of plan balances to investment providers that are covered under the plan. In addition, the guidance notes that it should be permissible for an employer to draft plan documents, although DOL expects that documents for safe harbor plans will generally consist of a variety of writings, including a simple plan document, the salary deferral agreement, the annuity contract and/or custodial agreement.</p>
Form 5500	<p>Non-ERISA 403(b) plans and many small 403(b) plans do not have to file Form 5500. There is no requirement that 403(b) plans be audited by an independent auditor.</p>	<p>Under proposed changes to the Form 5500 effective for the 2009 plan year, 403(b) plans will be subject to the same Form 5500 filing requirements as 401(k) plans. While non-ERISA plans will not need to file Form 5500, and many 403(b) plans of small employers will file only the small employer Form 5500, 403(b) plans of large employers subject to ERISA will have to file a complete Form 5500, including an independent audit report, although in many cases it may be a limited scope audit.</p>
Miscellaneous		
Timing of Contributions	<p>There are no rules under section 403(b) which required that contributions be remitted to the plan within a specified period after such amounts would otherwise have been paid. ERISA imposes timing requirements on salary reduction contributions to ERISA-covered 403(b) plans. Section 415 also imposed rules on timing of contributions for 415 limit testing purposes. State law may also impose requirements.</p>	<p>The final regulations require the employer to remit contributions within a reasonable period for the administration of the plan. The regulation suggests that remitting salary reduction contributions within 15 business days after the end of the month in which such amounts would otherwise have been paid would be considered reasonable.</p>
Post-Termination Deferrals	<p>The extent to which employees may make salary reduction deferrals out of compensation that is paid after termination of employment, such as severance pay, was unclear.</p>	<p>The 403(b) and 415 regulations provide that salary reduction contributions may be made from post-termination pay only if the pay would have been paid if the employee continued in employment (or is attributable to unused vacation or sick leave) and the contributions are made within the later of 2½ months of termination of employment or the end of the year in which the termination of employment occurred. Salary reduction contributions may not be made out of severance pay.</p>

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In-Service Withdrawals	Distributions from 403(b) plans must generally be restricted during employment, subject to limited exceptions (e.g., attainment of age 59½, hardship). One exception has been for amounts that are attributable to employer contributions to a 403(b) annuity contract (but not a custodial account), which may be freely distributable.	The regulations extend restrictions on in-service distributions to amounts attributable to employer contributions to a 403(b) annuity contract. Under these restrictions, similar to restrictions on 401(a) profit-sharing plans, 403(b) annuity contracts may permit in-service distributions of employer contributions only after a fixed number of years or upon the participant's attainment of a stated age. Grandfathered Contracts. Contracts issued before January 1, 2009 are exempt from this requirement, including contributions made after 2008.
Roth Contributions	A 403(b) program may permit employees who make salary reduction contributions to designate some or all of those contributions as Roth contributions. Designated Roth contributions are currently included in an employee's gross income. However, if certain requirements are met, a distribution of an amount attributable to designated Roth contributions is entirely excluded from the employee's gross income.	The final regulations confirm that 403(b) plans may offer employees the right to make Roth contributions. The regulations also clarify that the right to make Roth contributions is subject to the universal availability requirement.
Loans	A 403(b) plan may allow participants to take loans, which are nontaxable up to certain limits specified in the Internal Revenue Code.	The regulations confirm that 403(b) plans may permit participant loans on generally the same basis as 401(k) plans.
Hardship Distributions	An exception from the general prohibition against in-service distributions is available in the event of a participant's hardship.	The regulations confirm that 403(b) plans may permit hardship distributions on generally the same basis as 401(k) plans.
Vesting	It has not been entirely clear whether vesting is allowed with respect to employer contributions.	The regulations confirm that vesting is permitted with respect to employer contributions, but a separate accounting is required for vested and non-vested amounts.
Prohibition Against Life Insurance	Life insurance is a permitted investment in a 403(b) plan, provided that the insurance is incidental.	The final regulations prohibit the purchase of life and other insurance contracts in connection with a 403(b) plan and require that death benefits under the plan be incidental. Grandfathered Contracts. Life insurance contracts issued before September 24, 2007 are grandfathered from the prohibition against life insurance, and premium payments may continue to be made.
Plan Terminations	It has been unclear whether it is possible to terminate a 403(b) plan and, if so, how to do so.	The final regulations officially acknowledge for the first time that an employer may terminate a 403(b) plan. An employer may immediately replace a terminated 403(b) plan with a 401(k) plan (in the case of a tax-exempt employer) or a 457(b) plan (in the case of a public school employer).



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